U.S. Domestic Interests and The Latin American Debt Crisis

U.S. Domestic Interests and
The Latin American Debt Crisis

by

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Abstract

The most recent Latin American debt crisis is a fascinating political phenomenon because it demonstrates very convincingly the complexity of the relationship between economics and politics. The rapid growth of U.S. commercial bank lending to Latin American governments in the 1970s helped to make many banks vulnerable to the decisions of Latin American government officials. Given that many of the most vulnerable banks were also the largest in the American and international financial systems, the U.S. government had an understandable interest in devising means and goals to manage the situation once the Mexican financial crisis unfolded in 1982. The goals and means chosen over the next several years reflected a special consideration for the largest American commercial banks, and clear apathy for the interest of other American and Latin American interests. To understand the choices made by U.S. government officials, one has to understand the relationship between the American government and U.S. commercial banks in general, and with the largest U.S. commercial banks in particular.

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Introduction

1. An Outline of the Argument

This thesis is concerned with the respective roles of American commercial banks and the U.S. government, and the evolving relationship between them, with respect to the Latin American debt crisis. This concern deserves attention because American commercial banks and the U.S. government vitally affected the supply of external credit to Latin America in the post-war period, and because U.S. banking interests have largely shaped U.S. strategies towards the crisis in the 1980s and 1990s. It is therefore likely that the region's economic problems will not be substantially diminished without a change of attitude from either, or both, of the key actors in question.

There can be no doubt that the U.S. government has played a decisive role in the debt crisis, both in its initial development and subsequent management. This role has its roots in the Bretton Woods system, when the dollar became the key currency for the international economy. U.S. macroeconomic policies first flooded the international economy with dollars in the 1950s, 1960s, and 1970s, and then reversed this flow with cataclysmic force in the early

1980s. In essence, those policies provided the basis on which American commercial banks ascended in the international banking community, and then helped to undermine the banks by ruining many of their Latin American customers.

But the U.S. government has affected the crisis with more direct policies and actions. Its international financial policy helped to spur the growth of the Euromarkets, from which most of Latin America's loans came. These markets were remarkable for their comparative lack of regulation. This characteristic made the Euromarkets more competitive than many national markets by lowering the costs of funds and operations. The lack of regulation also defied the original efforts of the authors of Bretton Woods, who wanted to limit the freedom of private financial actors.[1] The U.S. even encouraged its commercial banks to play an important role in those markets, and facilitate the recycling of finance after the two oil price shocks of the 1970s. As a result of these policies, previously segmented financial markets became more internationalized.[2] In turn, the framework of balance-of-payments settlement became more

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[1] Richard Gardner, Sterling-Dollar Diplomacy in Current Perspective (New York: Columbia University Press, 1980), 265.

[2] Philip Wellons, Passing the Buck: Banks, Governments and Third World Debt (Boston: Harvard Business School Press, 1987), 2.

privatized': private commercial banks began to dominate lending for balance-of-payments purposes.

Finally, the U.S. government played a critical role after the bubble of sovereign lending to Latin America burst in the early 1980s. Debtor countries could not service their debts, and many U.S. banks, which had imprudently lent ever-larger sums after the oil shocks, were immediately threatened - loans to Latin America constituted a large portion of their assets. If a substantial amount of the debt was not serviced, or was repudiated, many banks would become insolvent. This in turn would have undermined the safety of many the stability of both the American and international financial systems, and necessitated some form of emergency rescue action by the U.S. government. The U.S. government acted quickly to shield the banks from the consequences, and push them to take painful steps to overcome the crisis, so that they could return to health and competitiveness.

The decision to support the banks, however, entailed other decisions about the American national interest. In particular, the choice of supporting the banks brought with it a range of costs which would have to be shared by other Americans; taxpayers have footed a small part of the bill, but the largest costs have fallen on exporters with markets in Latin America. American agricultural and manufacturing interests with markets in Latin America have been punished as Latin American governments have curtailed investment, spending and imports. Even after several years of depressed economic conditions, U.S. exporters and other economic or political groups could not exert sufficient political pressure to challenge banking and financial interests. These losses of markets have translated into losses of employment and income for many Americans. In effect, then, the U.S. government has enforced a solution which made both Latin Americans **and** the vast majority of Americans pay for the continued support of the largest U.S. banks. This lop-sided distribution of costs within American society, like the larger course of the debt crisis, was a result of the relationship between the government and the banks.

These initial, rather ad hoc, steps soon became institutionalized, and formed the pattern for future debt management. Even though the largest banks eventually adopted painful measures to adjust to the Latin American debt crisis, they enjoyed many privileges from the U.S. government's debt management policies. These priveleges have been maintained partly as the result of their role in the national and international economies, and their articulation of interests to government institutions.

The role of the largest banks, therefore, requires careful analysis. They were not passive agents which lent to Latin American governments on demand, or obeyed the whims of the American government. The banks aggressively pursued OPEC deposits and potential Latin American sovereign loan customers. Above and beyond official encouragement, commercial banks voluntarily entered the business of lending to Latin America. They failed to counter the attraction of sovereign lending to Latin America, and its high profits and prestige, with a realistic view of the risks and potential consequences involved.

As the Mexican crisis broke out in 1982, the banks continued to treat their loans to Latin America as fully performing assets. The banks hoped to delay the time when the they would have to reduce profits or suffer losses as a result of the recognition that losses on the loans were highly probable. But the financial markets had begun to operate on the conclusion that the loans were already bad. In addition, prudential supervisory authorities pushed the banks to set aside provisions against potentially bad loans. In effect, the markets and the authorities punished those banks that did not take sufficient steps to set aside provisions against those loans or unload them, by making access to credit more difficult. Finally, the consequences of the debt crisis for the banks have impinged on the debtor countries - the banks have continually reduced Latin America's access to new credit.

And yet some banks, especially the largest banks, continue to carry many of their sovereign loans on their books, and demand repayment as if the loans were worth 100 per cent of their face value. This intransigence, in combination with the refusal to grant new credit, is a key to the perpetuation of the debt crisis. The continuation of this strategy is sustained by the relationship between the largest banks and the U.S. government.

A key to the bank-government relationship in the U.S. is the fact that the banks have both considerable structural and negotiating power vis-a-vis the American government. First, the U.S. government sees it as vital to have a strong and internationally competitive banking system, and that system is anchored by the largest money-centre banks. Although there are a large number of banks in the U.S., the money-centre banks occupy a central position: they are the largest source of funds for smaller banks' local lending[3], and they connect American finance to some of the largest pools of international capital.[4] For these reasons, U.S. domestic economic stability and growth depend on the stability of the largest banks. Moreover, given that U.S.

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[3] John Makin, The Global Debt Crisis (New York: Basic Books, 1983), 137.

[4] William Greider, Secrets of the Temple (New York: Simon and Schuster, 1987), 27.

transnational banks and financial markets are some of the largest in the world[5], the international financial and trading systems also depend on the soundness of the largest U.S. banks. In consideration of the profound importance of the largest U.S. commercial banks for both the U.S. and international economies, the U.S. government understandably had substantial interests in protecting and fostering those banks, even after the banks reduced their exposure in the late 1980s.

Second, even though the relationship between the Treasury, the prudential supervisory authorities and the banks reflects the importance of the largest banks, official institutions did not always work toward the same specific purposes; the relatively complex jurisdictional framework made the formulation and execution of a coherent official strategy very difficult. On the one hand, if the largest banks incurred heavy losses on Latin American loans, the U.S. taxpayer would have to come to the rescue to ensure

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[5] Congress, House of Representatives, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Task Force on the International Competitiveness of U.S. Financial Institutions, of the Committee on Banking, Finance and Urban Affairs, Role of the Financial Services Sector, 101st Cong., 2nd Sess., 24 April 1990, 4; Testimony of C. Fred Bergsten, Director, Institute for International Economics.

stability.[6] The Treasury obviously has an interest in preventing that situation, and this interest prompted it to aid the banks by arranging for the transfer of emergency funds to their customers, the debtor governments, and by maintaining pressure on those governments to continue the service of their debts. The Treasury has also tried to persuade the banks to continue to lend to Latin America for the banks' own good.

On the other hand, the prudential supervisory institutions - the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) - operated with the broader purpose of ensuring the stability of the banking system.[7] For example, the Federal Reserve had a mandate to supervise the foreign activities of American banks.[8] Unfortunately, there developed excessive "regulatory accommodation" between authorities and the banks, whereby the policies of the authorities have come to reflect the

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[6] Secretary Donald Regan made this point quite clearly in his testimony to the Subcommittee on International Finance and Monetary Policy in 1983. Congress, Senate, Subcommittee on International Finance and Monetary Policy, of the Committee on Banking, Housing, and Urban Affairs, International Debt, 98th Cong., 1st Sess., 14, 15, and 17 February 1983.

[7] A brief description of the institutions and their responsibilities can be found in "Banking Brief," The Economist 316 (25 August 1990): 67.

[8] Ibid.

views of bankers in economic matters and various aspects of debt crisis management.[9] The scope and intensity of regulation and supervision were largely inadequate in the 1970s, in no small part due to the banks' successful political pressure.[10] Official supervisory efforts, if undertaken too intensely, might have restricted the ability of the banks to operate in the then profitable business of balance-of-payments lending. Moreover, in the 1980s, the prudential supervisory institutions have worked partly at cross-purposes with the Treasury, by constantly pressuring banks to reduce their exposure (loans to a certain borrower as a proportion of bank capital), and thus new lending, to Latin America.

Third, the banks are able to exert pressure on the government through individual and collective representation to the prudential supervisory institutions, including the Federal Reserve, the Treasury, and Congress. For instance, the Federal Advisory Council (FAC) is a committee of twelve bankers elected by the member banks in each Federal Reserve district, and it meets privately with the Federal Reserve chairman and governors four times a year to communicate their thoughts and advice about Federal Reserve policy.

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[9] Thomas Dye and Harmon Zeigler, The Irony of Democracy (North Scituate, Mass.: Duxbury Press, 1978), 265.

[10] Ibid., 264-265.

This council is furthermore dominated by the largest banks, officials of which usually make up the majority of the elected members. While all of this does not ensure that the wishes of banks are followed, it does give the banks yet another channel of influence.[11]

The influence of the banks on the U.S. government has been considerable, and thus the U.S. government has been critical in shaping the range of possibilities for the evolution of the debt crisis since the crisis in 1982, and even in determining its precise course. The Treasury helped prevent the collapse of the American banking system by providing direct financial support, and by catalyzing international financial support (principally through the IMF and World Bank) to many of the banks' sovereign customers. The Treasury also has been critical in insisting upon debtor government adjustment, in contrast to debt reduction, as the primary plank to any resolution of the crisis. This allowed debtor countries to accumulate more debt and continue to service their debts, and banks to maintain the loans to those nations on their books as fully-performing assets, at least for several years. The government has exerted some pressure on the banks to alter the terms of old loans, and provide new loans, to sovereign debtors so that they could

[11] Greider, Secrets of the Temple, 114-115.

appear liquid and creditworthy over the medium-term. This would reinforce the quality of loans that had become suspect after 1982. But at no point did this pressure take the form of a command; banks were always left with the freedom to voluntarily comply with or refuse such pressure. Much stronger pressure was exerted on the banks to decrease their exposure, and thus vulnerability, to those debtor countries altogether.

An inescapable problem with these arrangements is that they have produced a solution that is far from optimal. For the U.S. government, at least one important objective has been achieved: U.S. banks have retreated from the brink of insolvency as a result of their exposure to Latin America. But many large U.S. banks continued to be plagued with problems of under-capitalization and a lack of international competitiveness, and the U.S. government was consequently moved to maintain its commitment to the fundamental elements of the old debt strategy. That is, the loans would continue to be worth 100 per cent of face value, debtors would be pressured to undertake economic reform and continue their debt-servicing efforts, and banks would continue to lend to Latin America if it was possible to do so. But this was a prescription for continued confrontation and uncertainty. As bank lending declined, and transfers from official sources continue remained relatively small, Latin America floundered in economic and social crisis.

The foreign policy problem for the U.S. was that the economic crisis threatened to undermine fledgling democracies in the region. Just as "military regimes withdrew in disgrace (Argentina), further liberalized (Brazil), or tried to cope with vigorous popular pressures to restore democracy (Uruguay and Chile)", the debt problem weakened the capacity of those countries to respond to the expectations and needs of their citizens. Social unrest and political instability seemed imminent, and the prospects for increasing democratization seemed to be in great jeopardy.[12]

The economic problem for the U.S. is that several large sovereign debtors have met the twin challenges of debt and democracy by quietly defying the U.S. debt strategy and accumulating arrears on interest payments to commercial banks since the late 1980s. The debtors countries' continued accumulation of arrears was a sign of their will to become more confrontational in negotiations with their creditors. Moreover, the U.S. Current account deteriorated as U.S. exports to the region declined precipitously, and Latin American exporters became more and more aggressive in

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[12] Riordan Roett, "Democracy and Debt in Southern America: A Continent's Dilemma," Foreign Affairs 62, chronology (1983): 695-697.

a variety of sectors, including agriculture.

A third problem is that international financial institutions, especially the IMF and the World Bank, have been accorded new roles and responsibilities in the debt crisis, without sufficient funding relative to the magnitude of debtors' external financial requirements. This will remain the case so long as the U.S. places domestic budgetary concerns over the plight of the Latin Americans.

The suboptimality of the current official strategy is also pronounced in comparison with alternative strategies which entail more effective leadership, and more direct financial support, from the U.S. government. Despite the host of obstacles - the current U.S. budgetary problem, American opposition to bailing out banks and debtors alike, and so on - the potential benefits to be derived are enormous and far-reaching. On the one hand, more direct financial support might facilitate a greater amount of debt reduction, and thus Latin American debtors, having had their adjustment period shortened, might become more cooperative. But this is only one step in the return of those debtors to market access. The U.S. government might also consider providing stronger conditions for their financial support with respect to the banks: perhaps the government could exchange financial support for banks' commitments about future lending to Latin America.

The latter sounds highly improbable in the current American political environment. The American banking industry as a whole faces so many perils, from exposure to depressed domestic real estate and junk bond markets, to its current recession, rising foreign competitors and emerging international supervisory agreements, that it is very unlikely that it will soon increase its exposure to Latin America. Even U.S. government institutions such as the Treasury and the prudential supervisory institutions are pressing the banks to reduce such exposure, by promoting debt reduction and progressive provisioning. Moreover, it is unlikely that the government will coerce the banks to adopt policies that are fundamentally against their interests, given the current quality of regulatory accommodation in their relationship.

Virtually the only factor which might generate enough political support for stronger government leadership is a reconsideration of America's self-interest in Latin America. As evidence for the 1960s and 1970s indicates, Latin America has the potential to offer a multitude of opportunies to a variety of American economic interests. The region was one of America's fastest growing export markets in that period.[13] Combined with the long history of economic interaction, and a troubled international trading order, Latin America could once again become a critical and positive aspect in America's economic future. Specifically, if the U.S. government more fully considers the many domestic interests that are involved, the government might realize that its concern for the banks has injured a wide range of U.S. producer, exporter, and other financial interests. It is in consideration of these interests that the U.S. government has good reason to alter its strategy toward the debt crisis.

2. The Argument: Implications for the Literature

The argument outlined above poses a challenge to much of the current literature on the debt crisis. Most of the sources are principally concerned with debtors or the banks or OECD governments (which also provide the general policy direction for international financial institutions). The focus on the US government and American commercial banks is meant to provide an alternative to studies which a)

[13] Congress, Senate, Subcommittee on International Finance and Monetary Policy, of the Committee on Banking, Housing, and Urban Affairs, International Debt, 98th Cong., 1st Sess., 14, 15 and 17 February 1983, 109; Testimony of Lionel Olmer, Under Secretary for International Trade, Department of Commerce.

characterize the policies of the sovereign debtors as the predominant causes of the debt crisis, or b) centre exclusively on either the banks or the OECD governments as the central force in the supply side of external credit to Latin America.

Many Western accounts of the debt crisis attribute paramount importance to the policies of debtor countries in the development of the debt crisis. Nigel Harris has pressed the case that the debt crisis was in part a direct consequence of development strategies followed by Brazil and Mexico in the 1960s and 1970s.[14] Both countries pursued import substitution policies, and when the world economy deteriorated after the oil shocks, Brazil and Mexico attempted to sustain the strategy of import substitution through borrowing from abroad. But this analysis misses the other component of debt - debtor countries had to perceive borrowing as relatively attractive, and this implies a great deal about the availability and conditions of finance from abroad. This thesis will shed some light on that line of inquiry, by analyzing the the most powerful influences on external finance for Latin America, American banks and the U.S. government.

A different line of academic literature has emphasized

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[14] Nigel Harris, The End of the Third World (London: Penguin Books, 1986), 76-82.

the role of the IMF in the developing country debt crisis. Cheryl Payer, in The Debt Trap, looked at the power of the IMF over Third World countries:

> Since its founding at the end of the Second World War, the IMF has been the chosen instrument for imposing imperialist financial discipline upon poor countries under a facade of multilateralism and technical competence.[15]

The sole connection drawn between the IMF and the agents which support it is left very vague: the real villains of the piece are "the multinational corporations and capitalist governments which are the natural enemies of Third World independence".[16] This thesis argues that the largest influence behind international financial institutions is the U.S. government, and that the U.S. government used the IMF to promote its national self-interest - for support for American banks and for political cover from Third World reactions - and not for the support of some broader and vague goal such as capitalist imperialism.

As the Latin American debt situation moved toward crisis, a great deal was written on the power of the banks. Much was made of their ability to deter debtors from taking uncooperative action, or to impose unacceptable costs on

[15] Cheryl Payer, The Debt Trap: The IMF and the Third World (Harmondsworth: Penguin Books, 1974), x.

[16] Ibid., xii-xiii.

them if they did so. Charles Lipson argued in 1981 that

> Commercial banks are crucial actors here. It is bank lending syndicates that are the source of powerful and virtually self-sufficient sanctions against default by solvent borrowers.[17]

The only potential weakness Lipson acknowledged at the time was the situation in which the sanction power of the banks was undermined by the incapacity of the banks to take concerted action. But he was confident that the IMF could provide the necessary leadership and maintain bank unity toward debtors.[18] At the same time as this analysis overemphasized the power of the banks, it also underemphasized the potential power of the debtors and the direct role of the OECD governments, and especially the U.S. government. In particular, the U.S. Treasury went to great lengths to maintain a high degree of unity among the banks in the early stages of the debt crisis, and this unity contributed to the largest banks' power vis-a-vis the debtor countries until the late 1980s.

William Cline has written a history of the debt crisis[19] in which he characterized the banks as subservient

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[17] Charles Lipson, "The International Organization of Third World Debt," in International Political Economy, eds. David Lake and Jeffrey Frieden (New York: St. Martin's Press, 1987), 321.

[18] Ibid., 321-327.

[19] William Cline, International Debt: Systemic Risk and Policy Response (Washington, D.C.: Institute for International Economics, 1984).

to the U.S. government and the IMF once the debt crisis had broken. This subservience manifested itself in the continued extension of private credit, which gave Cline the hope that debtors could successfully adjust and end the crisis.[20] Indeed, this was the case for the year after the debt crisis, in which Cline wrote the book. But the evidence since then has indicated that the banks have rejected the role assigned to them by Treasury plans. Moreover, neither the Treasury nor any other government institution has attempted concretely to impose that strategy on the banks. Because of these developments, the relationship between the banks and the U.S. government needs more careful attention.

Finally, Robert Gilpin has combined attention on the leadership provided by the OECD governments and the IMF with recognition of the fact that the banks had decidedly turned against lending to Latin America. The only two connections Gilpin makes between the two is the fact that the banks were urged to lend by the Baker Plan, and that the banks' decision to reduce lending was reinforced by regulatory pressures which limited foreign loans.[21] Other than this

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[20] Ibid., 29-34.

[21] Robert Gilpin, The Political Economy of International Relations (Princeton, N.J.: Princeton University Press, 1987), 317-327.

reinforcement' and encouragement, little is made about the complex relationship between the banks and the U.S. government, and how that relationship allows the banks to resist some forms of government pressure and forces them to bow to others. In this regard an explanation of the individual and collective interests of these institutions requires attention.

It is readily apparent that most sources used for this thesis are western'. The literature used to support the thesis is composed principally of Western institutional literature, scholarly books and journals, and the financial press. This is the case because this thesis is not an attempt to study Latin American countries, or the differences and similarities among their circumstances and policies. Such will be considered only when they have vitally affected the position and negotiating stance of creditors.

This thesis is also not an attempt to study international financial institutions. These institutions will enter the analysis, but only when they were formed and when they played their role in the the 1982 crisis and after. The IMF and the World Bank, for example, played relatively small roles as sources of finance for developing countries up until the early 1980s. They were conservative in nature, and had little resources relative to the needs of the debtor countries in the face of the oil shocks and the large payments imbalances which ensued. The role these institutions played after the 1982 crisis will be examined in light of its contribution to the overall U.S. debt strategy.

This thesis is an attempt to understand how the supply of credit to Latin America is affected by the respective roles of the banks and the U.S. government, and the relationship between them. The actions and interactions of the commercial banks and the U.S. government, as well as the sometimes coherent, sometimes contradictory policies of different government institutions, have all been crucial to the development and evolution of the debt crisis. Therefore, considerable emphasis is placed on an analysis of the logic which drives the commercial banks and U.S. government institutions to act as they do, and the struggles over economic ideology and interest as they are manifested within the U.S. political system, and their consequences for the Latin America debt crisis.

3. The Structure of the Thesis

The first chapter will begin with a brief description of the nature of the international monetary and financial systems immediately following the war. It shall be shown that, in contrast to today's system, it was overwhelmingly dominated by governments, according to international agreement.[22] However, this characteristic changed over time as the U.K. government encouraged the development of the privately-dominated Euromarkets, and other governments, including the U.S., did nothing to inhibit their growth. In fact, the markets were encouraged because they satisfied important interests.

The international monetary order after the war was established at Bretton Woods in 1944. It was an attempt to construct a dollar-gold exchange standard, one in which the U.S. dollar was the world's key reserve currency. The status of the dollar was based on the U.S. commitment to maintain the fixed price of gold at U.S.$35 per ounce. This commitment helped dollars to become an alternative source of international liquidity to gold: U.S. balance-of-payments deficits were settled with outflows of gold and dollars, and these outflows financed European and Japanese reconstruction.[23]

But this international monetary system depended on the willingness of the foreign countries to accept the dollar as the key reserve and transaction currency. This willingness

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[22] Richard Gardner, Sterling - Dollar Diplomacy, 2-3. Jim Hawley, Dollars and Borders (London: M. E. Sharpe, Inc., 1987), 7.

[23] Hawley, Dollars and Borders, 7-8.

was in turn based partly upon the confidence of foreign currencies in the free convertibility of the dollar into a fixed amount of gold. This confidence, however, was undermined by the excessive growth of U.S. dollars in comparison to its gold supply.[24] The consequences of the over-supply of dollars were ameliorated at first by the creation of the Euromarkets, and then the U.S. decision to abandon the Bretton Woods system.

The Euromarkets were crucial for the alleviation of international economic conflict. For the Europeans and others, the markets absorbed the oversupply of dollars (that amount of dollars which foreign governments were accumulating, and that amount which those governments wanted to hold) in the 1960s. For the Americans, these markets, which were based largely on dollar-denominated transactions, helped to stabilize demand for the dollar and thus reduce the outflow of gold from the U.S. Finally, markets also emerged as a source of liquidity for non-oil producers in the 1970s, and thus a way for governments to evade greater responsibility for action in the wake of the oil crises. In fact, those markets were used by many governments to avoid or mitigate the impact of substantial macroeconomic

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[24] Gilpin, The Politiacal Economy of International Relations, 137-141.

adjustment.[25]

The Euromarkets also served private market interests. London banks were subjected to government controls on sterling in the late 1940s and 1950s. However, they were able to continue to compete in international financial services because operations in the Euromarkets were conducted in other currencies.[26] American transnational banks and corporations (TNBs and TNCs) used the Euromarkets to overcome U.S. capital controls which were imposed in the 1960s. These controls discouraged private capital outflows from the U.S. in the forms of investment and lending.[27] U.S. TNCs were thus encouraged to finance their investment and trade from funds in the Euromarkets. American TNBs soon followed in order to service their corporate customers, and pursue other lines of international business.[28]

The Euromarkets could only postpone the day of reckoning for the Bretton Woods system, however. The over-supply of dollars eventually spurred private speculation

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[25] Eric Helleiner, "The Internationalization of Private Finance and the Changing Post-war Order: The Unplanned Child'," Paper presented at the ISA/BISA conference, London, 28 March - 1 April 1989, 2-8.

[26] Helleiner, "The Unplanned Child", 5.

[27] Hawley, <u>Dollars and Borders</u>, 43-47.

[28] W.P. Hogan and I.F. Pearce, <u>The Incredible Eurodollar</u> (London: Unwin, 1984), 64.

aginst the dollar, and led to transfers of capital i..
other currencies and gold. In addition, foreign central banks began to conduct conversions of dollars into gold. In order to defend the dollar, the U.S. closed the gold window by suspending the convertibility of dollars into gold in 1971.[29] The U.S. gained several positive results from this move: it released the dollar from the discipline imposed by the commitment to gold convertibility[30]; it allowed the U.S. to leave the determination of exchange rates to private markets, and these markets effectively produced a devaluation of the dollar (which was prevented by the Bretton Woods arrangements)[31]; and it left the world on a de facto pure dollar standard, in which the U.S. Treasury controlled the world's key currency with little external constraint.[32]

One of the major consequences of the transition to a pure dollar standard was that then, more than ever, the world was subject to the effects of U.S. macroeconomic

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[29] Howard Wachtel, The Money Mandarins (New York: Pantheon Books, 1986), 75-85.

[30] Benjamin Cohen, "U.S. Monetary Policy and Economic Nationalism," in The New Economic Nationalism, ed. Otto Hieronymi (London: Macmillan Press, 1980), 56.

[31] Susan Strange, Casino Capitalism (New York: Basil Blackwell, 1986), 38-40.

[32] Gilpin, The Political Economy of International Relations, 140-141.

policy, just at the time that such policy was released from important international constraints. Over the next decade, U.S. monetary policy would continue to be expansive, with marked growth in 1971-1972 and 1975-1977.[33]

But the growth in dollars not only came from government policy - they also were created in private markets, through bank notes and bank deposits.[34] The Euromarkets became a major, and relatively unregulated, source of liquidity in the 1970s with the advent of the oil shocks. The shocks brought about huge payments imbalances, and the banks in the Euromarkets moved aggressively to attract OPEC deposits in order to finance oil-importing countries. The availability of credit from the banks had two effects for oil-importers: it made the financing of balance-of-payments deficits more attractive than adjustment, and it lessened the balance-of-payments role of the IMF.[35]

Given the profitability of lending to Latin America in the mid-1970s, and risk-reducing techniques such as loan syndication and floating interest-rate loans, there followed

[33] Richard Timberlake, "Federal Reserve Policy Since 1945: The Results of Authority in the Absence of Rules," in Money in Crisis, eds. Barry Siegel and Leland Yeager (Cambridge: Ballinger Publishing Co., 1984), 182.

[34] Ibid., 204.

[35] David Llewellyn, "The Role of International Banking", in The Political Economy of International Finance, ed. Loukas Tsoukalis (London: The Royal Institute of International Affairs, 1985), 213.

a herd effect in which many Western, and especially U.S., commercial banks competed aggressively to extend loans to Latin American sovereign debtors.[36] This is the period in which many of the largest banks built up their exposure beyond prudent limits, and in which prudential supervisory authorities failed to act.[37] Although many of the financial indicators in the Latin American debtor countries showed no cause for undue alarm, this was the case in part because of the prevailing, underlying international macroeconomic conditions. The banks and the government knew well of the banks' overextension, and of the potential threat to the American and international financial systems. But warnings to this effect were overcome by the evidence of sufficient profit and stability, and disaster myopia'.[38] It was also overcome by concerted action between the banks and government officials which had an interest in ensuring the international competitiveness of the banking community.[39]

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[36] United Nations, Economic Commission for Latin America and the Caribbean, Transnational Bank Behaviour and the International Debt Crisis, 1989, 38.

[37] Wellons, Passing the Buck, 100-116. Wellons characterizes the period as subject to an enforcement hiatus'.

[38] Benjamin Cohen, In Whose Interest? (New Haven: Yale University Press, 1986), 44-46.

[39] Wellons, Passing the Buck, 100-116.

Chapter two will explore the consequences of American domestic politics for its macroeconomic policy, which so vitally affects the international and Latin American economies. A conjuncture of events occurred in the late 1970s which precipitated the debt crisis. 1 First, the second oil crisis helped to unleash new waves of payments imbalances and bank lending to the Latin American countries through the Euromarkets. 2 From 1977 to 1978, gross Eurocurrency credits to Latin America rose from U.S.$9.4 billion to U.S.$18.5 billion. For the next two years the figures were U.S.$22.0 and $18.1 billion, respectively.[40]

However, there were important differences in the nature of the loans as compared to earlier ones. For instance, maturities on loans had been shortened. This was a response by the bankers to the increased risk due to the increases in stocks and service-burdens of debt. But it merely served to bunch the debt coming due in the near future.[41] Another difference between lending after the two oil shocks was that the ratios of debt service requirements to various measures of the debtor countries' capacity to pay (to exports or GDP, for example) had reached truly worrisome levels. If there

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[40] Robert Devlin, Debt and Crisis in Latin America (Princeton, N.J.: Princeton University Press, 1989), 40.

[41] Harold Lever and Christopher Huhne, Debt and Danger (Harmondsworth: Penguin Books, 1985), 58-61.

was any negative fluctuation in the capacity to pay (such as recession in export markets), or an unexpected rise in debt-servicing costs (such as a rise in real interest rates), debtor countries might find it impossible to continue to service their debts. And that spelled trouble for the banks.[42]

Second, a loose but broad coalition of political forces in the U.S. arose in the late 1970s and early 1980s to establish a campaign against inflation, and the primary instrument was contractionary monetary policy. This helped to bring down inflation, stabilize the value of money and draw capital to the U.S. from around the world.[43] The effects of the prolonged and intense pursuit of tight money, however, were first the squeeze on all debtors, including those from Latin America, and then the accumulating problems for their creditors, the U.S. banks. In 1982, the creditors were faced with two of their worst fears: i) sovereign debtors asserted their illiquidity, and ii) Mexico, one of the largest and most cooperative debtors, and of ultimate

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[42] Llewellyn, "The Role of International Banking," 217.

[43] Colin Crouch, "Inflation and the Political Organization of Economic Interests", in The Political Economy of Inflation, eds. Fred Hirsch and John Goldthorpe (Cambridge: Harvard University Press, 1978), 228-229. John Odell, U.S. International Monetary Policy (Princeton, N.J.: Princeton University Press, 1982), 330-333. Wachtel, The Money Mandarins, 132-137. Greider, Secrets of the Temple, 40-45.

importance to the U.S., was about to declare a moratorium on its debt payments. If other debtors followed suit, thousands of banks would be faced with insolvency, and their governments would be forced to come to the rescue in drastic fashion.[44]

The final section of the second chapter contains an analysis of the initial U.S. strategy toward the resolution of the debt crisis. It shall be demonstrated that the U.S. treated the debt crisis primarily as a crisis for the banks. Two of the central elements of the U.S. debt-management strategy reflects this concern: the strategy put great pressure on the debtors to service their debts on contractual terms, and little pressure on the banks to lend new money. The results of the strategy over the next two years reveal that the banks were the top priority: the banks profited during the early phases of the crisis, built up capital at the same time, and continually decreased their new lending to Latin America. The Latin American debtors slashed imports and domestic investment, and incurred growing poverty and social unrest. When the debtors began to show signs of rejecting the U.S. strategy, the U.S. government came up with the Baker Plan.

Chapter three concerns the details of the Baker Plan,

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[44] Cohen, In Whose Interest?, 212-214.

and the Brady Plan which followed it. The strategies have evolved over time, with important changes, but the similarities are strong and enduring. In fact, many of the original ad hoc tactics of the U.S. government became institutionalized. On the one hand, debtor macroeconomic adjustment has remained the key element of those strategies.[45] The U.S. Treasury has continued to exert pressure on the debtors to maintain debt service, and thus prevent the banks' loans from being declared non-performing' (in the event of which the banks must set aside capital).

On the other hand, the U.S. prudential supervisory authorities have effectively encouraged American commercial banks to reduce their exposure and new lending to Latin America. This effect has been reinforced by the recent capital standards agreement which discriminate against international loans. The result of these policies has been a continuous financial bind for the Latin American debtors, and revolving periods of debt service and effective default.

Chapter four will examine the successes and unfortunate consequences of these strategies for the U.S. The successes include the restoration of some stability in the American banking system. An important consequence involves the

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[45] Jeffrey Sachs, "Making the Brady Plan Work", in Foreign Affairs 68, no.3 (1989): 89.

negative impact of the Latin American debt crisis and the rescue of the banks for the non-financial sectors of the U.S. economy. Specifically, debtor countries have adjusted to the debt crisis partly through policies which have compressed imports and boosted exports. This has cut American exports, both to Latin America directly, and to customers for which U.S. exporters compete directly with Latin American exporters.

The fourth chapter will also provide a brief discussion of the relative influences of domestic American interests on the U.S. government, and how the relative strength of the banks, and the relative weakness of producers and exporters, has helped to shape and maintain the U.S. debt-management strategy. Stemming from this discussion is a suggestion as to how the U.S. government could alter the course of the debt crisis by altering its perceptions about its self-interest in the region. In particular, the U.S. can promote its economic self-interest by alleviating the costs of the debt crisis for Latin American debtors. Less Latin American debt might lead Latin American countries to adjust their current policies; this in turn might mean more exports, less export competition, and an improved trade balance for the U.S. in the future.

Chapter One

Some of the Building Blocks of the Latin American Debt Crisis

1. Introduction

The basis of the post-war international financial order was determined at the Bretton Woods conference in 1944. Two aspects of that order are essential for understanding the development of the Latin American debt crisis: the nature of both monetary and financial arrangements. The study of these arrangements is essential because U.S. post-war macroeconomic and financial policies helped to undermine them, and thus the stability they helped to provide. The Latin American debt crisis was in large part a consequence of those policies.

First, those agreements effectively located the U.S. dollar at the centre of the international financial and monetary systems.[1] Proclaimed as an attempt to provide greater international monetary stability, they established the dollar as the principal reserve asset for central banks - the dollar-gold exchange standard'. All other countries

[1] Hawley, Dollars and Borders, 7.

than the sterling bloc settled their international balances in dollars. The U.S. maintained the fixed price of gold at U.S.$35 per ounce, maintained substantial gold reserves, and settled external accounts with gold bullion payments and receipts.[2] In this way, American macroeconomic policy, and its effect on the value and stability of the dollar, acquired powerful influence over the cohesion and stability of international monetary system.[3] With this amount of influence comes an expectation of commensurate responsibility for the sensible management of American macroeconomic policy.

Second, those agreements provided for a system which was meant to avoid the crises of the 1930s - a period of catastrophic disorder in private international financial markets. In this regard, governments agreed to segment and regulate international finance, and legitimize and aid a variety of forms of government intervention and domination in the sphere.[4]

There are many U.S. policy decisions which helped to

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[2] Michael David Bordo, "The Gold Standard: Myths and Realities", in Money and Crisis, eds. Barry Siegel and Leland Yeager (Cambridge:Ballinger Publishing Co., 1984), 210.

[3] Eugene Versluysen, The Political Economy of International Finance (New York: St. Martin's Press, 1981), 27.

[4] Leonard Rapping, International Reorganization and American Economic Policy (New York: New York University Press, 1988), 140.

undermine these institutional structures, but several broad trends stand out in particular. One concerns the privilege which the gold-exchange standard permitted the U.S.: American balance-of-payments deficits could be liability-financed in its own currency.[5] In the early years of the post-war period, this system had sufficient appeal to both the U.S. and its economic partners such that the underlying order was not challenged in a serious way. The U.S. enjoyed relative freedom from international financial constraints, and was able to maintain a surplus in the current account. America's partners sustained their corresponding current account deficits through U.S. foreign aid and military spending, including the Marshall Plan.[6] The outflow of dollars from the U.S. allowed Western Europe, Japan and others to rehabilitate their economies and their export industries.[7]

From the 1950s onward, however, the U.S. began to generate large and sustained budgetary and balance-of-payments deficits. The consequence of these deficits, and the expansive monetary policy which underpinned them, was

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[5] Benjamin Cohen, "United States Monetary Policy and Economic Nationalism", 55.

[6] Fred Block, <u>The Origins of International Economic Disorder</u> (Berkeley: University of California Press, 1977), 107.

[7] Ibid., 55-56. Hawley, <u>Dollars and Borders</u>, 10-11.

excessive growth in the supply of U.S. dollars in relation to the more slowly growing gold supply which backed the system. The Europeans and the Japanese, once they had obtained sufficient dollar reserves, began to challenge the U.S. over its macroeconomic policies, and the priveleges the U.S. gained from the operation of the dollar-gold exchange system. Nevertheless, the U.S. persisted in running these deficits, and instead of pursuing painful structural economic changes to correct them, it decided to follow expansive monetary policy and smash the Bretton Woods system.[8] Both of these decisions helped to accelerate inflation in the 1970s.[9]

The inflation of the 1970s seemed to be an apparent boon for many Latin American countries, in two ways. First, inflation translated into a force for the depreciation of the dollar. In turn, this helped to drive up the costs of raw material and metals prices in dollar terms, and made Latin America more attractive to investors and banks. Second, inflation helped to offset, if not counter, the rates of interest charged by most lenders, and thus

[8] Gilpin, The Political Economy of International Relations, 134-137.

[9] Ibid., 138-140.

borrowing made sense.[10] These are two of the forces which led commercial banks and Latin American sovereign debtors to develop their relationship into one of vulnerable interdependence. But as the 1970s progressed, there developed within the U.S. the seeds of a conservative response, the response of which was to deflate, and throw the bank-debtor relationship into disarray and crisis.

The regulation and segmentation of international finance were undermined by the effects of both American domestic and international financial policy. On the domestic side, commercial banks were restricted from freely deciding interest rates, participating in certain fields of financial services, and in certain geographical sectors of the U.S. market, by pre-WWII legislation. The commercial banks chafed under these restrictions, and were further irritated by the restrictive terms of the Bretton Woods system, and, later, the capital control measures imposed by the Johnson Administrations in the 1960s.[11] Given these constraints in the domestic domain, international activities looked relatively attractive, and more and more American banks began to open offices abroad, where the regulatory

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[10] Alfred Watkins, Till Debt Do Us Part (Boston: University Press of America, 1986), 21.

[11] Hawley, Dollars and Borders, 101-106.

environment was less restrictive.[12]

Over the 1960s, U.S. banks began to participate more actively in the Euromarkets, where currencies were held outside of the jurisdiction of the issuing country. The advantage of these markets included freedom from many national regulatory restrictions, and thus an important competitive edge.[13] The U.S. not only failed to bring these markets under some sort of government management, as would be fitting of the spirit of Bretton Woods, but it also encouraged its commercial banks to participate in the markets, and even tapped the markets itself in the 1970s.[14] In this way the nucleus of a largely private international financial system developed. When the two oil shocks induced OPEC surpluses and others' deficits, the leading powers, including the U.S., were able to choose the private system for recycling surpluses rather than the public system.

The internationalization of the international financial system was also aided by the effects which the Euromarkets had on domestic financial systems. As international commercial banks gained a competitive edge,

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[12] Ralph Bryant, International Financial Intermediation (Washington, D.C.: The Brookings Institution, 1987), 67.

[13] Ibid.

[14] Lever and Huhne, Debt and Danger, 52-57. Helleiner, "The Unplanned Child", 7-8.

policy-makers began to incur pressure to deregulate their domestic sytems so as to maintain competitive domestic financial sectors. Throughout the 1970s the U.S. passed several pieces of legislation which undercut the effects of pre-WWII legislation. One consequence of these actions was to allow a trend toward higher interest rates, which were further spurred by inflation and financial innovation.[15]

2. The Bretton Woods System

The Bretton Woods conference of 1944 set out commitments which were meant to stabilize and liberalize international trade, finance, and investment. It also created institutions to supervise and maintain the system.[16] It set the stage for post-war international finance by delineating the principles and rules which would serve to anchor the system.

The general object was to promote multilateralism to international financial relations, with enough exceptions for nations aiming to reconstruct after the war or to adjust to temporary financial problems. The goal was in all likelihood based on the experience of the interwar period;

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[15] Rapping, Intenational Reorganization and American Economic Policy, 91-125. Henry Kaufman, Interest Rates, and the New Financial World (New York: Times Books, 1986), 120-122.

[16] Jeffrey Frieden, Banking On The World (New York: Harper and Row, 1987), 61.

it sought to "prevent the recurrence of the competitive and disruptive trade and payments practices which had devastated international commerce and finance of the 1930s."[17] In that period, there was a "free-for-all regime" in which "countries consciously engaged in competitive depreciations of their currencies in attempting to cope with their critical payments and unemployment problems."[18] The long-term object of multilateralism was one which sought the flow of capital across national boundaries "in response to the law of supply and demand without political interference favouring one nation or another."[19]

The International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (the World Bank) were created to serve these ends. The World Bank was created in order to funnel investment into projects that were "essential to a healthy world economy", such as ports, canals, and irrigation systems, but would not likely be undertaken by private capital. The World Bank would borrow from private investors and lend "on its own

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[17] D.F. Lomax, The Developing Country Debt Crisis (London: Macmillan Press, 1986), 1.

[18] Benjamin J. Cohen, "A Brief History of International Monetary Relations", in International Political Economy, eds. Jeffrey A. Frieden and David A. Lake (New York: St. Martin's Press, 1987), 253.

[19] Block, The Origins of International Economic Disorder, 36.

responsibility and at its own risk."[20] The Bank's first focus was the provision of assistance for the reconstruction of the productive capacity of Europe, but later the Bank turned to the longer-term task of aiding the development of the LDCs.[21]

The IMF dealt with two broad issues: balance-of-payments adjustment and international liquidity. The first issue concerned the methods by which countries would seek to remedy payments difficulties when they arose. The second issue concerned the provision of adequate foreign exchange reserves allowing nations to avoid discriminatory practices in the face of temporary balance-of-payments difficulties.[22] This provision of liquidity would allow countries to overcome temporary balance-of-payments problems without sacrificing important domestic objectives such as economic growth.[23]

he first issue was settled with an agreement by which countries refrained from arbitrarily managing their exchange rate in order to remedy their trade balances. The Bretton Woods system was based on a commitment to fixed

[20] Frieden, Banking on the World, 63.

[21] A.I. MacBean and P.N. Snowden, International Institutions in Trade and Finance (London: George Allen and Unwin, 1981), 211.

[22] Ibid., 37.

[23] Gardner, Sterling-Dollar Diplomacy, 71.

exchange rates. Each nation was obliged to declare a par value for its currency, by which nations committed themselves to keeping the exchange rate of its currency relative to the dollar within a prescribed band. The standard for this system was the U.S. dollar, which was convertible into gold at $35 dollars an ounce.[24] The IMF was designed to supervise adherence to the maintenance of those par values, and any changes in them.[25]

The second issue was settled by the creation of the Fund as a supplementary source of reserves, so that countries could draw upon it in times of balance-of-payments problems to defend the par value of their currencies.[26] Member nations agreed to deposit contributions with the Fund, in the form of gold, local currencies and government securities, and the Fund could advance short-term credits to members in order to ride out temporary problems without the resort to discriminatory measures in trade and exchange rates.[27] The interesting characteristic of the arrangement is that the only large creditor in the post-war period, the

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[24] Ibid., p.39. Gilpin, The Political Economy of International Relations, 134.

[25] Joan Spero, The Politics of International Economic Relations (New York: St. Martin's Press, 1985), 37.

[26] Cohen, "A Brief History of International Monetary Relations," 257.

[27] Gardner, Sterling-Dollar Diplomacy, 74.

U.S., had great influence over all debtors: debtors could only draw upon as many dollars as the U.S. would deposit with the Fund.[28] This, and the veto power the U.S. derived from its allocation of votes in the Fund[29], gave the U.S. direct discretionary power to influence debtor through the supply of international official credit, and access to it.

A further note needs to be made concerning the Fund's and Bank's supply of liquidity and lending policies. The total resources of both institutions were far too inadequate relative to the financial needs of countries trying to reconstruct after the war. Extensive bilateral (Marshall) aid augmented the funds available through the World Bank for the purpose of European and others' reconstruction. Moreover, the Fund was prohibited from lending for the purposes of relief and reconstruction finance.[30] Finally, the terms for loans from both institutions were conservative and stringent, imposing a degree of conditionality which made those funds desirable only in the last resort. All of these qualities helped to make the institutions acceptable to private financial actors: the Bank and the Fund did not compete with them, and

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[28] MacBean and Snowden, International Institutions, 38.

[29] Spero, The Politics of International Financial Relations, 37.

[30] MacBean and Snowden, International Institutions, 39-40.

in fact they reinforced market discipline.[31] Those qualities also ensured that the Bank and the Fund would play a relatively small role in international finance.[32]

3. The breakdown of the Bretton Woods system

The breakdown of Bretton Woods was greatly aided by the development of contradictory U.S. economic policies. Specifically, the U.S. sought to preserve the advantages of Bretton Woods - the role of the dollar and its privileges - while undermining the stability of the dollar with inflationary domestic macroeconomic policies and the enlargement of military commitments abroad.[33] In addition, the U.S. took no fundamental steps to deal with the consequences developing from the internationalization of its corporations. The internationalization process involved the transfer of large amounts of dollars out of the U.S. for the purposes of investment and lending, and this transfer exacerbated the deficit on the capital account. The growth in the supplies of foreign-held dollars soon came to exceed

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[31] Frieden, Banking on the World, 63-65. Spero, The Politics of International Economic Relations, 181-183.

[32] Benjamin Cohen, "A Brief History of International Monetary Relations," 260.

[33] Spero, The Politics of International Economic Relations, 54.

the demand for dollars on the part of America's major economic partners, and this led to instability and conflict in the international monetary order. In addition, once the banks established offices overseas, those branches operated in a very different and more lenient regulatory environment. The latter was a key to the growth of the Euromarkets and the development of the Latin American debt crisis.

A) The undermining of international monetary stability

The operation of the gold exchange standard provided for an extended period of relative international monetary stability. This system, established at Bretton Woods, placed the dollar at the heart of international finance and commerce, because it was based upon a commitment by the U.S. to keep the dollar convertible into gold at $35 per ounce. Other nations agreed to support the value of their currencies around a pegged' exchange rate to the dollar. The U.S. commitment to the stability of the value of the dollar in terms of gold, and the confidence in that commitment based on America's large gold holdings, made it a virtually risk-free, and thus preferred, denominator for international financial transactions.[34]

Other nations needed to obtain and keep large

[34] Versluysen, The Political Economy of International Finance, 27.

amounts of American dollars for reconstruction and balance-of-payments settlement as the dollar became "the principal numeraire and currency of settlement for international trade."[35] These needs were so great as to prevent many countries from restoring convertibility immediately after the war, and thus from adhering to the principles of Bretton Woods. But this was to be transitional, and with a relatively small intial liquidity pool for the IMF, these countries had to depend on the U.S. balance-of-payments deficits and private American aid, finance and investment for supplies of dollars.[36]

These arrangements kept demand for the dollar at high levels, even as late as the mid-1950s; the period was characterized by a dollar shortage'.[37] They also help to explain why the dollar did not come under speculative pressure throughout the late 1950s as military spending and Marshall aid, and U.S. private foreign investment and commercial bank lending, poured dollars overseas in return

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[35] Ibid., 22.

[36] Block, <u>The origins of International Economic Disorder</u>, 110-114.

[37] James Burtle and Sydney Rolfe, <u>The Great Wheel</u> (New York: Quadrangle 1973), 70-72. It should be noted that i) the perceptions of a dollar shortage persisted even up to 1957, and ii) up until the late 1960s, the U.S. had a current account surplus, which was usually more than offset by a capital account deficit.

for influence, assets, and profits.[38]

That order underpinned a remarkable period of global expansion in production, trade and investment. The world statistics on gross domestic product and export and production show that growth was a constant characteristic of the 1950s and 1960s.[39] But three other trends of this period deserve attention. First, as U.S. transnational corporations spread into Europe, American transnational banks followed them to provide financial services. This was partly a result of the nature of European capital markets at the time: the limited size of some of the countries within Europe, restrictions on the free flow of investment funds between them, and the abnormal needs and circumstances of postwar reconstruction.[40] Second, in the case of the largest TNBs, they came to conduct a large amount of business out of these European branches relative to that conducted by branches at home.[41]

Third, this posed an important potential challenge

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[38] Ibid., 70. Versluysen, The Political Economy of International Finance, 29-30.

[39] Lomax, The Developing Country Debt Crisis, 2. Bryant, International Financial Intermediation, 19-21.

[40] Marcello de Cecco, "International Financial Markets and U.S. Domestic Policy Since 1945", in International Affairs 52, no.1 (1976): 394.

[41] Hawley, Dollars and Borders, 5.

to the U.S. government: a healthy and competitive banking sector was strategically necessary, but the TNBs' international activities were partly beyond the government's jurisdiction.[42] Indeed, the TNBs international interests could be at odds with, and even oppose, those of their government. Both TNCs and TNBs were exacerbating the U.S. balance-of-payments deficits in the 1960s.[43] This development concerns the the limits of U.S. regulatory power and the growth of the Euromarkets, and more shall be said about this topic under the heading of international finance.

Some of the very underpinnings of the post-war growth soon began to falter, however. American military leadership of the West remained relatively stable, but U.S. political and economic leadership became more and more contested over the 1960s and 1970s. Notably, the U.S. was trying to accommodate the pursuit of a variety of political and economic interests: the containment of communism around the world, including the Viet Nam war; the pursuit of inflationary macroeconomic measures, such as the tax cuts of 1964, the Alliance for Progress, the Great Society program and the space program; and Nixon's re-election measures.

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[42] Philip Cerny, "The Reregulation of Financial Markets in a More Open World", Paper presented at the ISA conference, Vancouver, B.C., 19-23 March 1991, 8. Cohen, In Whose Interest?, 14-17.

[43] Hawley, Dollars and Borders, 43.

The costs of these policies were partially offset with a overly expansionary monetary policy.[44] But this expansive monetary policy led to tremendous inflationary pressures and more capital outflows, as investors switched to assets in more stable currencies, such as the deutschemark. These inflationary and speculative pressures were in turn central to the undermining of the fixed exchange-rate system, a pillar of the Bretton Woods sytem, because they produced overwhelming pressure on the U.S. to defend the dollar's fixed value. After paying a heavy price to do so over the 1960s, the U.S. was no longer willing to do so at the beginning of the 1970s.[45]

Conversely, the growing export competitiveness and wealth of Western Europe and Japan gave those nations more power in the international economic system, and consequently more of an ability to influence U.S. policies.[46] There was no mistaking their objections to U.S. abuse of the gold exchange standard. Expansive U.S. monetary policy served to finance the U.S. interests mentioned above, but threatened to intensify instability and conflict in the international

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[44] Gilpin, The Political Economy of International Relations, 314.

[45] Block, The Origins of International Economic Disorder, 197-206.

[46] Cohen, "A Brief History," 266.

monetary system through the undermining of confidence in the American commitment to dollar convertibility.[47] The basis of the post-war monetary order was changing, from one in which all of America's partners desperately needed dollars, to one where the largest of the partners (West Germany and Japan) agreed to hold onto dollars despite their already large and growing dollar reserves.[48]

Other objections to the over-supply of dollars, led by the French, focused on the fact that the U.S. used expansive monetary policy to underwrite imperial policies around the world. The objection was that the U.S. was funding its global ambitions, some of which many of her allies considered abhorrent (the escalation of the Viet Nam war was an example), through a monetary policy which threatened the international monetary system. The only potential constraint on these ambitions and policies was the threat of large-scale conversions of the dollars that Europe and Japan already held into gold. This threat was only used by the French, however, and certainly not on a major scale; a concerted conversion would have seriously undermined the whole of the Bretton Woods system, and that would have hurt

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[47] Burtle and Rolfe, The Great Wheel, 77.

[48] Gilpin, The Political Economy of International Relations, 136.

every nation's interests.[49] However, the continuation of that arrangement would require extensive policy adjustments in the most powerful nations.

Signs of the unravelling of the post-war international monetary system appeared as early as the late 1950s. In academic circles, the French economist Jacques Rueff, in 1958, warned of the inherent and developing difficulties in the relationship between relatively slow growth in the gold supply and a relatively rapid growth in the supply of U.S. dollars. Yale economist Robert Triffin produced another work, Gold and the Dollar Crisis, in the same vein in 1960. This work argued that the flaw of the dollar-exchange standard centred around the inherent contradictions of the dollar's roles in the post-war international financial system. On one account, that system required American balance-of-payments deficits in order to increase international liquidity; but on another account prolonged periods of such deficits would generate a dollar overhang' and undermine confidence in the dollar and the dollar-exchange system. However, neither of these important warnings were heeded in U.S. official policy circles at the time, because American gold supplies still seemed relatively adequate, and the American general inflation rate was still

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[49] Cohen, "A Brief History," 266.

relatively low.[50]

The second sign of the unravelling of the Bretton Woods order came about as a consequence of political developments in West Europe. On the one hand, the European Payments Union was dissolved, and thus many West Europe countries returned to external convertibility for the first time in the post-war period. The simple fact was that the dollar shortage was easing. On the other hand, the Treaty of Rome was signed in 1958. This created an economic space, in the form of the Common Market, behind a unified tariff barrier; this had the effect of encouraging large flows of American investment dollars from the U.S. to Western Europe, and in turn the deterioration of the American capital account deficit and the development of a dollar glut.[51] The consequences of these political processes were augmented by the simultaneous advent of an American recession in 1958 which, when set against the robust growth in West Europe, further encouraged dollars to flow across the Atlantic.[52] These developments precipitated a spate of conversions of

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[50] Gilpin, The Political Economy of International Relations, 134-135.

[51] Burtle and Rolfe, The Great Wheel, 76.

[52] de Cecco, "International Financial Markets and U.S. Domestic Policy Since 1945," 388.

dollars into gold[53], and the creation of the seeds for an American political reaction, which sought to limit the outflow of capital - the capital export restraint initiatives of the 1960s.[54]

The U.S. government tried to stem the outflow of capital from the U.S., without inducing foreigners to exchange dollars for other currencies, through a series of banking and commercial regulations which were instituted throughout the 1960s. These were the Interest Equalization Tax (I.E.T.) of 1963, the Voluntary Foreign Credit Restraint (V.F.C.R.) programme of 1965, the Johnson Guidelines' and the witholding tax of 1968. The specific purpose of these regulations was to reduce the export of loan funds and investment capital by U.S. banks and corporations, and foreigners, either voluntarily or mandatorily.[55]

B) The internationalization of international finance

The internationalization of the international financial system came about not as the product of any single nation's policy, nor as the result of international

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[53] Burtle and Rolfe, The Great Wheel, 76. The value of the gold converted between 1958 and 1960 was U.S.$5.1 billion, as compared to U.S.$1.7 billion between the years of 1945 and 1957.

[54] de Cecco, "International Financial Markets and U.S. Domestic Policy Since 1945," 388.

[55] Hawley, Dollars and Borders, 45-107.

cooperation. It came about in a piecemeal fashion over time. This development was due in part to the post-war agreement that governed the international financial system; it was an agreement that sought to limit the involvement of private actors by allowing governments to intervene with exchange and capital controls. Indeed, many of the authors of the Bretton Woods agreement were positively hostile to the thought of private sector domination of the field, and thought that government intervention was prudent and reasonable. U.S. Treasury Secretary Henry Morgenthau had pointed out that one of the goals of the Bretton Woods agreement was to "drive ... the usurious moneylenders from the temple of international finance." Keynes strove to ensure that governments would have the right to intervene in central areas of international finance; for instance, Keynes noted that "the plan accords every member government the explicit right to control all capital movements," both inward and outward.[56]

National systems of capital movement and currency exchange controls were put in place, in effect leading to the segmentation of the international financial system.[57] Governments were thus also left to operate the international

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[56] Helleiner, "The Unplanned Child," 1.

[57] Ibid., 2. See also Bryant, International Financial Intermediation, 60-61.

balance-of-payments mechanism; this is a matter of considerable importance, and it will be revisited at several points in the thesis. As well, the IMF and the IBRD were multilateral institutions, in which member governments alone could be represented in negotiations and voting; they also contributed all of the funds involved. This is another way in which private actors, such as commercial and investment banks, were prevented from serving to channel financial movements between countries.[58]

This government domination and intervention began to recede in the 1950s. Again, several political developments in Western Europe were especially important. First was the decision by the Soviets and East Europeans, in the context of the Cold War, to shift their dollar deposits out of New York to banks in Western Europe; this move was calculated to keep their deposits outside of the immediate reach of U.S. financial authorities, which the Soviets feared might try to freeze them. Regulation Q (which placed ceilings on interest on time deposits in the U.S.) did not apply to deposits by foreigners.[59] The success of the Soviet and East European moves was the first step in the creation of

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[58] Helleiner, "The Unplanned Child," 4.

[59] Charles Kindleberger, International Capital Movements (Cambridge: Cambridge University Press, 1987), 46.

the offshore currency deposit market.[60]

The second set of developments was the decision of the British government to make two changes in financial regulation: i) to impose a ban on new overseas loans, denominated in sterling, to finance trade between countries outside the Sterling Area, and ii) to create a comparatively lenient regulatory atmosphere with respect to international financial transactions denominated in foreign currencies. Both decisions were designed to protect the domestic economy from international constraints[61], and promote London-based financial institutions to switch operations into dollar-denominated assets, so as to escape the controls on sterling.[62] The second step encouraged American and West European financial institutions to set up branches in the City, and expand operations there.[63]

Two general results of these political developments have special importance for the international financial system. First, the success of the Soviet attempt to move dollar deposits beyond the immediate reach of the U.S.

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[60] Versluysen, <u>The Political Economy of International Finance</u>, 22-23.

[61] Eric Helleiner, "The Unplanned Child," 5.

[62] Versluysen, <u>The Political Economy of International Finance</u>, 23-24.

[63] Helleiner, "The Unplanned Child," 5.

regulatory authorities created an 'offshore' space, the Euromarkets, where regulation was vague or non-existent. For example, dealings in Eurocurrencies were not subject to reserve requirements or deposit insurance fees. These advantages, in addition to others, allowed TNBs to offer higher rates of interest to depositors and lower lending rates to borrowers, and still earn higher profits than they do on domestic accounts.[64] As well, many banks were able to reduce or escape surveillance.[65]

The Americans, furthermore, did not mount any serious effort to bring these markets under control.

> Eurodollars remained outside of the regulatory authority of the U.S. government not because of any insurmountable technical problem in monetary policy. Eurodollars are beyond the government's regulatory reach because there has never been the political will to place them in the jurisdiction of public policy.[66]

In fact, the U.S. encouraged the Euromarkets: they allowed financial actors, including U.S. subsidiaries to borrow and lend in dollars without affecting the American balance-of-payments position. This also avoided a situation wherein government intervention at home penalized American private

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[64] Wachtel, The Money Mandarins, 102.

[65] Kindleberger, International Capital Movements, 46. E.A. Brett, International Money and Capitalist Crisis (Boulder, Colo.: Westview Press, 1983), 209.

[66] Wachtel, The Money Mandarins, 101.

interests abroad.[67]

The second general result was the creation of an additional incentive for Western Europe to hold on to dollars, and thus delay the need for adjustment in international monetary arrangements. As mentioned above, the 1960s witnessed an increasing and alarming flow of dollars into the international monetary system; if the American commitment to stability of the value of the dollar was to continue, Western Europeans and others had to formally or informally agree to retain those dollars. This arrangement might have been dismantled in the 1960s if the Euromarkets had not come into existence. Helleiner argues convincingly that the Euromarkets in effect encouraged Europeans to hold on to dollars because they could receive a higher rate of return on their dollar holdings in those markets than in the relatively more regulated American financial system, and they could also "partially offset the inflationary effect of the dollar inflows by placing them offshore."[68]

The attractions of the Euromarkets were further amplified by the capital control measures instituted in the U.S. throughout the 1960s. The IET, for example, had three

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[67] Helleiner, "The Unplanned Child," 6.

[68] Ibid.

effects on the appeal of those markets. First, purchases by U.S. residents of non-U.S. securities were taxed. Second, the IET in turn effectively raised foreigners' costs of raising funds through U.S. markets. Third, as overseas subsidiaries of U.S. corporations were defined legally as non-residents, and thus not subject to various domestic laws and regulations, "it provided an incentive for the financing of foreign ventures with funds raised overseas ... in the Eurodollar market."[69] In this way, the mechanisms and funds of the Euromarkets were put in place. Moreover, a great many incentives, some induced by government action, and the lack of it, were put in place to attract lenders and borrowers to those markets. The markets had a key weakness, however: there was no formal lender-of-last-resort as in most domestic financial systems.[70] When the size and scope of the markets were relatively limited, say before 1970, the potential consequences for the entire international financial system, and most domestic systems, were also limited.[71] This would change in the 1970s as a great

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[69] Versluysen, The Political Economy of International Finance, 24-26.

[70] Pierre Sauve, Private Bank Lending and Developing Country Debt (Montreal: The Institute for Research on Public Policy, 1984), 32.

[71] Stephany Griffith-Jones and Osvaldo Sunkel, Debt and Development Crisis in Latin America (Oxford: Clarendon Press, 1986), 72. The estimate for the size of the Eurocurrency market in

quantity of the surpluses and deficits derived from oil trade were intermediated through the Euromarkets, and banks aggressively marketed large loans to sovereign, and especially Latin American sovereign, debtors.

4. <u>The Shocks of the 1970s</u>

A) <u>The Fall of Bretton Woods</u>

A fourth sign of the unravelling of the post-war international financial order came in August of 1971. For several years prior to that date, expansive U.S. fiscal and monetary policies had led to a rising domestic inflation rate. This inflation was also spreading to Western Europe and the rest of the world economy via "the channel of price levels in integrated commodity and product markets as well as via capital flows." The resultant effect was the distortion of absolute and relative currency values and thus the further undermining of domestic and international economic stability.[72]

The strategies available to the American President seemed to boil down to two broad choices. On the one hand, internally-oriented adjustments could have been undertaken in order to bolster confidence in the dollar. These would

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1972 is U.S.$57 billion.

[72] Gilpin, <u>The Political Economy of International Relations</u>, 140.

likely have entailed either contractionary monetary policies (to raise interst rates and attract dollars back to the U.S.) or contractionary fiscal policies (to reduce balance-of-payments deficits and the creation and flow of dollars abroad). But both of these measures would have had a deflationary impact, and may have sent the U.S. economy on the road to recession. The domestic political interest of the Republican administration did not lie in this direction, and Nixon's re-election bid for 1972 has been widely credited, rightly or wrongly, with the continued expansionary bias of U.S. monetary policy in the early 1970s.[73]

As it happened, however, the Nixon administration opted for a policy package that forced other nations to undertake most of the adjustment. The U.S. suspended its commitment to convertibility - destroying a central pillar of the financial arrangements of Bretton Woods agreements. There was no doubt, as Joanne Gowa has argued, that the central focus of the steps taken was to smash the Bretton Woods system in order to free the U.S. of important international constraints on its potential policy

[73] For a good discussion of the merits of both sides of the debate, see Greider, Secrets of the Temple, 342-345.

options.[74]

The fall of the dollar-exchange standard proved to be of tremendous significance to the future because, in the absence of any other sizable and expandable international reserve asset, the international monetary system soon moved toward a pure dollar standard. Essentially, there was nothing like a relatively neutral commodity (such as gold) which would serve as an effective check on U.S. fiscal and monetary policy, which for years had demonstrated erratic and irresponsible qualities even with such a check. The only real alternative check was the political opposition that the rest of the world could muster, and this had hardly proven effective in the past. Just as important, additional space was created for competitive exchange rate adjustments, the very fear of which had motivated post-war financial planners.[75]

The events immediately following 1971 were largely the results of forces already in progress in the international monetary system. Because of the differences in macroeconomic policy and economic performance, several West European currencies (including the mark) had a momentum to appreciate in price, while other currencies (including

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[74] Gilpin, The Political Economy of International Relations, 140.

[75] Ibid., 141-142.

the dollar) had a momentum to depreciate. Two of the important questions at the time concerned the extent of exhange rate movements, and the nature of the movements' determination.

Official negotiations took place in 1971 in an attempt to manage the the extent of exchange rate movemments. These negotiations were concluded in December. There was an agreement to revalue currencies ranging from 7.5 per cent to 17 per cent relative to the dollar, and to give greater flexibility to the exchange rate system by a widening of the Bretton Woods margins to 2.5 per cent of parity. But these agreements did not last long. Even though the American balance of payments was aided by the depreciation of the dollar, the deficits remained large. These deficits were accompanied by expansive monetry policy. The result was the perpetuation of a continued and sizeable flow of dollars out of the U.S. to West Germany, Japan, and other countries. This created pressure on many countries to move toward floating exchange rates, and this was brought into effect by the Paris agreements of March, 1973.[76]

There was another important issue raised by prevailing economic and political forces. As the international monetary system moved to a pure dollar

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[76] W.M. Scammell, The International Economy Since 1945 (London: Macmillan Press, 1980), 183-185.

standard, two contradictory imperatives were created. On the one hand, with the alteration of the link between gold and the dollar, U.S. monetary policy was subject more than ever to domestic concerns and interests. The configuration of U.S. concerns and interests at the time supported a continuation of expansive monetary policy and domestic economic growth. On the other hand, the rest of the world was more subject to the effects of the dollar, and thus the responsible management of the dollar became of ultimate importance. One of the effects of expansive U.S. monetary policy was the building of inflationary pressures world-wide for years to come. The immediate result of this pressure was a support for a general rise in commodity price inflation.[77]

In the early 1970s, therefore, the international economic order was being undermined and destabilized by U.S. macroeconomic and monetary policies which served American national interests. Even if the international economic growth of the 1950s and 1960s was to continue, international economic relations would have continued to be conflictual and uncertain. The U.S. had altered the international monetary order in the interest of placing it on a pure dollar standard, and replaced the international liquidity

[77] Richard Timberlake, "Federal Reserve Policy Since 1945," 181-183. Scammell, The International Economy Since 1945, 194.

mechanism designed at Bretton Woods - international financial institutions - with private international financial markets. When the oil crises hit in the 1970s, and U.S. monetary policy adopted a sharp, disinflationary change, one consequence of the earlier U.S. actions was the Latin American debt crisis.

B) The Reactions to the Oil Shocks

It was the reactions to the OPEC oil price increases which brought the Latin American sovereign debtors and American TNBs together, each in a position of interdependence and vulnerability. OPEC countries had to decide where to invest their surpluses. Latin American sovereign debtors had to decide between adjustment and finance, and if the latter, among potential sources of funds. The U.S. government and American banks played vital roles in shaping the decisions of both OPEC and Latin America.

The first oil shock, in 1973, pushed prices from U.S.$2.70 per barrel to U.S.$10.72 in 1975. This near quadrupling of prices created large balance-of-payments surpluses for OPEC, and those countries had a variety of investment decisions to make with respect to markets and instruments. The international capital markets provided attractive options. By 1974, the Euromarkets were the largest single depository of OPEC funds. It has been estimated that "fully 41 per cent of that year's total surplus of U.S.$56 billion entered the international private banking system."[78] (This sum augmented the second largest source of funds for the Euromarkets, America's large dollar deficits).[79] Second, a substantial amount of those surpluses, especially those of Saudi Arabia, were invested in American Treasury bills. This assisted the American balance of payments in the mid-1970s.[80]

The investment decisions made by OPEC were greatly influenced by TNBs, and especially American TNBs, in the Euromarkets. TNBs had decisions to make about accepting deposits, making loans, and providing intermediation services. In the wake of the first oil shock, banks borrowed from OPEC in order to finance oil-importing countries. In essence, "it must be presumed that banks, having a choice, willingly took it upon themselves this particular role because of their own portfolio objectives and perceptions of risk."[81] This is all the more important since the largest American banks expanded their activities

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[78] Devlin, Debt and Crisis in Latin America, 43.

[79] Brett, International Money and Capitalist Crisis, 212.

[80] Gilpin, The Political Economy of International Relations, 315-316.

[81] Llewellyn, "The Role of International Banking", 212-213.

aggressively, and perhaps recklessly. By the late 1970s, lending was very concentrated, and so was borrowing. Thirteen leading banks controlled two thirds of U.S. foreign bank lending, and three quarters of all Third World debt was accounted for by just eleven countries.[82] In effect, many of America's largest banks, the stability of which was vital to both the American and international financial systems, had their fortunes tied to the circumstances and policies of a small number of foreign sovereign customers, through rapid growth in exposure.[83]

The TNBs' decisions to lend to Latin America were guided by several factors. First, since the Eurocurrency markets operate on a wholesale basis, the TNBs usually lent to very large customers. The demand of large corporate borrowers in the industrialized countries dropped in the early 1970s because of a weakness in industrial activity there. Given the balance-of-payments deficits of oil importers in both the OECD and in the Third World, the official demand for finance was extraordinarily high.[84] Second, Third World countries seemed to be relatively good

[82] Brett, International Money and Capitalist Crisis, 213.

[83] Ibid. Devlin, Debt and Crisis in Latin America, 43. Devlin remarks that "[e]xpansion of bank exposure in developing areas was exceptionally rapid, reaching an average annual rate of 30% per annum in the latter half of the decade."

[84] Brett, International Capital and Capitalist Crisis, 213.

customers. Many had experienced strong growth in the late 1960s: for instance, Latin America's gross domestic product rose by an average of 6 per cent per annum between 1965 and 1970, and this growth was led by strong export expansion in such countries as Brazil and Mexico.[85] Third, TNBs saw that the average rate of return on loans to the region were above those of domestic loans, the comparative loan-loss record since the war was good[86], and banks could protect the real value of their returns from interest rate swings through the recent invention of variable interest rate loans.[87] This was enhanced by the fact that TNB competition in the OECD area was growing, and thus depressing profit margins on loans there, while profits margins on loans to Latin America remained relatively large as TNB competiton was only beginning in the Latin American region.[88]

Finally, the decisions of the TNBs were affected by their perceptions of the influence of governments both in the OECD and in Latin America. The OECD policy toward the oil shock was that the OPEC surpluses should continue to

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[85] Devlin, Debt and Crisis in Latin America, 42.

[86] Cohen, In Whose Interest?, 44-46.

[87] Lever and Huhne, Debt and Danger, 52-53.

[88] Sauve, Private Bank Lending and Developing Country Debt, 12.

grow and that "it should be recycled' to the borrowing countries, including in particular the developing countries."[89] Officials from many OECD countries, and the IMF, encouraged their banks to participate in the recycling. This may have reinforced the assumption of the TNBs that OECD financial authorities would intervene in case serious problems cropped up. Whatever the case, the TNBs characterized the risk of default on sovereign loans, and thus the need for the assistance from OECD governments, as minimal. As Walter Wriston said in 1981, "Any country, however badly off, will own' more than it owes'." They are always solvent, and thus they can never go broke.[90]

The Latin American sovereign debtors also had decisions to make. First and foremost, the oil importers had to choose between adjustment and finance. Specifically, they had to choose between a path of financing growth and oil imports from external sources, and a path of closing the balance-of-payments gap with contractionary macroeconomic measures and resultant decreases in oil imports. Overwhelmingly, the choice was the former. In the 1970s, economic development was highly politicized, and public opinion demanded both economic growth and a measure of

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[89] Lomax, The Developing Country Debt Crisis, 18-19.

[90] Lever and Huhne, Debt and Danger, 53.

economic autonomy.[91] Balance-of-payments deficits and economic growth required external finance, and relative autonomy required a minimum of restrictions on that finance.

These domestic constraints influenced the decisions of the debtors as to the source of external finance. Official bilateral aid, and IMF and World Bank loans, usually have attached to them restrictions as to their use and requirements as to commitments to alterations of macroeconomic policy. Moreover, the uses of foreign direct investment were controlled largely by the corporation, and none could be used for balance-of-payments purposes. In contrast, there was a large, private international financial system in place, with TNBs willing to lend, and only a superficial capacity to impose conditionality (where it was attempted). Latin American debtors preferred this avenue, and they were willing to pay higher market interest rates to obtain funds through the TNBs.[92]

Supporting this choice was the development of a large gap between the rising financial needs of the debtors and the relatively stagnant growth of financial resources available through non-TNB sources. During the 1970s, the

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[91] Jeffrey Frieden, "Third World Indebted Industrialization", in International Political Economy, eds. Jeffrey Frieden and David Lake (New York: St. Martin's Press, 1987), 301-302.

[92] Liewellyn, "The Role of International Banking," 208-209.

lending capacity of the IMF, for example was not increased in line with the demand for balance-of-payments financing facilities.[93] Indeed, many forms of official bilateral and multilateral lending, such as through the World Bank and USAID, showed little growth in the 1970s.[94] National budgets in the OECD were themselves being strained by balance-of-payments difficulties, and significant increases in foreign assistance likely would have a tough time of surviving legislative processes.[95] Thus, as private markets were filling the finance void, OECD governments did nothing to interfere.

On the other hand, with the brief exception of 1975, TNB lending continued to grow in volume and improve in terms of falling profit margins and increasing maturities. These developments came about largely as a result of increasing syndication of loans and intensifying competition between syndicates. The growth in TNB lending also came about as a result of the "almost total lack of control and supervision with respect to the process of expansion of private international lending."[96] In addition, banks could protect

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[93] Ibid., 211.

[94] Devlin, Debt and Crisis in Latin America,46.

[95] Lomax, The Developing Country Debt Crisis, 8.

[96] Griffith-Jones and Sunkel, Debt and Development Crisis, 61-62. Devlin, Debt and Crisis in Latin America, 47-48.

the real value of their returns from inflation and real interest rate swings through the recent invention of variable interest rate loans.[97]

For a while after the first oil shock, it appeared as if the international economy had weathered the storm quite well. After an initial deflationary period, many OECD and LDC were able to both achieve impressive growth rates and bring inflation down to levels thought acceptable under the circumstances.[98] Continued price inflation in commodities helped Latin American countries to meet their scheduled debt-service payments. The banks were comforted by the prompt debt service, and by the fact that earnings from LDC loans in general were rising substantially.[99] In addition, the Euromarkets helped to postpone the day of adjustment for many countries, and that may have contributed in turn to the continuing openness of the world economy after the first oil shock.[100]

The second oil shock occurred in 1979-1980 and the Euromarkets played a similar role to the one they played after the first shock. OPEC surpluses rose from U.S.$2

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[97] Lever and Huhne, Debt and Danger, 53.

[98] Lomax, The Developing Country Debt Crisis, 18-20.

[99] Makin, The Global Debt Crisis, 124-125.

[100] Lever and Huhne, Debt and Danger, 8-16.

billion in 1978 to U.S.$114 billion in 1980 and U.S.$60 billion in 1981 (the fall between 1980 and 1981 can be accounted for largely by the recession in the OECD). Over the same period, Latin American non-oil LDC deficits rose from U.S.$41 billion in 1978 to U.S.$108 billion in 1981.[101] The banks intermediated these surpluses and deficits, and subsequently raised their exposure to Latin America even further. At the same time, the conditions of the banks' LDC customers were deteriorating. Debt-service ratios for the largest LDCs grew larger and larger. Even though bankers normally consider a coefficient of interest payments/exports in excess of 20 per cent to be a sign of great burden, by 1982/1983 more than 40 per cent of the region's exports were absorbed by interest payments.[102]

This uncertainty surrounding the relationship between the banks and Latin American debtor countries was magnified by the American reaction to the oil shock. Specifically, even though West Germany and Japan began to modify their energy policies by the late 1970s, so as to substantially moderate their demands for imported energy in general and oil in particular, the U.S. did very little to

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[101] Brian Kettell and George Magnus, The International Debt Game (London: Graham and Trotman, 1986), 52-53.

[102] Devlin, Debt and Crisis in Latin America, 52-53. See Annex 1 for more statistics on Latin American debt.

adjust its demand. When this fact was put in combination with American expansionary fiscal and monetary policies[103], the international financial markets developed a fearful perception about American inflation and speculators transferred funds out of the dollar. This weakness of confidence was a spur to both the development of the European Monetary System in 1978, largely centred the deutschemark, and the dramatic reversal of monetary policy in the U.S., which from 1979 on restricted the creation of money and sent interest rates in the U.S. to unprecedented levels.[104]

5. Conclusion

Although the banks helped to temporarily delay the day of adjustment for many after the oil shocks, the weaknesses of Latin American loans were many and varied. As with all markets, there is a natural tendency toward panic and crisis; the Latin American loan market was ripe for the fruition of such a tendency. As mentioned above, the Euromarkets were key to the panic which enveloped the U.S. dollar in the late 1970s, and which helped to bring about the sharp reversal in U.S. monetary policy. The Euromarkets

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[103] Makin, The Global Debt Crisis, 123-124.

[104] D.F. Lomax, The Developing Country Debt crisis, 19. Gilpin, The Political Economy of International relations, 145.

in turn were subjected to the rise in American interest rates, and this filtered into the rates charged on Latin American loans. These two elements turned out to be the keys to the break of the Latin American debt crisis, the subject of the next chapter.

Chapter Two

The Turn of the Tide

1. Introduction

The situation up until 1978 was characterized by moderate economic growth worldwide, rising but tolerable debt levels in the Latin American LDCs, and surging rates of inflation. There were a number of good reasons to believe that the dislocations induced by the first oil price shock, and its potential deflationary impact, had been successfully managed. OECD policies directed at growth, petrodollar recycling and the dismantling of international trade barriers were essential to bringing this situation about. But the second oil shock and rising inflation in the U.S. helped to boost the political fortunes of social groups in that country which were set on thwarting inflation. The success of these groups would make the 1980s very different from the 1970s.

The rise of conservative political forces in the U.S., bent on arresting inflation, supported a transition in U.S. monetary policy from relative laxity to sharp restriction. This transition had two subsequent effects.

First, the price of credit was raised in the U.S. through increases in real interest rates, and this imposed tremendous burdens on all economic agents with debt. Many domestic corporations and individuals went bankrupt, and a severe recession unfolded. The pressures on foreign debtors was the same, but it was compounded by the loss of American markets.

Second, high real U.S. interest rates had a profound effect on both international capital markets and the U.S. exchange rate. The increase in U.S. interest rates made the return on capital high relative to foreign markets, forced up interest rates in the Euromarkets, and attracted massive flows of capital to the U.S. from the rest of the world. These funds helped the U.S. to sustain large public deficits, to "live beyond its means". The inflow of funds also helped to push up the value of the dollar's exchange rate. This made the products of U.S. exporters relatively less competitive in world markets, and encouraged substantial political efforts toward more protectionism. A great many of Latin America's exports were hurt by U.S. protectionist legislation. Furthermore, the rise in the value of the dollar made many commodities (most of which were quoted in dollars for international trade) less competitive in European, Japanese and other markets. Finally, the rising value of the dollar pushed up the value of all debt outstanding, making the debt burden even larger.

The results were devastating for the Latin American debtor countries. Both sides of the financial equation were undermined. The value of the debt outstanding had risen. The cost of servicing old debt, and obtaining new credit, had increased. At the same time, the ability to service debt through export surpluses was being undercut by policies and markets beyond Latin America's control. But the Latin American debtor countries were also customers of a large number of American banks, and the deterioration of the banks' largest customers raised doubts about the solvency of the banks themselves. When Mexico declared its inability to make debt-service payments, the core of the U.S. financial system was put at dire risk. At this point, the U.S. government stepped in.

The U.S. government could not permit the collapse of the banks involved. Those banks were heavily linked to the rest of the banking system in the U.S., through syndicates and interbank deposits. The failure of the largest banks would immediately and powerfully affect the entire U.S. banking system. That would would wreak economic havoc at home and send shock waves through the international economy. Thus, the government developed, in an ad hoc process, a loose strategy of tactics aimed at managing the debt crisis, without necessarily resolving it. The strategy had the purpose of rescuing the banks, and this purpose overshadowed the goal of resolving the debt crisis of the Latin American debtor countries. The tactics of the plan reflected this hierarchy of goals. It included keeping the debtors afloat financially, pressuring them to keep current on their debt service to the banks, and reducing the banks' exposure in Latin America. Whereas the strategy had success in reducing the banks' exposure, it had less success at keeping the debtor countries afloat. The debtor countries reacted by once again threatening to stop sevicing their debts. This in turn necessitated new attempts on the part of the U.S. government to manage the crisis - the Baker and Brady Plans.

2. Inflation and American Politics

Inflation erodes the value of money, and in this way inflation erodes the value of financial assets denominated in the currency of the country that experiences inflation. A broad range of social groups were hurt by the effects of the 1970s'inflation that the U.S. had helped so much to generate, in at least three ways. First, as the fear of inflation accelerated the flight out of dollar denominated securities, it simultaneously helped to drive the exchange rate down, thus exposing the dollar to speculative attacks in financial markets across the world.[1] Second, inflation punished American creditors, both savers and financial intermediaries, and benefited American and foreign borrowers; this sustained distribution of gains and losses spurred the wealthiest sections of American society to attempt to reverse the government policies that perpetuated inflationary forces.[2] Third, the real purchasing power, savings, and pensions of ordinary people were being diminished faster and faster every year, with little hope of relief in the near future.[3] This loose group of social forces was no doubt a key to the fortunes of Reagan's success in the 1980 presidential election.

It must be pointed out that, as pressure mounted on the Carter administration to do something about inflation, the administration did take one very important step (even though it was too late in the presidential term to help the Democrats' re-election chances). In August of 1979 Carter appointed Paul Volcker, then President of the New York Federal Reserve Bank, to the position of Chairman of the Federal Reserve. Volcker was the favourite choice of financial interests on Wall Street, and his preference for

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[1] Odell, U.S. International Monetary Policy, 330-333.

[2] Crouch, "Inflation and the Political Organization of Economic Interests", 228-229.

[3] Greider, Secrets of the Temple, 40-45.

the tightening of monetary policy (which would raise interest rates, and thus the return on capital) was well known.[4] This was Carter's message to the public that inflation would be controlled, and to the international financial community that the dollar would have a stronger value in the near future.

It was under the chairmanship of Volcker that the Federal Reserve would develop a very conservative and monetarist character, with powerful deflationary implications for both the American and international economies. Reagan's campaign platform contained several planks, but the most important one reinforced Volcker's attack on inflation. The Reagan team successfully attributed the blame for inflation to the Carter administration, in light of its supposed profligate spending and endorsement of loose monetary policy. The necessary cure involved tighter monetary policy and reduced government involvement in the economy.[5]

With respect to the former, Milton Friedman and other monetarists wanted to impose external discipline on the Federal Reserve with regard to money supply, which, as has been mentioned before, had previously demonstrated

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[4] Ibid., 45-77.

[5] Ibid., 352-354.

considerable laxity. They aimed to do so by switching the focus of Fed policy from interest rates, which the Fed could only partly influence, to growth in monetary aggregates, which the Fed could directly influence.[6] In turn, then, Fed policy could be more accurately interpreted as being expansionary, stabilizing, or contractionary. The immediate discipline to be imposed on the Fed, and which the Fed readily accepted, would entail a strong and prolonged contractionary monetary policy.

The Reagan Administration was furthermore successful in fostering and protecting conservative doctrine by appointing conservatives to other central government posts. Donald Regan and Beryl Sprinkel, the Secretary and Under Secretary of the Treasury, were both monetarists.[7] In addition, David Stockman, Director of the Office of the Management and Budget, was a monetarist.[8] These actors played a critical role in advancing and protecting

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[6] op. cit., p.91. As Greider goes on to argue, the ability of public officials to manage monetary aggregates, let alone gauge them, was vastly overestimated by monetarists. Part of the problem concerns which monetary aggregate is involved, and innovative financial techniques which were being disseminated throughout the American financial system helped to exacerbate this problem. Another aspect concerns the velocity of the circulation of money, which had exhibited considerable stability before the 1970s, but instability afterwards.

[7] op. cit., pp.364-5.

[8] David Stockman, The Triumph of Politics, pp.64-65.

monetarism, and Volcker. This was especially so when such policy was increasingly attacked as excessive and self-debilitating.[9]

With the Federal Reserve as the point man', and support from the executive branch, the policy of tight money was nurtured. Between October 1979 and May 1980, the policy drove prime rates from 9 per cent to 20 per cent. By January of 1981, the rate was 21.5 per cent. These increases fed into a rise in the LIBOR, which peaked at 18 per cent.[10] The differences in real interest rates between the 1960s and the 1970s, and the 1970s and 1980s, were startling. The average real interest rate over the years 1961 - 1970 was 4.1 per cent. Over the years 1971-1980, the average was -0.8 per cent. This was abruptly altered in the early 1980s, with the rising U.S. nominal interest rates and the subsequent reduction of inflation. In 1981, the real interest rate was 7.5 per cent; in 1982, it was 11 per

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[9] The sources of criticism finally included a broad range: producer groups, the unemployed, professional economists, incumbent poliiticians, and important factions of the staffs of the the Reagan administration and the Treasury. Paul Volker even suffered a rebellion of this nature on the staff of the Federal Reserve. Constant references to the range of sources of criticism can be found in the latter chapters of William Greider's <u>Secrets of the Temple</u>.

[10] Sue Branford and Bernardo Kucinski, <u>The Debt Squads</u>, p.95.

cent.[11] In addition to the direct domestic effects of monetarism, there was an important external result: support for the dollar's exchange rate. As interest rates in the U.S. rose over the next several years, more and more funds flowed in from overseas, toward relatively high-yielding dollar-denominated investments.[12] These funds had to be converted into dollars, thus raising the demand for, and price of, dollars.[13]

The reduction of government intervention was highly touted as a key to successful supply-side strategy and economic growth. "Getting the government off the backs of the people" was part of the "supply-side" strategy of Reaganonomics. The supposed attractions of the theory were essentially two-fold. First, it was argued that many forms of state intervention were impairing the private economy's ability to perform optimally - subsidies, protectionism, regulation and a "punitive" tax system. The supply-side strategy included a prescription to reduce or eliminate

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[11] William Cline, International Debt, p.11. The real interest rate is measured as the LIBOR (London Interbank Offer Rate) on U.S. dollar deposits minus the U.S. wholesale price increase.

[12] Sue Branford and Bernardo Kucinski, The Debt Squads, p.106. Branford and Kucinski argue that high interest rates and the role of the dollar as a safe refuge' helped to bring into the U.S. $11.6 billion in 1982, $36.6 billion in 1983, and $100.2 billion in 1984. This flow of capital to the U.S. helped to reduce over time the amount of funds available to Latin American borrowers.

[13] I.M. Destler and C.R. Henning, Dollar Politics, p.19.

these forms of state intervention; deregulation and a cut in personal income taxes were promoted as means toward this end.[14] The promised benefits of supply-side economics were the liberalization of the marketplace from government interference and reinvigourated economic growth.

Once elected, however, the Reagan team deviated from its strategy in a number of specific ways. For example, government spending reached historical proportionsduring Reagan's two terms. The Republican administration's own expenditure agenda, in such areas as defense and tax rate cuts, combined with the agenda of an predominantly Democratic congress to produce budget deficits which made Carter's deficits seem pale in comparison.[15] In fact, Reagan presided over the transition of the U.S. from a net

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[14] David Stockman, The Triumph of Politics, p.41. The three attractions of supply-side economics are taken from pp. 41 - 54 of this book.

[15] It should be pointed out that even though the Reagan candidacy and administration promised to substantially reduce government spending, movements in government expenditure figures proved to successive increases. In addition to the higher defense spending and losses from tax cuts, the Democrats were largely able to save some of the largest social programs from the knife, including Social Security, Medicare, and veterans' benefits. It is a tribute to the Reagan era that one of the largest spending cuts achieved occurred in the programs designed to benefit the poor (including school lunch subsidies and food stamps), and that the tax cuts were enormously regressive. Murray Weidenbaum, former Chairman of Reagan's Council of Economic Advisers, in Rendezvous with Reality (New York: Basic Books, 1988), 10.

creditor to a net debtor.[16] The public deficits would generate large financial requirements, and this reinforced pressures to attract domestic and foreign funds back to the U.S., away from potential use in Latin America.

However, the Reagan administration received and achieved important gains in efforts toward deregulation. The word received' is used intentionally and carefully. Throughout the 1970s, as a result of the competitive pressures exerted by the Euromarkets[17], legal ceilings on U.S. interest rates were being relaxed or removed on a piecemeal basis. Following the Federal Reserve decision to target growth in monetary aggregates, Congress passed the Deregulation Act in March of 1980. This act mandated the phased removal of all ceilings still subject to Regulation Q ceilings.[18] Regulation Q imposed limits on how much interest banks and Savings and Loans institutions could pay on savings deposits. The benefits of the deregulatory process for American commercial banks included the fact that they could improve their competitive appeal for funds

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[16] The figures for U.S. public and private debt, and sources of supply of finance, are found in Henry Kaufman, Interest Rates, the Markets, and the New Financial World, pp.160-1. [photocopy to be included].

[17] Philip Cerny, "The Reregulation of Financial Markets", pp.14-15.

[18] Leonard Rapping, International Reorganization and American Economic Policy, pp.116-117.

relative to their foreign competitors.[19] The process of deregulation took one furhter step when, in October of 1981, the Federal Reserve granted states the right to create International Banking Facilities (IBFs). IBFs are "zones" where bank's international activities are exempt from taxation, reserve requirements on their deposits, and government insurance on their deposits.[20] All of these steps increased the competitiveness of the American banking sector more competitive.

There were potential dangers arising from the deregulatory process, however, and the dangers affected the Latin American debt situation. First, the process of deregulating interest rates undermined the ability of public authorities to influence financial markets. The risk was that there was less of an ability to control or manage their behaviour. Indeed, beyond the push of lower growth in monetary aggregates, the absence of control was what allowed nominal interest rates to rise to historical levels and

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[19] In the late 1960s and 1970s, Regulation Q severely disadvantaged the banks, because the imposed limit on interest rates for savings deposits was 5 per cent, while market interest rates for money market instruments (like Treasury bills) could offer 9 or 10 per cent. The effect was to bring about financial disintermediation, as funds drained out of financial institutions. Several years of financial disintermediation helped to push the cause of financial deregulation by the late 1970s. The explanation is found in Henry Kaufman, Interest Rates, the Markets, and the New Financial World, pp.74-75.

[20] Howard Wachtel, The Money Mandarins, p.116.

unprecedented variability.[21] This made the situation of the debtors more precarious by allowing debt-service levels to vary unpredictably.

The second danger involved the deal that was struck in the process of deregulation. The Fed wanted to impose reserve requirements on the entire banking system so as to balance the reduction of government influence (resulting from the deregulatory process) by broadening the Federal Reserve's constituency. Under the traditional arrangement, membership in the Federal Reserve system was originally voluntary; under the new Act, it would be mandatory. Many banks saw this as discriminatory, since funds held in reserve received no interest, and thus the banks lost potential competitiveness. The banks were finally assuaged through a reduction of reserve requirements, from 16.25 per cent to 12 per cent.[22] This reduction of reserve levels made the banks more competitive, but at the same time it decreased the amount of capital that could be called upon in

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[21] Leonard Rapping, International Reorganization, pp.116-117.

[22] William Greider, The Secrets of the Temple, pp.155-162. The reduction meant an effective loss of $11 billion in Fed reserves (from $27 billion to $16 billion), precisely at the time that deregulation and adverse world macroeconomic developments would reveal the need for greater reserve requirements. Robert A. Jones accurately characterizes the case when he terms the reduction in reserves as "dramatic." See his article entitled "U.S. Monetary Policy Responses to the Debt Crisis," in World Debt Crisis, ed. Michael Claudon (Cambridge: Ballinger Publishing Co., 1986).

the case of an emergency, such as the deterioration of loans to Latin America.

Third, financial deregulation also made it attractive for the commercial banks to refocus on domestic operations. As was mentioned, the financial regulations of the 1960s helped to spur the banks to develop and pursue international business, one of the key processes of the development of the Latin American debt crisis. But the inflation of the mid-1970s and the rapid build-up of Latin American and other sovereign debt, which threatened the credibility of such loans on bank balance sheets, had made further international lending a very risky endeavour. Domestic financial deregulation made domestic operations much more attractive just as the allure of international, and especially sovereign, business was waning.[23] Moreover, domestically-based operations would receive the same regulatory treatment as they could abroad, with large savings and greater freedom as a result.[24] The growing attraction of domestic activities helped to seal the fate of the business of lending to Latin America.

Finally, these benefits from deregulation came on top of the advantages derived from weak domestic oversight

[23] Henry Kaufman, Interest Rates, the Markets, and the New Financial World, pp.98-101.

[24] Howard Wachtel, The Money Mandarins, pp.116-117.

of the banks' international operations. While the Fed was zealous in its efforts to decrease the money supply and bring down inflation, it was much less active in the supervision of the banking system. In particular, the Fed did not take the necessary steps to ensure that the banks were properly assessing the risks involved in their loans. This was true whether the loans were domestic or foreign, private or sovereign.[25] Again, the tendency to overlook the potential problems in lending to Latin America may have given the banks a competitive edge in the late 1970s and early 1980s, but it only served to increase the magnitude of the problem if the quality of the loans deteriorated.

3. Winners and Losers Under Reaganomics and Monetarism

Even though the collective pressures of various factions of finance capital contributed to a rise in real

[25] The concentration of focus on lending to sovereign governments should not deflect the student of finance from recognizing the problems that U.S. multinational banks had with loans to private domestic corporations. The cases of the Penn Square and Continental Illinois banks adds evidence that to the argument that many banks were not giving sufficient attention to the risks involved in their lending, and to the argument that the Fed was not very dilligent in enforcing discipline in this regard. Two reasons are offered: a lack of interest or will, and a lack of political weight in the era of deregulation, to back up any measures to be adopted. Indeed, more forceful supervision would mean an attack by the Fed on its own constituency, and thus a potential decrease in support of its tight monetary policy. For evidence, see Greider's Secrets of the Temple, pp.495-663; pp.523-526 are especially important.

interest rates, the desired degree of elevation was surely different for different groups which had influence over that policy. It must be pointed out that one economic group, that of investors, prospered in general.[26] The particularly strong regard Paul Volcker had for the bond markets was essential to the maintenance of interest rates at their historically high levels.

It is clear that the policies adopted under the aegis of Reaganomics and monetarism were welcomed early on by the banks. The fight against inflation and the continuation of the deregulation process aided their objectives of stable money and freedom of action. As time proceeded, however, government policies produced consequences which threatened to make the banks insolvent. The policies had that effect by maintaining high real interest rates, and making the burden of many economic agents with debt unbearable. With the banks' customers faultering or going under, the solvency of the banks came into question.

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[26] "In short, the bondholders and other financial investors won both ways. They collected the bonus income of high real rates. Meanwhile, the value of their money was not only protected from the dilution of inflation, but their financial wealth was actually magnified in value as monetary policy drove the prices of real assets lower...According to the Shearson Lehman Government/Corporate Bond Index, which added interest income and price appreciation, bond returns had averaged 18.5% in the four years since 1981 - the most profitable era for bondholders in the twentieth century." William Greider, Secrets of the Temple, p.682.

One of the first domestic effects of high real interest rates was what Greider calls "the rolling liquidation." Raising the price of money and credit necessarily meant that more people, corporations and governments would not have access to it. For those that had already borrowed on variable rates, higher interest rates tacked on additional costs[27], and made repayment more front-heavy'.[28] The prolonged raising and maintenance of interest rates in the U.S. contributed in a major way to the development of the worst economic downturn in the post-war era.

The downturn began in the U.S. and then filtered into the international economy. American interest-rate - sensitive consumption in such areas as real estate and housing, automobiles and other big-ticket durable goods

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[27] This is true in different degrees for different groups. According to Branford and Kucinski, "it must be remembered that in the U.S. many kinds of interest can be deducted from income tax. As this deduction can be worth up to half the nominal value of interest, the part effectively paid during periods of high interest and high inflation can be even less than inflation itself." This provision sheltered many domestic borrowers, and is a key difference between the plight of U.S. and foreign debtors. Sue Branford and Bernardo Kucinski, op. cit., p.104.

[28] Rudiger Dornbusch, "Debt Problems and the World Macroeconomy", in Developing Country Debt and the World Economy, edited by Jeffrey D. Sachs. On p.301, Dornbusch notes that increases in nominal interest rates imply an early real amortization of external debt. Whether or not real interest rates change, a cash flow problem for debtors results from increased nominal interest rates.

began to dive. Producers reacted to fewer and smaller orders from retailers by shutting down operations and laying off workers, and by moving abroad. Personal and corporate bankruptcies rose to record levels. The intended effect was achieved - the recession meant the idling of productive resources and the reduction of American purchasing power, and thus domestic sources of inflation were being wrung out of the economy.

The rising interest rates also hurt American exports. As Destler and Henning pointed out, the Reagan administration gave too little attention to the link between interest rates and the exchange rate, and the potential consequences of a rising dollar on exporters. These policies, especially when seen against a backdrop of fundamentally different policies in Western Europe and Japan, resulted in "at least one million jobs lost [and] firms abandoning plants and lines of production, which could not easily be restarted when the dollar's value receded ..."[29]

The high value of the dollar also increased American trade deficits as exports became overpriced relative to foreign goods. Recession and unemployment in turn fueled a political reaction which, instead of looking inward, focused

[29] I.M. Destler and C.R. Henning, Dollar Politics, pp.4-5.

on European, Japanese, and other competitors. The result was the mounting of protectionist pressures in the Democratically-controlled Congress, and a more aggressive international trade policy from the administration.[30] Indeed, it was all too easy for foreign governments and peoples to be identified as the central problem.

For many banks, the domestic recession meant that an increasing amount of domestic customers could not repay their loans. This in turn forced the banks to write off the loans, to use profits to cover bad loans, and take a hit on the balance sheet. As the recession wore on, these losses mounted, and in 1984, Continental Illinois, America's eight largest banking institution, only escaped collapse with the help of the U.S. government.[31] The detrimental effects of the interest rate hike in the American economy soon spread

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[30] Sue Branford and Bernardo Kucinski, op. cit., pp.106-107. "It has been calculated that for each percentage point the dollar rose on the foreign markets, the U.S. lost $3 billion in its trade balance. The trade deficit reached $148 billion in 1984, $134 billion in 1985, $156 billion in 1986 and $171 billion in 1987." I.M. Destler argues that the American-Japanese trade conflicts of the 1980s were caused by the Americans' mistaken interpretation of the real causes of U.S. trade deficits. He agrees with Marris, Bergsten and Cline, who support the thesis that the rising dollar played the central role, rather than discriminatory Japanese trade practices. Destler goes on to argue that Japanese and West European success in cutting budget deficits led to accumulation and outflow of savings, which then went to the U.S. to both finance American budget deficits and support the value of the dollar. I.M. Destler, op. cit., pp.177 - 183.

[31] Benjamin Cohen, In Whose Interest?, p.295.

into the international economy, and this is what most banks feared, with so much exposure to the Latin American sovereign debtors, and vulnerability to their circumstances and policies. It did so in two successive ways, each with a different twist. The first was the recession's contractionary effects on American imports, and the second was the supportive effect that the interest rate hike had on international exchange rates.

To begin with the first point, the initial international effect of the recession was to cut U.S. and OECD economic growth and, therefore, demand for foreign exports. Every major exporting nation felt the consequences. As opposed to the 1973 - 1979 period, in which the greal growth in industrial countries averaged 3.2 per cent annually, that figure fell to 1.2 per cent in 1980 - 1981, and -0.3 per cent in 1981 - 1982. But Latin American nations were especially sensitive to the downturn in the U.S. For one, the U.S. was one of their largest markets for exports for a wide range of goods.[32] Given that much of the external finance which was supplied to Latin America in the post-war period was American, and denominated in dollars, the Latin Americans were in a severe bind. Latin American borrowers, private and public alike,

[32] See Annex 2 for statistics on Latin American - U.S. trade.

needed to earn dollars to make repayments on their loans; but their largest source of dollars was being choked off, and the terms of trade were getting worse.[33]

Another effect of rising interest rates was the steepening of Latin America's interest payments. Branford and Kucinski calculate that Latin America had to pay an extra U.S.$1.8 billion for every increase of one percentage point. Thus, in "just three years - 1981, 1982 and 1983 - Latin America forked out $94.8 billion in interest payments, twice its total outlay on interest for the whole of the 1970s."[34]

The second and later international consequence of rising U.S. interest rateswas to send the dollar soaring in international exchange rates. As most commodities are quoted in dollars, the rising value of the dollar meant that Latin America's commodities became less attractive on markets in Europe and Japan, thus undermining demand and prices.[35] The falling prices forced Latin American and other exporters to produce and export more for the same total value. In combination with recession in the OECD,

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[33] ECLAC, International Economic Relations and Regional Cooperation, pp.24-25. See also William Cline, International Debt, pp.12-13.

[34] Sue Branford and Bernardo Kucinski, op. cit., p.95.

[35] See Annex 3 for trends in commodity prices.

this unleashed waves of supply in already weak commodity markets, further depressing prices. Even the rising demand resulting from the U.S. recovery in the mid-1980s failed to raise prices, and thus Latin American recovery was anemic at best.[36] Although these consequences were a reward for the anti-inflation efforts of the Reagan administration, they were a blow for the debtors and their creditors, the banks.

Another consequence of the soaring dollar was the positive revaluation of dollar-denominated debt. Unlike the inflationary period of the 1970s, where borrowers benefited by being able to repay in cheaper dollars, the deflationary period of the 1980s meant paying back more expensive dollars. Combined with variable interest rate loans[37], the impact on the borrowers was devastating.

By the early 1980s, the policies adopted in the U.S. at the turn of the decade ended up hurting Latin American debtor countries, a large number of U.S. corporations and workers, and finally the banks which pushed for the policies in the first place. Virtually the only group which benefited from Reaganomics and monetarism beyond the short-term were the investors in the bond markets. Thus, when one

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[36] ECLAC, International Economic Relations and Regional Cooperation, pp.24-25.

[37] Pierre Sauve, Private Bank Lending and Developing Country Debt, p.19. Sauve reports that 75% of LDC bank debt carried floating interest rates.

attempts to identify the causes of problems in the international economy in the 1980s, American government policies must receive considerable attention. These policies include not only Reaganomics and monetarism, but also those which were developed in reaction to the problems caused by Reaganomics and monetarism.

4. The Explanation of the 'Fire-fighting' Approach

As Latin America plunged into economic and financial difficulty as a result of American policies and their effects, there was a sense of uncertainty and crisis in the U.S. and the rest of the OECD. The American banking system, and via the interbank market, the entire financial system, was threatened with disaster and chaos because of the mix of American deregulatory and macroeconomic policies. The response was tailored to short-term, patch-work solutions, with little consideration of a long-term, comprehensive and durable strategy. This development can be seen as an extension of American policy reactions to the experience of other international debt problems, especially the one involving Poland, which had flared in 1981. Those policy reactions were shaped by the governments' desire to shield the banks from adverse Polish decisions, without tackling the larger problems of the Polish financial crisis.

Prior to the 1980s, several debtor nations had fallen in arrears after the first oil shock. Argentina, Indonesia, Peru, Turkey and Zaire were the largest problem countries in this respect. But as Benjamin Cohen suggests, neither the multinational banking community nor the governments of the industrialized countries were moved to interpret this as a sign of weakness in the international financial system:

> Such problems, it seemed, were sui generis and could each be managed individually through established and evolving debt- rescheduling techniques. ... Not even the near-bankruptcy of Turkey in 1978-79 did much to shake the general air of complacency.

All considered, the lack of concern may have had much to do with the numbers involved - $2 billion in the Peruvian payments problems of 1976, and $3 billion in the case of Turkey in 1978-79.[38]

Poland proved to be more of a problem, and it not only involved much larger sums but also revealed with stunning clarity the potential for crisis in sovereign lending. By 1981, Poland had a total external debt of $26 billion, of which $16 billion was owed to Western commercial banks. The loans to Poland had become increaasingly questionable by the late 1970s as the Polish economy began to deteriorate, and the Polish government continued to defer substantial corrective policy measures. The banks lacked

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[38] Benjamin Cohen, In Whose Interest?, pp.178-185.

the ability even to monitor concrete economic performance - the Poles released very little data, and what was released could not be trusted as accurate.[39]

The Western commercial banks were unduly complacent in view of these trends, for two principal reasons. Ever since the early 1970s and the beginning of the period of detente, Western governments started to promote the flow of finance to Soviet bloc countries. Not only was it profitable for the banks, but it might also have helped to further centrifugal forces within the bloc. With respect to Poland in particular, it was hoped that the Solidarity movement would not be set back by an external financial squeeze on Poland, and an internal political squeeze by the Polish government. The banks were further encouraged by the fact that the American government was concretely supporting the flow of finance: through the Department of Agriculture's Commodity Credit Corporation (CCC), which augmented aid for Poland's grain purchases, through other public guarantees of private credits, and public support of official debt rescheduling.[40] These considerations reinforced a faith the banks had in the Soviet umbrella and the relative ability of communist governments to ensure debt service.

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[39] op. cit., pp.185-186.

[40] op. cit., pp.187-191.

Despite these factors, Poland declared a moratorium on its debt service in March of 1981. Panic and fear set in with investors, the financial markets, and the banks. The international financial system was shaken, not by the size of Poland's debt alone, but by the question of whether Poland's situation might influence the situation of other debtors, and especially Latin America. Each bank began to make the situation worse by acting in its own best interest, i.e. by reducing its own exposure as quickly as possible.[41] The problem was that the net result of these actions, if allowed to continue, would be a void in new private lending. Without new lending from the commercial banks, Poland couldn't continue to service its debts, and thus the banks would be forced to write those loans off. That would slash profits and undermine market confidence in the banks. This in turn would reverberate throughout the U.S. financial system, by forcing the banks to build base capital, raising the denmand for capital, and thus producing higher costs for credit. Faced with these potential consequences, the U.S. government found it necessary to stabilize the relationship between American banks and Poland. U.S. officials acted to stem the tide out of lending to Poland, to coordinate a more

[41] op. cit., pp.192-193. They reduced exposure by reducing their interbank lines in Eastern Europe and declining to roll over many maturing short-term loans. Through these actions, Romania and Yugoslavia soon required refinancing as well.

orderly reduction of bank exposure to the country, and temporarily offset the financing void with its own credits.

The U.S. government, led by the Treasury and the State Department, spent a great deal of effort trying verbally to persuade the banks that the West still had important interests in Poland and the Eastern bloc, and that the banks themselves had an interest in not abandoning business in the region too quickly.[42] The government acted more directly when, despite the fact that talks had broken off between official creditors and the Polish government, it waived cross-default clauses on its Commodity Credit Corporation loans when the Poles defaulted on them in January of 1982. This move was essential so that the default on official loans did not automatically spread to Poland's bank loans. Several of the largest American banks continued to receive payments as a result while negotiations on rescheduling were in process.[43] Those negotiations were finally concluded successfully in November of 1982, and two other sets of reschedulings followed in the next two years.

The Polish crisis was for the international

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[42] op. cit., p.196. The State department was particularly worried that the declaration of default might reduce the leverage that the debt situation represented in the context of other negotiations, including the authoritarian stance of the government and its declaration of martial law in December of 1981.

[43] Ibid., 194-198.

financial system only a harbinger of things to come. Latin America's collective debt dwarfed that of Poland, and the vulnerability of the commercial banks to Latin America was much higher. But there were to be several similarities with respect to the responses of the banks and the creditor governments to such challenges. For one, the banks had a tendency to pursue individual interests even at the cost of undermining the collective interest. Second, and directly flowing from the first, public financial institutions had to act quickly to stabilize the situation. There is a third similarity: the actions of U.S. government helped to provide short-term, ad hoc crisis relief for its banks, but did not create a more durable and comprehensive strategy which was capable of resolving the crisis. In fact, U.S. government aid for American banks helped the banks to disentangle themselves from the crisis. This ensured the decline of bank lending. Moreover, the ad hoc manner in which the U.S. government's debt-management strategy was cobbled together prevented a more systemic response from being developed.

5. The Latin American Crisis Arrives

As mentioned above, the size of Latin America's debt dwarfed that of Poland's, and this was so in almost every respect. The data on total debt, net debt and debt service as a percentage of exports exports are only a few categories that can be used to demonstrate this fact. For the big three Latin American debtors (Argentina, Brazil and Mexico) alone, the numbers were staggering. In 1982, total debt in U.S. dollars was 38, 88.2 and 82 billion, respectively. For the same year, net debt as a percentage of exports for the big three was 353.5 per cent, 365.3 per cent, and 248.6 per cent, respectively; and debt service as a percentage of exports was 102.9 per cent, 87.1 per cent, and 58.5 per cent, respectively.[44]

But an important feature of the Latin American debt was different from the Polish case - the extent of private bank involvement and exposure.[45] The 1982 bank debt of Argentina, Brazil and Mexico in U.S. dollars was 25.3, 55.3 and 64.4 billion, respectively. Much of this debt, furthermore, was short-term in nature.[46]

American banks played by far the largest role in the supply of external finance to Latin America from the mid-1970s to the present. By the end of 1982, the nine leading money-centre banks had exposure to the big three debtors, and Venezuela and Chile, between 107.5 per cent and 262.8

[44] William Cline, International Debt and the Stability of the World Economy (Washington D.C.: Institute for International Economics, 1983), 130-131. For more information, see Annex 4.

[45] See Annex 5 for more statistics on the involvement of banks in the flow of funds to Latin America.

[46] Lomax, The Developing Country Debt Crisis, 90-91.

per cent of the banks' capital.[47] The result of this exposure was a dependence on continuing interest payments on those loans by the Latin Americans, not only for support of current profits[48], but also as a signal of confidence to the banks' equity markets as to the quality of the entire debt. Another result was the potential need for official intervention if circumstances took a turn for the worse.[49]

Events did turn for the worse in August of 1982, as Mexico declared its inability to meet its external payments obligations. The sums involved were enormous and the number of banks affected was large. It was true that the largest American banks had a great deal of potential leverage in negotiations with Mexico, but realizing that potential rested on two assumptions. First, that Mexico was in fact able to meet its obligations. Ever since the 1970s, and before, there was a common belief that countries could never go broke. But this did not settle the question of whether or not countries would be able to service debt on schedule. Second, that power was contingent on the degree of cohesion within the banking syndicate; i.e., it rested on the ability

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[47] Cline, International Debt and the Stability of the World Economy, 32-34. See Annex 6 for more statistics on U.S. bank exposure to Latin America.

[48] Makin, The Global Debt Crisis, 134-135.

[49] Ibid., 36.

and will of the banks involved to take concerted action.[50]

If the history of lending to Latin America was not enough of a concern to the banks, perhaps they should have taken more heed of the warnings of American government officials and financial experts. Governor Henry Wallich of the Federal Reserve Board gave a speech in June of 1981 in which he stated that "Fundamentally, a good number of countries are borrowing amounts that cannot be continued far into the future without leading to burdens that appear unsustainable from historical experience." Anthony Soloman, then president of the N.Y. Federal Reserve, commented that the bankers were letting the need to be competitive and the thought of safety in numbers of banks involved obscure their country-risk assessments.[51]

A crucial factor in the banks' reckless expansion of Latin American sovereign portfolios was the prudential supervisory weakness demonstrated by the Federal Reserve. After all, it was a central if overshadowed stipulation of the mandate of that institution to maintain the safety of the American financial system, by ensuring that banks had adequate provisions to deal with potential problems. The Federal Reserve and the Office of the Comptroller of the

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[50] Lipson, "The International Organization of Third World Debt," 323.

[51] Greider, Secrets of the Temple, 433-434.

Currency had taken a step towards fulfilling this directive in December of 1981, but it was sadly inadequate. Together the two institutions required that banks keep on hand a higher minimum of their own capital as a hedge against their larger loan portfolios. But the seventeen largest banks were exempted, and these were the banks with the weakest capital-to-asset ratios. This exemption concretely supports Greider's contention that what was involved was a classic case of regulatory capture.[52] The largest banks were able to negotiate their exemption from the new government directives. Apart from attempts at persuasion, the Federal Reserve did not take the necessary and sufficient steps to force the largest banks on the issue of capital-adequacy. The largest banks continued to be heavily exposed when the crisis hit the next year.

When Mexico ran into serious problems in 1982, then, it was the largest American multinational commercial banks that were the most vulnerable. By extension, but to differing degrees, the rest of the American banking system was threatened, through syndicates and interbank deposits. The fact that banks had different degrees of exposure to

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[52] Ibid., 432-439. Greider contends that "The Federal Reserve ... behaved in this crucial matter much like other regulatory agencies of the federal government. It yielded to the ambitions of the industry it was supposed to regulate, instead of enforcing the larger public interest."

Latin American debtor countries turned out to be one of tremendous importance. The differences led to a divergence of views when faced with the crisis. The largest and most exposed banks did not want a sudden drop in bank lending to Latin America because that would impair Latin America's ability to service its debts, and thus the value of the banks' loans. The smaller U.S. banks, and many foreign banks, were less exposed; less exposure meant less opposition to writing off their loans and abandoning the business of lending to Latin America. Many smaller U.S. banks and foreign banks reduced their capital flows to Latin America, and this exacerbated Mexico's financial crisis. In turn, Mexico's outstanding claims were even more concentrated in the portfolios of the largest banks, and the burden of providing fresh credit was left to a smaller group of financial institutions.

Mexico was under severe economic pressures in the early 1980s. The price of its principal export, oil, was sagging because of the international recession. A number of long- and short-term loans were coming due, and fears of a devaluation of the peso led domestic and foreign holders to shift into safer currencies, such as the dollar. The rapid depletion of the government's foreign exchange reserves spread fear in the American and international financial systems that Mexico would be forced to default if it did not get some relief. This in turn would raise questions about the solvency of the largest American banks[53], and might even have led to market panic and their collapse. As in the case of Poland, it was no means certain how much the crisis in Mexico might affect other problem debtors.

The Mexican government turned directly to American public officials for emergency loans, and two institutions, the Federal Reserve and the Treasury, came to the rescue. Acting as a lender-of-last-resort, the Fed initially granted in April a short-term loan of U.S. $600 million, "to get them through the summer" and allow Mexico to undertake negotiations with the IMF. By July, Mexico required another U.S. $900 million. In August, the Fed and the Treasury organized a rescue on a much larger scale. The plan involved two government departments at home - Energy and Agriculture - and, with Paul Volcker's powerful persuasion, the help of the Bank for International Settlements, the central bank of central banks. The total amount involved was U.S. $3.5 billion.[54]

These actions were not only key to preventing an actual default on a Mexican loan, but they were also a crucial signal to the banks that the U.S. government was

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[53] Cohen, In Whose Interest?, 211-213.

[54] Greider, Secrets of the Temple, pp.484-486 and pp.516-518.

fully committed to stabilizing the situation. Without such action, many banks might have chosen another, equally rational way of dealing with the crisis. They might have tried to pursue the strategy pursued in the Polish crisis: cutting their losses and abandoning the field altogether. Indeed, that is what many chose to do in the years ahead. But the Government's actions prevented a disorderly stampede out of lending to Latin America, something which could have induced grave panic and the collapse of the largest banks. Instead, the bank syndicates organized steering committees which would conduct loan-restructuring negotiations with Mexico and the other problem debtors which would follow in Mexico's path.[55]

After the rescue of Mexico, a loose collection of U.S. tactics began to crystallize with respect to the larger Latin American debt crisis. The first and most important tactic was to move the debtors to undertake serious adjustment policies. In short, the debtors had to pursue painful austerity measures in order to rectify their balance-of-payments problems and service their debts. The second tactic was to reinforce government efforts to convince the smaller and medium-sized banks not to stampede out of lending to Latin America, and to encourage the

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[55] Ibid., 517-519.

largest banks to reduce their exposure.[56] Indeed, many commercial banks agreed to reschedule their loans and provide some fresh credit.[57] At the same time, however, the prudential supervisory institutions were pressing in the opposite direction, by pressing the banks to build up their capital/asset ratios. The institutions issued new regulations on international loans in 1984 which were meant to comply with the International Supervision Lending Act passed by Congress in 1983. Those ratios could be reduced in essentially two ways: by diverting profits from dividends toward increases in capital, or by reducing or shedding questionable assets on the balance sheet.[58]

The third tactic was to elevate the role and influence of the IMF, the World Bank, and other international financial institutions. These institutions were to provide resources to Latin America, give policy advice, and supervise debtor adherence to agreements. The role of supervision of debtor adjustment was the focus of considerable opposition in Latin America, and in performing that role, the IMF took the political backlash in Latin

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[56] Cohen, In Whose Interest?, 217.

[57] Margaret Garritsen de Vries, "The Role of the IMF in the World Debt Problem," in World Debt Crisis, ed. Michael Claudon (Cambridge: Ballinger Publishing Co., 1986), 116-117.

[58] Shelagh Heffernan, Sovereign Risk Analysis (London: Unwin Hyman, 1986), 156-157.

America for both creditor governments and the banks. The onset of the debt crisis forced industrialized countries, and especially the U.S., to expand their IMF quotas in order that the IMF could play a larger role in the management of the crisis. New IMF loans such as those to Argentina, Brazil and Mexico in January of 1983, which together amounted to roughly U.S. $10 billion, forced the U.S. alone to increase its quota to the IMF in that year by U.S. $8.4 billion.[59] In each restructuring, however, the Federal Reserve worked closely with the IMF to negotiate market-based terms.[60] And the terms included a significant increase in the price of credit.[61] The mid-1980s witnessed the initial success but increasing failure of this loosely-knit strategy to deal with the debt crisis. Mexico was the first in a round of fourteen debt restructuring agreements, covering Argentina, Brazil, and others Latin

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[59] Greider, Secrets of the Temple, 545-548.

[60] Ibid. In Greider's view, the IMF and the Federal Reserve compelled the debtors to accept the bankers' terms in negotiations. For instance, Paul Volcker of the Federal Reserve "usually supported the bankers in their persistent refusal to make any concessions on interest rates."

[61] Devlin, Debt and Crisis in Latin America, 192-193. There were extra financial costs in two ways. First, "for most debtors the financial cost of credit in real terms during the first round of reschedulings was 20% or more above that prevailing before the crisis." In addition, the banks demanded and received Latin American government direct and indirect guarantees on previously unguaranteed debt of private sector firms and agents.

American debtors. The sheer number of problems, however, led to a decline and virtual cessation of provision of fresh credit.[62] Given that many Latin American nations were making considerable and successful efforts to reduce their balance-of-payments deficits[63], it became obvious that what was happening was a de facto but unannounced bailout of the the largest American banks. New resources would be channeled to the Latin American debtors, largely by the IMF and other international financial institutions, and it would be quickly sent to the banks in the form of debt service. In this way, the facade of the solvency of the banks and the creditworthiness of the Latin American borrowers was maintained, but at ever higher levels of debt.[64]

If the private banks continued their flight from lending to Latin America, however, the course of the crisis would certainly lead debtor governments to increase their opposition, and perhaps precipitate confrontation and crisis. Indeed, this was almost the case in 1984 and 1985.

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[62] United Nations, ECLAC, Transnational Bank Behaviour and the International Debt Crisis, 1989, 52.

[63] Sebastian Edwards, "Structural Adjustment Policies in Highly Indebted countries," in Developing Country Debt and the World Economy, ed. Jeffry D. Sachs (Chicago: University of Chicago Press, 1989), 251-252. Edwards argues that the closing of current account deficits was accomplished mostly by the retrenchment of imports and investment.

[64] Greider, Secrets of the Temple, 548-550.

Despite the elevated quotas of the IMF and the World Bank, international financial institutions could not realistically be expected to fill the financial void. If the void were left unfilled, the Latin American debtors would wonder about the benefits of cooperation and continued debt service, and some form of default strategy, or collective debtor action, might ensue.

From 1983 to 1985, events occurred which seemed to reinforce this possibility in important ways. First, there developed social unrest in several Latin American nations - the case of Brazil was prominent. Widespread strikes and confrontations between workers and police sprang up as a result of recession and austerity. This capped the increasing effects of growing unemployment and poverty.[65] These consequences led Brazil to question the viability of continuing its debt service and adoption of IMF policies. As early as mid-1983, Brazil, Argentina, Venezuela, and others were beginning to back away from fulfilling commitments undertaken during the rescheduling process.[66] In addition, in June of 1984, several Latin American debtors met in Cartagena, Colombia, in order to deliver a common statement about the debt problem, and express unity. As

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[65] Lever and Huhne, Debt and Danger, 100-104.

[66] Makin, The Global Debt Crisis, 232-233.

will be shown later, this expression of unity prompted the banks and the U.S. government to reconsider their attitudes toward the crisis. Finally, in 1985, Peru formally limited its debt service payments to 10 per cent of its export earnings.[67]

6. <u>Conclusion: Early Crisis Management</u>

The strategy which was implicitly followed in the first two years after the Mexican crisis in 1982 was plainly unsustainable, for two reasons. First, the debtors could not continue austerity policies and debt service indefinitely, without the prospect of relief in the foreseeable future. Political unrest and the undermining of the Latin Americans' ability to repay would likely overcome their commitments to debt service. That fear of debtor fatigue' would continue to lead the commercial banks to reduce their lending and exposure to Latin America, and thus the reward for the Latin Americans' sacrifice was not materializing as planned.[68] The harsh terms of rescheduled loans[69] and the growing debt levels gave little promise to

[67] Devlin, <u>Debt and Crisis in Latin America</u>, 222-225.

[68] Paul Krugman, "Private Capital Flows to Problem Debtors", in <u>Developing Country Debt and the World Economy</u>, ed. Jeffry Sachs (Chicago: University of Chicago Press, 1989), 287.

[69] United Nations, ECLAC, <u>Transnational Bank Behaviour and the International Debt Crisis</u>, 1989, 57.

Latin American debtor governments that sacrifice would bring anything in return.

Second, the fear of debtor fatigue, the inequality of returns to differently positioned banks in syndicates, and the appeal of "sound bank management" were all helping to create a divergence of strategies in the American banking community. The smaller regional and local banks, for which international lending was a relatively small venture, and for which the return from participating in syndicated loans was relatively small, demonstrated a consistent preference for selling Latin American loans on secondary markets. The fear of debtor fatigue was reinforced by the appeal of sound management: if it is thought likely that the borrower will fail to fulfill its obligations, why throw good money after bad?[70] In addition, there is evidence that steering committee members, usually the largest banks involved, used their position not only to strengthen their position vis-a-vis the debtor countries on behalf of the syndicate, but they also acted to increase their income and portfolio security at the expense of other banks.[71] The record of the smaller banks proves that many were successful in

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[70] Greider, Secrets of the Temple, 549.

[71] United Nations, ECLAC, Transnational Bank Behaviour and the International Debt Crisis, 1989, 46.

abandoning the business.[72] That success was raising questions about the supply of finance to the Latin American debtors, given that the IMF and other multinational institutions did not have nearly enough resources to fill the void and remain prepared to solve other potential problems.

The sum of these forces was to make for bleak prospects for the successful resolution of the Latin American debt crisis. The immediate goals of the U.S. government were being accomplished in that the collapse of the largest banks had been avoided. But the debtor countries' situation was deteriorating: they were simply piling on more debt in order to keep current on their debt-service obligations. In fact, this exacerbated the crisis for the Latin American countries. Again, the U.S. government would have to come to the rescue, this time in the form of the Baker Plan. As we shall see, the Baker Plan was not very different from the original strategy, and the Plan contained the same contradiction: the protection of the banks prevented the resolution of the larger crisis.

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[72] Ibid.

Chapter Three

The Rescue

1. Introduction

As mentioned in the previous chapter, the U.S. government set out at the beginning of the Latin American debt crisis to manage its course and mitigate the impact on American commercial banks. The management strategy included the goals of debtor adjustment and debt service; larger roles for international financial institutions in the areas of the supervision of, and the supply of finance to, Latin American debtor countries; and, most importantly, the orderly reduction of bank exposure to the debtor countries. Efforts toward all three goals have achieved some success, but a contradiction among the goals appeared very early on. The goal of reducing bank exposure has undermined the chances of continued debtor adjustment and debt service.

This chapter will demonstrate how the contradiction among the goals of the U.S. strategy allowed the Latin American facet of the crisis to threaten the American banking system once more in 1984 and 1985. In addition, it will be demonstrated that the U.S. strategy was not will be demonstrated that the U.S. strategy was not substantially altered in response to the problems of the mid-1980s; in fact, the strategy was only slightly modified and reasserted as the solution to the crisis.

The reason for the lack of substantial change can be found within the relationship between the U.S. government and American banks: many of the latter were still too fragile, with problems of excessive exposure in Latin America and a lack of international competitiveness, to be able to contribute more to the resolution of the larger crisis. In fact, equity markets and official authorities were punishing those banks that did not attempt to reduce their exposure to Latin America, in order to meet the challenges from international competition. Thus the U.S. government continued to promote essentially the same tactics. As a result, the early strategy, with all of its problems, has become institutionalized as the accepted way of dealing with the Latin American debt crisis.

2. The Mechanics of the Early Strategy

Commercial banks, the U.S. government and debtors all achieved some important objectives under the first round of reschedulings. Restructured loan agreements, including longer maturities and new money packages, helped many creditors to keep the loans on their books at 100 per cent of face value. The IMF and the World Bank aided this process by extending funds and supervising debtor adjustment. These actions in turn allowed the banks to maintain their profit levels and appear attractive in stock and credit markets, while the creditor governments attempted to retreat from the role of direct and prominent intervention.[1]

The debtors were also relieved. The eruption of a widespread and protracted payments crisis might have shut down their access to international credit markets, and interfered with their ability to conduct international trade and generate current account surpluses. The debtors hoped that the new agreements would tide them over their temporary liquidity problems, until world economic recovery could reverse their fortunes.[2]

However, the U.S. strategy which governed the development of the first two rounds (1982 - 1984) turned out to be incapable of providing a lasting solution to the debt

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[1] The U.S. and other OECD governments consistently tried to limit their official intervention in the crisis, even during the Baker and Brady Plans. See John Calverly and Ingrid Iversen, "Banks and the Brady Initiative," in Third World Debt: Managing the Consequences, ed. Stephany Griffith-Jones (London: IFR Publishing, 1989), 133.

[2] Peter Kenen, "The Use of IMF Credit," in The IMF in a Multipolar world: Pulling Together, eds. Catherine Gwin and Richard Feinberg (Washington, D.C.: Overseas Development Council, 1989), 78. Stephany Griffith-Jones, "A history of debt crisis management," chap. in Third World Debt (London: IFR Publishing, 1989), 10-16.

crisis. The banks continued to reduce their Latin American exposure, both out of self-interest, and out of pressures exerted by the International Lending Supervision Act signed in 1983 and the new regulations issued by U.S. regulatory authorities in 1984. Conversely, several debtors were failing to comply with IMF programmes, as a result of domestic backlashes against austerity measures. The deterioration of the debt situation, and the potential consequences of such a deterioration for what was still a large number of U.S. commercial banks, which had necessitated official intervention two years before[3], brought first the Baker Plan and then the Brady Plan.

There are at least three continuous themes over the course of the evolution of U.S. strategies to manage the debt crisis: 1) the emphasis on mandatory debtor adjustment; 2) voluntary commercial bank cooperation and exposure reduction; and 3) the emphasis on the growing role of international financial institutions. These themes have been relatively stable because they serve the following U.S. objectives. The primary emphasis on debtor adjustment at once accentuates the responsibility for the debt crisis on debtors and mitigates such responsibility for the commercial banks and creditor governments. With less responsibility,

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[3] Spero, The Politics of International Economic Relations, 79.

the banks have been accorded the freedom to wind down their involvement in lending to Latin America, and pursue other lines of business. This is the case in spite of the public exhortations of creditor governments for the banks to extend new funds to Latin America. Furthermore, the U.S. is overseeing the transfer of Latin American debt from its commercial banks to international financial institutions; in this way, U.S. commercial banks benefit as the U.S. government spreads the risk of debtor default onto other creditor governments as well.

There were important changes in the strategy over the rest of the 1980s, however. The first two rounds of restructurings proved to be very different from those that followed. The results of the former were clearly more favourable to the creditor banks, but the degree of favour tended to decline over successive rounds. Changes in creditor unity, debtor resistance, and creditor government involvement contributed to this development. These forces also combined to drag the Latin American debt problem from crisis to crisis, and spur the U.S. government to adjust its strategy.

3. The Market' Solution

As mentioned in the second chapter, the U.S. initially promoted what it called a market' solution. But it was not really a market solution. More accurately, it was a strategy which endorsed the repayment of debt on contractual terms, and which sponsored direct and indirect U.S. government intervention to reinforce the bargaining power of the banks vis-a-vis the debtors, and thus the stability and competitiveness of American banks. The market' part of the strategy involves the aim of ensuring that contractual obligations would continue to prevail in the repayment of the debt - it would be repaid in full, on original market terms.

The initial outcomes for both sides reflected this imbalance of power: many banks were able to report relatively high profits for several years[4], while Latin American nations were forced into austerity and deep cuts in current account deficits.[5] By 1984, however, the original distribution of power began to falter and shift away from creditor dominance, with the potential for renewed uncertainty and crisis. The official American response was the Baker Plan, an apparent commitment to a different solution.

It must be remembered that the market power of the banks was quite strong before the advent of the crisis. One

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[4] Devlin, Debt and Crisis in Latin America, 235.

[5] Edwards, "Structural Adjustment Policies in Highly Indebted Countries," 249.

market-related factor was the oligopolistic nature of the banking sector. Banks can easily identify, and communcate with, each other. Moreover, the evolution of syndicates, which had helped to organize the growth of lending to Latin America in the 1960s and 1970s, provided a channel for communication after the eruption of the crisis. These syndicates formed Steering Committees in the wake of the Mexican payments crisis to represent their interests, and to offer a strong, unified position in negotiations with the debtors.[6] Moreover, lending among banks in syndicates tended to be concentrated in the largest banks, giving them overwhelming decision-making power within the Steering Committees, and thus the syndicates.[7] Given these elements of organization, the banks were in the position to drastically reduce the flow of credit to recalcitrant debtor countries.

The U.S. government put a great deal of pressure on the banks to act in their collective (as opposed to individual) self-interest, by extending new loans and changing some terms of the debt being restructured. Even though further lending seemed to be an anathema to the

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[6] United Nations, ECLAC, The Evolution of the External Debt Problem in Latin America and the Caribbean, 1988, 12.

[7] United Nations, ECLAC, Transnational Bank Behaviour and the International Debt Crisis, 30-31.

banks, lending was extended. It soon fell rapidly over the years since 1982, however. In 1982, the growth in bank debt to problem debtors was U.S.$6.1 billion; in 1982, it was U.S.$3.1 billion; in 1983, it declined by U.S.$0.1 billion.[8] The U.S. government was more successful in getting the banks to reduce interest spreads and fees, and undertake major, multi-year debt restructurings.[9]

But bank cooperation would not save them from a chain of debtor country defaults: a simultaneous default of just Argentina, Brazil and Mexico would be enough to cripple the leading money-centre banks. The US government therefore set the tone of crisis management from the beginning. Treasury Secretary Donald Regan and Federal Reserve Chairman Paul Volcker insisted that debtor country adjustment was the key to the resolution of the crisis, and that only direct negotiations between the banks and the debtor governments would resolve the issue. In addition, debt reduction was ruled out as a possible approach - the debt would have to be repaid in full on commercial terms.[10] This management

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[8] Krugman, "Private Capital Flows to Problem Debtors," 289.

[9] Richard Feinberg, "LDC Debt and the Public Sector Rescue," in International Political Economy, ed. Jeffrey Frieden and David Lake (New York: St. Martin's Press), 400.

[10] Jeffrey Sachs, "Making the Brady Plan Work," Foreign Affairs 68, no.3 (Summer 1989): 92. Robert Wesson, "Wrapping Up the Debt Problem," Symposium 23, no.3 (September 1990): 422.

tactic ensured that the banks' income and asset quality would not be threatened by uncertainty regarding the matter of repayment. This in turn would reinforce the strength of the banks in credit and equity markets.

The U.S. government also took action to keep the debtors afloat temporarily, and reduce the vulnerability of the banks. The U.S. government helped to arrange for the provision of short-term bridge financing, both directly and through the BIS, so as to alleviate their liquidity problems and prevent them from declaring moratoria on debt service payments. Direct government operations were carried out through short-term "swap" lines of credit from the Federal Reserve System and the Treasury Department's Exchange Stabilization Fund.[11]

BIS?

The U.S. also helped to arrange a U.S.$1 billion bridging loan through the BIS for Mexico in 1982, and the BIS has provided other emergency bridging loans to several debtors since.[12] In this way, the U.S. reduced the individual lender-of-last-resort burden for the U.S. Treasury by sharing the costs with other central banks. Thus, ironically, other nations helped to ensure that the debtors would have enough financial resources to continue

[11] Feinberg, "LDC Debt and the Public Sector Rescue," 396.

[12] Spero, The Politics of International Economics, 79.

debt service payments to American commercial banks.[13]

The U.S. acted through another multilateral channel: the U.S. government reinforced the IMF as a powerful and central actor in the international debt situation.[14] The IMF in turn helped the situation of the banks in at least four ways. First, almost all bank rescheduling packages were conditional on the debtor accepting IMF stabilization programmes, compliance with which signalled the commitment of the debtors to cooperation, and to austerity programs. In return for adherence to painful macroeconomic-policy reform prescriptions and the continued service of debt on market terms, the IMF helped to mobilize bank cooperation in negotiations for debt restructurings and new money packages.[15]

Clearly, however, the IMF served the banks in an important way. The banks had limited capacity to ensure that foreign governments paid their debts, and the IMF helped to pressure governments into making political decisions which would ensure adjustment and debt service.[16]

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[13] Wellons, <u>Passing The Buck</u>, 246-247.

[14] Ibid., 219.

[15] United Nations, ECLAC, <u>The Evolution of the External Debt Problem in Latin America and the Caribbean</u>, 1988, 12-13.

[16] Congress, Senate, Subcommittee on International Finance and Monetary Policy, of the Committee on Banking, Housing, and Urban Affairs, <u>International Debt</u>, 98th Cong., 1st Sess., 14, 15 and 17

In this way, the IMF became a debt collector for the banks.[17] As well, while the IMF tried to persuade the banks to lend more money, the IMF had no authority to force the banks to lend.

The IMF also helped to transfer billions of dollars worth of its own resources to the Latin American debtors. This was vital to the rescue of Mexico in 1982, as the IMF extended U.S.$3.84 billion in credit between 1983 and 1985. When seen against the backdrop of continually decreasing new money packages from the banks[18], IMF transfers were especially helpful in helping the debtors maintain private bank debt service and the facade of creditworthiness, and the banks to maintain the appearance of stability and profitability.[19] The U.S. aided this transfer of resources by agreeing, after considerable internal debate, to enlarge

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February 1983, 170-171. Testimony of Richard Debs, President, Morgan Stanley International, Inc., on behalf of the Chamber of Commerce of the U.S.

[17] John Loxley, Debt and Disorder (Boulder, Colo.: Westview Press, 1986), 117.

[18] United Nations, ECLAC, Transnational Bank Behaviour and the International Debt Crisis, 1989, 52.

[19] Jeffrey Sachs, "Strengthening IMF Programs in Highly Indebted Countries," in The IMF in a Multipolar World, ed. Catherine Gwin and Richard E. Feinburg (Washington, D.C.: Overseas Development Council, 1989), 104.

quotas in 1984. The U.S. portion amounted to $8.4 billion.[20]

The third way in which the IMF helped to reinforce the position of the banks was its role in using moral suasion' to get the great majority of private banks, and especially the smaller, less exposed banks, to cooperate with its own strategy of providing new resources to reforming debtors. Bank cooperation was a key to unity in the banking community; if all banks acted in unison, there was less potential for centrifugal forces to develop within the community, and less potential for debtors to exploit the differences within the community. Despite this, not all banks were in the same position, and more and more wanted out. The IMF tried to persuade the banks to forego that option.[21] The U.S. Federal Reserve also played a crucial role in this regard, by having its regional banks to exert pressure on the smaller banks to continue their

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[20] Jeffrey Frieden, Banking on the World (New York: Harper and Row, 1987), 189.

[21] Devlin, Debt and Crisis in Latin America, 219. "... bank regulatory authorities in the U.S. and elsewhere were usually tolerant of the creative accounting of the banks; this insulated the lenders from a market valuation of their problem loans in the region and assuaged political dissension among institutions with different abilities to write down their assets." See also Howard J. Wiarda, "The Politics of Third World Debt," Symposium 23, no.3 (September 1990).

participation in lending to Latin America.[22]

The fourth way in which the IMF helped to strengthen the position of the banks was its concurrence with traditional U.S. views on several aspects of debt crisis management: orthodox financial policies would form the core of adjustment programmes. For instance, in agreement with the U.S. Treasury, the IMF refused to consider the possibility of partial debt reduction or forgiveness. Second, again in agreement with the U.S. Treasury, the IMF insisted that each case should be treated separately. The former prohibited consideration of what was a potential key to bank insolvency, and an incentive for debtor cooperation[23]; the latter prohibited a strategy which would enhance the debtors' negotiating position - cooperation and collective action.[24]

The early reschedulings therefore set the scene for later debt management. The banks were sheltered, and their power was reinforced, while a financial squeeze was enforced upon the Latin American economies. The latter showed a

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[22] Wellons, Passing the Buck, 256.

[23] Jeffrey Sachs, "Conditionality, Debt Relief, and the Developing Country Debt Crisis," chap. in Developing Country Debt and the World Economy (Chicago: University of Chicago Press, 1989), 275-277. See also Jeffrey D.Sachs, "Making the Brady Plan Work", p.89, in Foreign Affairs 68, no.3 (Summer 1989): 89.

[24] Devlin, Debt and Crisis in Latin America, 220.

dramatic improvement in the current account, but this improvement came about as a result of a sharp drop in imports and investment rather than from a rise in exports. The effect of this strategy in turn deprived many nations of the vital resources needed for private and public production and investment, thus impairing their future capacity for economic growth and debt service.[25] Moreover, while reschedulings included a grace period and a stretched payment schedule, they only piled on more debt for Latin America. Finally, the real economic issues, as perceived by the debtors, remained unresolved.[26]

4. <u>The Unravelling of the Original U.S. Strategy</u>

The original U.S. strategy, the so-called market' approach, began to unravel because of increasing divisions among the private banks involved, the deteriorating circumstances, and changes in the strategies, of debtor governments, and the growing pressure of domestic prudential supervisory authorities in the U.S. on the banks.

The growing division among the banks was based on the degree of exposure of different banks to Latin American

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[25] Christine Bogdanowicz-Bindert, "World Debt: The U.S. Reconsiders" <u>Foreign Affairs</u> 64, no.2 (Winter 1985-1986): 266-267; and Karin Lissakers, "Closing the Books on Third World Debt" <u>Journal of International Affairs</u> 42, no.1 (Fall 1988): 137.

[26] Kettle and Magnus, <u>The International Debt Game</u>, 150-158.

countries. Exposure refers to "the maximum potential loss if the borrower does not repay." The decline of new lending was largely brought about by the retreat of smaller banks which had joined the lending boom late in its cycle, and which consequently had less exposure. Once the crisis hit there were immediate incentives for the smaller banks to defect from new lending packages. Three such incentives were a) the lack of additional fee income from restructuring agreements (which Steering Committee members received)[27]; b) the possibility of being able to free-ride' on the willingness of other larger banks to make bailout loans, and thus improve the quality of all outstanding loans; and b) the possibility of gaining competitive advantages vis-a-vis the more heavily exposed banks as far as bank depositors, customers, and equity markets are concerned.[28]

Moreover, many European and Japanese banks were either more conservative in their lending practices, or better provisioned through the efforts of stricter regulatory authorities. Similar to the smaller U.S. banks,

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[27] United Nations, ECLAC, Transnational Bank Behaviour and the International Debt Crisis, 1989, 46.

[28] Jack Guttentag and Richard Herring, Accounting for Losses on Sovereign Debt: Implications for New Lending, Essays in International Finance (Princeton, N.J.: Princeton University Press, 1989), 12-24; and Jack Guttentag and Richard Herring, The Lender-of-Last-Resort Function in an International Context, Essays in International Finance (Princeton, N.J.: Princeton University Press, 1983), 6.

new lending made no sense for these banks.[29] This put a tremendous amount of pressure on the largest banks. Before 1984, many banks, and particularly the largest banks in the Steering Committees, were able to extract relatively profitable terms in negotiations with the debtors. The first two rounds restructured approximately U.S $49 billion, with the average spread at 2.25 per cent over LIBOR (the London Interbank Offered Rate) and the average commission at 1.25 per cent In effect, the banks had roughly doubled the cost of new loans, compared with 1980-81.[30] Moreover, with the major debtors locked into recently-negotiated restructuring agreements and debt service being carried out, the banks were being given the resources necessary to improve their capital reserve ratios.[31]

The banks, ironically, were apparently benefiting from a debt crisis. However, this depended largely on the unwillingness of regulatory authorities to refrain from taking action. As long as debtors appeared able and willing to pay, this remained only a remote possibility. However,

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[29] United Nations, ECLAC, The Evolution of the External Debt Problem in Latin America and the Caribbean, 1988, 18-19. For an analysis of the application of free-rider theory to the changes in bank negotiating positions, see Paul Krugman, "Private Capital Flows to Problem Debtors."

[30] Sue Branford and Bernardo Kucinski, The Debt Squads, p.115.

[31] Jeffrey Sachs, "Making the Brady Plan Work," 90.

since it was indeed a crisis, and the capacity of the debtors to repay their debt was at least suspect, the loans should have been more closely inspected by the regulatory authorities in the U.S. Under normal conditions, the banks would have had to set aside profits as a precaution against bad loans. But that would have exacerbated the banks' problems at a time when they were already facing enormous challenges. The Federal Reserve and Treasury played a key role by urging bank regulators to be more understanding' of the banks' problems. Paul Volcker himself said that "We're all being induced to close our eyes to loose banking practices."[32]

This regulatory environment began to change just a year after the Mexican crisis. The natural incentives of the banks to reduce their exposure to Latin America were compounded by the growing support in Congress, the Treasury, and especially the regulatory institutions, for tighter standards and better enforcement. The Federal Reserve and the Comptroller of the Currency pressed undercapitalized banks to improve their capital base and meet the new, higher capital requirements. This included the largest banks, which had been exempted from the new capital ratios of 1981. These steps were supposed to improve the abilities of the

[32] Greider, Secrets of the Temple, 635-636.

banks to deal with debtor default. In addition, the Comptroller imposed a regulatory order on two large banks which directed them to tighten their lending policies.[33] These official measures ended up squeezing the finances of the banks, however, and one result was the continued decrease of bank credit to Latin America.

With fresh credit being reduced, the conditions of slow growth, rising unemployment, and continued high inflation were all intensified in the Latin American debtor countries. The political response in Latin America was to question cooperation with the banks and the lack of cooperation among debtors. They questioned the short-term distribution of burdens, whereby debt service commitments were being fulfilled at great cost, while banks reaped tremendous profits and reduced new lending and exposure. The Latin Americans also questioned whether the debt crisis was indeed a temporary one: although the world economy was beginning to recover in 1984, the effect on Latin America was less beneficial than expected. A further change, at least in several nations, occurred in the way the costs of default were interpreted: would all banks cut off the supply of finance to a nation if it defaulted on a portion of its service payments? Could the Latin American nations sustain

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[33] Ibid., 636-637.

and counteract the costs which would flow from such an event?[34]

Reconsideration of all these issues brought different reactions from Latin American debtors. Several participated in talks about the debt issue in 1984. These contacts took several forms, from informal, regional and bilateral governmental meetings to the formation of the Cartegena Consensus, the establishment of a "G-3" consultation group and the holding of a "G-8" Presidential Summit. In addition to the fact that this kind of cooperation might strengthen the Latin American negotiating position on commercial bank debt, the three largest debtors (Argentina, Brazil and Mexico) were prominent supporters of the initiatives. Together they had the power to threaten a large number of banks with default and insolvency, and seriously destabilize the entire international financial system.[35]

The overall pattern of cooperation was therefore supplemented by increasing resistance of individual debtors to banks' demands, and more confrontational policies. Despite the fact that Argentina had signed a restructuring agreement, it had toughened its negotiating position by

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[34] United Nations, ECLAC, The Evolution of the External Debt Problem in Latin America and the Caribbean, 1988, 27-30.

[35] Ibid., 30.

accumulating arrears while insisting that only new loans would settle them. The new democratic government in Bolivia announced its intention of limiting debt service to 25 per cent of export revenue. Finally, even Peru, which had only restructured its debt the year before, could not keep up with its payment schedule. In April of 1985, Alan Garcia won the Peruvian elections with a programme that included confrontation with creditors. In July, Garcia announced that Peru would unilaterally limit its debt service to 10 per cent of export earnings.[36]

A final factor which shifted power away from the creditor banks was the growing opposition of both the Latin American debtors and the banks to the IMF. The IMF shouldered most of the public criticism for the austerity being imposed through its adjustment programmes. The legitimacy and potency of the IMF as an intermediary in the crisis waned when food riots, protests, strikes, looting, and violent demonstrations came in reaction to the austerity measures, and many Latin American governments ended compliance with IMF programmes in response.[37] The banks also came to see the IMF as part of the larger problem,

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[36] United Nations, ECLAC, Transnational Bank Behaviour and the International Debt Crisis, 1989, 97-99; and Devlin, Debt and Crisis in Latin America, 222.

[37] Howard Wiarda, "The Politics of Third World Debt," Symposium 23, no.3 (September 1990): 14.

particularly when its net transfer of resources began to decline in the mid-1980s and turn negative in 1986. This meant that the banks that were lending fresh credit to Latin America would be helping the Latin Americans repay the IMF. It in effect turned into a free rider.[38]

5. The Baker Plan

Given these developing problems, U.S. Treasury Secretary James Baker altered elements of the original American strategy. Baker announced his plan at a joint meeting of the IMF and World Bank in Seoul, 1985. The Plan targeted two groups, one involving the fifteen largest debtors (consisting mainly of Latin American countries), and the other involved Sub-Saharan African countries. For the purposes of this thesis, only the provisions of the Baker Plan concerning the first group will be considered.

The Plan called for each of the participants to intensify their efforts to resolve the debt crisis:

> First, it called for the adoption by debtors of comprehensive macroeconomic and structural policies to promote growth, to adjust the balance of payments, and to reduce inflation. Adjustment followed the orthodox model which emphasized reliance on the private sector, the undertaking of supply-side actions to facilitate efficient

[38] United Nations, ECLAC, The Evolution of the External Debt Problem in Latin America and the Caribbean, 1988, 24.

investment, and liberal international trade policies. The second element was the continued central role for the IMF as the coordinator of policy reforms and sustained capital flows. The World Bank also was asked to increase structural adjustment lending. The Plan proposed a fifty percent increase in their lending, from $6 billion to $9 billion over a three year period, with the World Bank supplying two-thirds of the increase. Third, the Plan called for commercial banks to extend new lending of about $7 billion annually ($20 billion over three years) to the fifteen major debtors.[39]

The major change was a change of focus, from austerity to economic growth, as to the means by which debtor governments should meet their debt service obligations.[40] The specific elements of the Baker Plan reflect this change of focus: the creditor banks and the official international financial institutions would support the process of debtor economic growth with a larger supply of finance (U.S.$20 billion and $9 billion were called for, respectively). This would aid and reward successful debtors for their structural adjustment and faithful debt service.[41]

Another new aspect of the Baker Plan was the

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[39] Howard Lehman, "Strategic Debt Bargaining of International Creditors," Paper presented at the annual meeting of the ISA, Vancouver, B.C., 19-23 March 1991, 7.

[40] Christine Bogdanowicz-Bindert, "World Debt: The U.S. Reconsiders," 268.

[41] Devlin, Debt and Crisis in Latin America, 195.

enhanced role to be played by international financial institutions. The IMF was again a central actor, but its level of disbursements was to be raised. It was furthermore interesting to note that the World Bank in particular, once suspected of being too socialist by the Reagan Administration, was now to take on a much greater role in the debt crisis by increasing its disbursements by roughly 50 per cent, by streamlining and shortening the application process, and by providing guarantees for direct investments in developing countries. The reinforcement and enhancement of the roles played by the international financial institutions attempted to recognize the limited success of market-oriented financing measures by supplementing them (if not replacing them) with official funds.[42]

Despite the virtues of the Baker Plan, it was critically flawed. The Plan overestimated the willingness of the banks and debtor governments to behave in their prescribed ways. The Baker Plan called on the banks voluntarily to offer debtors access to larger amounts of credit, but the banks did not want to lend more money; indeed, without explicit guarantees offered by the govrnments of industrialized countries, they reduced what

[42] Lehman, "Strategic Debt Bargaining of International Creditors," 7.

access they could.[43] That which was made available was considered involuntary' lending.[44] The debtor governments, on the other hand, did not want to implement strict austerity plans without concessions from the banks, in terms of either new money packages or debt service relief, which might contribute to economic growth.[45]

The reluctance of the banks to provide new loans was based on many of the same reasons that prodded them to abandon the business back in 1982. Many of the factors which supported those decisions had even strengthened. For one, it was increasingly questionable that Latin America was becoming more creditworthy over time. In many respects the situation had deteriorated. Debts grew (if more slowly) while the capacity to repay diminished. Repayment capacity was especially affected by the decline in domestic investment, which was reduced in order to make debt service payments in the first place, but which was also key to the future capacity of debtors to service their debts.[46] The fears of bankers about Latin American countries were being

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[43] Christine Bogdanowicz-Bindert, "World Debt: The U.S. Reconsiders," 268-269.

[44] United Nations, ECLAC, The Evolution of the External Debt Problem in Latin America and the Caribbean, 1988, 26-27.

[45] op. cit., p.26.

[46] Karin Lissakers, "Closing the Books on Third World Debt," 137.

exacerbated by two other developments: the decline of bank lending and the relatively minor impact of the OECD recovery.[47] In particular, the continued weakness of commodity markets gave both banks and debtors a less than sanguine view of debtor growth prospects.[48]

The banks also continued to feel pressure from the vulnerability to investor fears in equity markets. Those markets were conveying the message that Latin American loans were not considered quality assets, and therefore bank stocks would lose value if those loans were not dealt with realistically.[49] The effect of this view of Latin American loans in particular was compounded by the scare given bank investors because of the near collapse of Continental Illinois in 1984, then the eighth largest commercial bank in the U.S. These pressures led to the growth of the secondary debt market, in which debt is traded at a discount. In this way, the market has developed a gauge of the real value of those loans, the capacity to evaluate the efforts of banks to treat them as value-impaired', and provided a viable

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[47] Pedro-Pablo Kuczynski, "The Outlook for Latin American Debt," Foreign Affairs 66, no.1 (Fall 1987): 134-135.

[48] Rudiger Dornbusch, "Debt Problems in the World Macroeconomy," in Developing Country Debt and the World Economy ed. Jeffrey Sachs (Chicago: University of Chicago Press, 1989), 302-303.

[49] Heffernan, Sovereign Risk Analysis, 150.

option for shedding those loans.[50]

Not all banks were well placed to meet the challenges of the equity markets. European, Japanese and the smaller U.S. banks were withdrawing from the Latin American loan market with relative ease, because of generally less exposure and stronger capital reserve positions. This left the largest U.S. banks at a severe disadvantage - not only could they not pressure the other banks to participate in new lending to Latin America, but the markets were rewarding the latter for not doing so. This influenced the largest U.S. banks to finally begin the process of setting aside relatively large reserves against existing loans, and reducing the numbers and amounts of new loans.[51]

The incentive to take those actions came not just from the stock market, but also from the combined pressure of prudential supervisory authorities in the U.S. and elsewhere. As mentioned, those authorities began to take a more critical view of the adjustment efforts of the banks,

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[50] Stanley Fischer, "Resolving the International Debt Crisis," in Developing Country Debt and the World Economy, ed. Jeffrey Sachs (Chicago: University of Chicago Press, 1989), 316; United Nations, ECLAC, Transnational Bank Behaviouur and the International Debt Crisis, 1989, 108-109; and Karin Lissakers, "Closing the Books on Third World Debt," 143. See Annex 7 for values of Latin American loans in secondary debt markets in 1988.

[51] United Nations, ECLAC, The Evolution of the External DEbt Problem in Latin America and the Caribbean, 1988, 18-19.

and this was especially true of the U.S. authorities and the largest American banks. The authorities issued new regulations on foreign lending in 1984 in order to comply with provisions set out by the International Lending Supervision Act signed in 1983. These regulations required the establishment of reserves against international loans, increased reporting of country exposures, and a more realistic account of income derived from those loans.[52] The desired effect for the regulators was synonymous with their vision of the collective interest of the banks: the reduction of exposure.[53]

Finally, the Baker Plan overestimated bank cooperation with the debt strategy because the banks pursued lending opportunities in the OECD area. Since 1979 there had been a movement in OECD economies toward the elimination of capital controls. This movement included provisions for increased foreign access to domestic markets and the deregulation of financial institutions to compete in previously restricted activities.

In addition, large and profitable lending opportunities appeared in the OECD area: examples include corporate merger proposals, infrastructural megaprojects,

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[52] Heffernan, Sovereign Risk Analysis, 156-157.

[53] Ibid.

and U.S. Treasury bonds (which carried high real interest rates in order assure the financing of U.S. budget deficits). In response to all these incentives, OECD-based bank lending outside the developed-country sphere, even to faithful debtors and non-rescheduling countries, has continued to decline dramatically.[54]

The Baker Plan's expectations about new money from the banks were far too optimistic. The threat from this mistake was that without new money, the debtors would not continue to service their debts. Without debt service, the largest U.S. banks would once again be threatened.

The prospects for a successful third round of rescheduling seemed rather dim. Negotiations between the banks were difficult and protracted. The process was jolted into motion once again by the developing financial difficulties of Mexico, this time in 1986. A combination of falling oil prices and a large earthquake in 1985 forced the Mexican government to demand either debt service relief or more new money, if a moratorium on payments due in 1987 was to be avoided. Mexico became the Baker Plan's first successful rescheduling case in 1986, but only after U.S. Federal Reserve Board Chairman Paul Volcker exerted great

[54] Karin Lissakers, "Closing the Books on Third World Debt," 140-141; Wachtel, The Money Mandarins, 175-178; and Eric Helleiner, "The Unplanned Child."

pressure on the banks to participate.

The banks were opposed to the style that the authorities used in arranging the agreements: the banks were allowed little chance to negotiate their form and level of participation, and were instead informed' of their expected commitments and concessions. The banks would not stand for this unexpected tactic in the debt strategy:

> By the last quarter of 1986 Chile, Venezuela, Argentina, and Uruguay had already knocked on their bankers' doors asking for "the Mexican treatment." Bankers, however, let it be known that the Mexican resceduling was a special case; indeed, Citibank publicly went on record to declare that it opposed any more concessions for the debtor countries.

This was important, for its contributed to a rift between U.S. banks and their government, and further discord in the creditor community.[55] The Baker Plan continued to stumble, therefore, and no other agreements were signed until 1987.

The third round of restructurings was eventually completed with the Argentina, Chile, Uruguay and Venezuela, but only after Ecuador and Brazil declared moratoria on their debt payments in January and February of 1987, respectively. Given that many of the largest banks still had considerable exposure to Latin American debt, the Brazil moratoria caused bankers "to reaffirm their unity." They

[55] Devlin, Debt and Crisis in Latin America, 230-231.

concluded agreements with Argentina, Chile and others partly in order to demonstrate to Brazil, and others which might follow it, the potential rewards of "staying within the international financial system".[56] As it turned out, Brazil came back to the negotiating table within the year, and began to make interest payments. This was rewarded with a restructuring deal and U.S.$5.2 billion in new credit.[57]

Although the banks demonstrated considerable cohesion in reacting to the Brazilian moratorium by arranging the third round of restructurings and new money packages, a number of banks took steps to set aside large reserves against outstanding loans. The Brazilian move adversely affected bank stock prices as Moody, a prominent credit rating agency, downgraded the credit rating of most major banks. Brazil's declaration also produced a sharp drop in the prices in the secondary market for country loans. In reaction to Brazil's declaration, and the recent U.S. signing of the capital standards agreement, Citicorp set aside U.S.$5 billion in May of 1987 as a provision against possible losses on its outstanding loans. Because of competitive, supervisory and other pressures, other American banks followed suit, and by the end of 1987, a

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[56] Ibid.

[57] Ibid.

total of U.S.$19 billion had been added to loan-loss reserves. As these steps were taken, the exposure of the banks was reduced, their incentive to lend more money was reduced, and the banks improved their bargaining power with respect to debtors.[58]

6. The Market Menu Approach and The Brady Plan

There was a sense of distress in the U.S. Treasury and the IMF in 1987, about the falling level of new private financial flows to Latin America in general, and the increasing amount of time that was being taken to conclude restructuring agreements.[59] Furthermore, the three rounds of restructurings carried out in the mid-1980s largely had affected the nature of claims, not the value of those claims. The Latin American debtors "still were faced with an escalating burden of debt."[60] These worries were compounded by fears that continually worsening economic conditions and diminishing access to new credit would spark

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[58] Congress, House of Representatives, Subcommittee on Finanacial Institutions Supervision, Regulation and Insurance, of the Committee on Banking, Fianace and Urban Affairs, Oversight Hearings on European Community's 1992 Program, 101st Cong., 1st Sess., 26, 27 and 28 September 1989, 29; Testimony of L. William Seidman, Chairman, Federal Deposit Insurance Corporation. See also Howard Lehman, "Strategic Debt Bargaining of International Creditors", 9-10.

[59] Michel Camdessus, "Strengthening the Debt Strategy: The Role of the IMF and of the Banks," IMF Survey 18, no.12 (12 June 1989), 178-183.

[60] Lehman, "Strategic Debt Bargaining," 10.

additional political instability in the region and widespread pursuit of confrontational debtor government strategies.[61] As American banks still had an exposure to non-oil LDCs of 54 per cent of bank capital, and that of the top nine money-centre banks was still 91 per cent of capital[62], there was a continuing need for management and intervention.

This led to the reconsideration of the ways in which debtors might reduce their debt stock while banks reduced their exposure. The Baker Plan's optimism about the banks' response to calls for increased lending on any substantial scale was misplaced. In 1987, the official strategy changed focus again, and altered its strategy concerning the role of the banks. The so-called menu' of voluntary, market-based techniques of debt reduction was endorsed. These techniques included buybacks, debt conversions and debt-equity swaps. In a buyback, debtor countries use cash reserves (either its own, or money borrowed from the IMF or World Bank) to repurchase some of its debt from creditor banks, at a discounted price. In a debt conversion, some existing debt is converted into a new asset, such as debt with more guarantees or collateral. In a debt-equity swap, the debtor

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[61] John Calverly and Ingrid Iversen, "Banks and the Brady Initiative," 132.

[62] Lehman, "Strategic Debt Bargaining," 10.

government repurchases existing bank debt using local currency, which then must be used by the seller to make a foreign direct investment in the debtor country.[63]

These options were pursued by many debtors and their creditors, but the impact on total debt stocks and total bank exposure has proved relatively small. This result derives from the fact that there are host of problems associated with each option. For example, take the example of debt-equity conversions. The creditor bank faces the task of choosing attractive investment opportunities in economies plagued by slow growth and vulnerability to external insolvency. The debtor government is faced with challenges concerning the money supply, exchange rate stability, and other matters. The end result is that the option of debt-equity conversions can only be pursued in relatively small amounts, relatively slowly.[64]

The "market menu" approach was altered in 1989, and took the form of the Brady Plan. This plan again carried several of the principles of the Baker Plan - the emphasis on voluntary, market-based transactions, the case-by-case approach and the continued supervisory role of the IMF and the World Bank. The Brady Plan also included many of the

[63] Sachs, "Making the Brady Plan Work," 93.

[64] United Nations, ECLAC, The Evolution of the External Debt Problem in Latin America and the Caribbean, 1988, 31-50.

themes of the market menu approach to the reduction of debt. However, it also called explicitly for the need to pursue debt reduction on an increased scale; a scale not necessarily attractive to the banks. The Baker Plan's hopes of stretching out debt-service payments, and allowing debtors to restore growth and creditworthiness, had not been realized. The Brady Plan recognized that "when the debt burden is too high to be repaid, it must be reduced before creditworthiness can be regained." The Brady Plan proposed cutting the commercial debt by 20 per cent by offering creditors new securities with either reduced face value or reduced interest rates with compensating collateral or backing of funds supplied from elsewhere.[65]

This process was to be accompanied and aided by important changes in IMF and World Bank lending policies. Ever since his appointment in 1987 as the Fund's managing director, Michel Camdessus has attempted to transform the policy focus of the IMF, from one of close alignment with the banks to more of one as a catalyst in resource transfers. In this regard, the IMF agreed to negotiate and conclude loans with debtor countries which have accumulated private arrears on debt-service payments, so long as arrangements were being made to eliminate those arrears. In

[65] Robert Wesson, "Wrapping Up the Debt Problem," 422; and Jeffrey Sachs, "Making the Brady Plan Work," 92.

addition, Secretary Brady attempted to use the IMF as a means of pressuring the banks to pursue debt reduction on a larger scale. The Plan called for the de-linking of the banks' negotiations from IMF and World Bank programmes. This step aimed at decreasing the negotiating power of the banks, by allowing IMF and World Bank funds to be disbursed even if debtors had not reached prior agreements with the banks. The banks could no longer necessarily pressure the debtors by delaying the commitment of both private and public funds.[66]

This plan was very significant for its recognition that the debt crisis was more than a transitory problem, and that the Latin American nations could not repay their debts on commercial terms. Unfortunately, the Brady Plan has exhibited the same weakness that plagued the market menu' approach - not enough transactions were undertaken to have a substantial impact.[67] This springs largely from one of the constant problems of all of the debt strategies -the reliance on the voluntary response of the banks. As mentioned before, each bank is faced with the incentive to free ride': if one bank balks at debt reduction schemes

[66] John Calverly and Ingrid Iversen, "Banks and the Brady Plan," 137-138; and Michael Camdessus, "Strengthening the Debt Strategy," 180.

[67] Robert Wesson, "Wrapping Up the Debt Problem," 422.

while other banks participate, there may be a greater chance that the debtor can repay its loans to the bank in full. The likely result of this individual incentive is a collective response to refuse to participate.[68] Thus, there has been relatively little action on the part of the banks in the way of debt reduction, and thus the financial demands imposed on Latin America by U.S. banks continues to be large.

A second and crucial weakness of the Brady Plan is that, similar to all previous strategies, it did not encourage the new flows of private finance that Latin America needed to achieve economic growth and increased debt service capability. The Plan in fact offered banks ways of cutting their ties Latin American debtors, leaving them "only an insufficient handful of banks as continuing lenders."[69]

When one combines the banks' refusal to participate in debt reduction on any meaningful scale with the decline in new bank lending, one can see that the many elements of the debt crisis are still in place. There are still powerful forces guiding the relationship toward confrontation and crisis.

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[68] Sachs, "Making the Brady Plan Work," 96-97.

[69] Peter Truell, "Brady Strategy: Rest in Peace," The Wall Street Journal, 11 January 1990, A1.

7. Important But Mixed Results

The strategies of the U.S. government with respect to the debt crisis yielded some important successes. The exposure of the banks has been reduced, to the point where they would remain solvent even if the Latin American debtors defaulted on outstanding loans. William Seidman, chairman of the FDIC, testified before the U.S. House of Representatives Committee on Banking, Finance and Urban Affairs in January of 1989:

> Even in what surely could be considered a worst-case scenario, each of the nine money centre banks could write off 100 per cent of their outstanding loans to these six [largest debtor] countries and, on an after-tax basis, each of these banks would remain solvent.

These words gave some comfort to those in the Treasury, for it meant that they could exert more pressure on the banks to pursue debt reduction without necessarily dire consequences for the banking system.[70] This may have been also good news for the debtors, because more confrontational negotiating tactics would not threaten the insolvency of the banks. But many banks will not give up on older loans, because there is still a chance that they will rise in value in the future.

The failures of the Brady Plan lay in two areas.

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[70] Sachs, "Making the Brady Plan Work," 90.

Although the international financial institutions helped to make debt reduction more attractive for the banks, it was not enough to convince all banks to participate on a large scale. Furthermore, there was no real incentive put in place to lend new funds. With fewer new funds and continuing financial demands from private banks, and only modest increases (relative to Latin American debtors balance-of-payments deficits) in the funds available from international financial institutions, the debtors were still in a financial bind. Therefore, there was still an incentive for debtors to limit or stop interest payments and build up arrears. This in turn would, if left to persist, lead to the downgrading of the quality on the remaining loans on the banks' books, and force more provisions and losses.

Finally, the Brady Plan failed to deal directly with the need to construct plans for the development of the public financial sytem which could take over the role formerly played by the private financial system. In effect, the Brady Plan, and U.S. debt strategies before it, enlarged the roles and responsibilities of international financial institutions without simultaneously and commensurately increasing their resources. The strategies aimed at rescuing the banks while limiting the costs to governments. The result was the eclipse of debtors' financial needs, and this has meant a continuation of the debt crisis.

Chapter Four

What Is and What Could Be

1. Introduction

The purpose of this chapter is to demonstrate that the course of the Latin American debt crisis has been shaped in large part by the relationship between the U.S. government and U.S. commercial banks. As the last several chapters have demonstrated, the U.S. government has played a large role in precipitating and managing the Latin American debt crisis. It was also demonstrated that the underlying motivation of U.S. government action was to shield the banks, reduce their exposure to Latin American debtor countries, and make them more competitive internationally.

But this concern has perpetuated the Latin American debt crisis by maintaining the outflow of funds from Latin America. In turn, Latin American governments have periodically resorted to confrontation and moratoria on debt-service payments as strategies to deal with the continuing economic and social dislocations. As we shall see, it has also hurt many producer and exporter interests in the U.S. One interesting aspect of the U.S. government's strategy toward the debt crisis is the failure of many producer and exporter interests to mount an effective challenge to policies that clearly hurt them. It is in part a reflection of the power of the banking community in U.S. politics.

2. The Obstacles to a Different Path for the Debt Crisis

There are a plethora of forces which act to maintain the present path of the debt crisis. This chapter is concerned with those forces which affect the supply of finance to Latin America. In particular, this chapter will focus on the pressures within the American banking community, the economic and political pressures on the American government, and its view of the importance of the banks and banking sytem to its national self-interest. It will be argued that a wider range of U.S. interests can be promoted with a reconsideration of U.S. interests and tactics.

It is becoming more and more apparent that the burden of adjustment which has been allocated to Latin America under the present debt management strategy cannot continue for long without engendering resistance, opposition and conflict. Latin American debtors are faced with an uncertain and troubled international economy. Latin American exports face a troubled trading system, which has been showing signs of stress because of the inability of the U.S., Europe and Japan to agree on a comprehensive set of trading rules.

Moreover, in international finance, there have arisen two obstacles to the provision of adequate levels of finance to Latin America. U.S. banks (previously the debtors' largest source of finance) are facing several challenges, ranging from prudential supervisory pressures to international competition, which make lending to Latin America highly improbable. In addition, an international credit crunch' is developing as new demands for private finance draw capital away from potential use Latin America. Without strong export trade, and especially without adequate amounts of finance to ease the burden of economic restructuring, the Latin Americans have little choice but to default on their loans in order to conserve financial resources.

If part of the burden of adjustment is to be shifted on to other groups, which groups will it be? It is unlikely that the private financial system, and the banks in particular, will voluntarily accept more of the burden by channelling more financial resources to Latin America in the near future. The banks' ongoing strategy of provisioning and debt-exposure reduction indicates that this is the case.

Two paths of action which could be taken by the U.S. government seem now to be unthinkable. First, the U.S. government could try to use some form of coercion - through regulatory orders and guidelines, for example - on the banks to pursue debt reduction and/or to maintain some level of lending to Latin America; this in turn would aid American exporters to Latin American markets. But this would fly in the face of all the work and resources the U.S. government spent in trying to overcome the crisis.

Moreover, the U.S. banking system is delicate at the present time. The rising competition from other financial intermediaries, the real estate and junk bond problems, the pressures from domestic prudential supervisory authorities and international regulatory agreements, and the current recession, have all undermined stability in the financial system. Finally, the U.S. Treasury and American regulatory authorities would likely defeat or countervail such an initiative; it is their responsibility to maintain the stability and competitiveness of the financial system.

Another possible path is to arrange the commitment of considerable amounts of public funds, either directly or through multilateral channels, to finance facilitate bank-debt reduction as banks write their debts off. However, it is extremely unlikely that the U.S. Treasury or Congress would sanction this approach. Congress has repeatedly given bills for increases in U.S. quotas to the IMF a very difficult time, because there are fears that the U.S. taxpayer is bailing out mismanaged banks or corrupt and wasteful debtors. The U.S. Treasury is already strapped by rising financial needs, stemming from continuing budget deficits and growing interest payments on the public debt.

If these paths are unlikely to be taken, what can spur action by the U.S. government? Only a fundamental reformulation of U.S. interests and goals by the executive and Congress could permit the executive to take bold action to resolve the debt crisis. There has been ample evidence, over the course of the debt crisis in the 1980s, that economic groups inside the U.S., other than the banks, have suffered as a result of the debt crisis. Latin America has had to generate current account surpluses in order to make up for the short-fall in private finance and make debt service payments. Exporters of manufactures and agricultural goods to Latin America, and all of the employees engaged in those industries, have suffered as Latin American debtors have cut imports drastically. Other U.S. exporters, the products of which compete with Latin American products, also have been hurt. The Latin Americans have constantly intensified efforts to export goods onto world markets in order to expand export surpluses. American exporters have seen their markets eroded, and the prices of their products have deteriorated with the growth in world supplies. American producers and exporters have presented their views to Congress, but this has done little to change the fundamental elements of the debt management strategy.[1]

Let us now return to an analysis of the forces which constrain the strategies of the U.S. government and American banks in the debt crisis. Such a consideration helps one to understand why the debt crisis has followed its particular path, and why alternative strategies have not been adopted.

A) Pressures on the U.S. Government

It is unlikely that the U.S. government will undertake the type of financial commitment necessary to aid the resolution of the Latin American debt crisis. This conclusion is based on an analysis of the domestic and external financial pressures acting on the U.S. government, and the lack of alternative sources of funds from other nations. The U.S. government faces budgetary problems and an international credit crunch'. And, as yet, only Japan, among all governments and OECD-based banks, has stepped in to provide a modest amount of leadership or financial

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[1] Congress, Senate, Committee on Banking, Housing, and Urban Affairs, The Impact of Third World Debt on U.S. Trade, 101st Cong., 1st Sess., 18 October 1989.

resources. Without much more bilateral or multilateral public aid, Latin America must look to US banks, with which many Latin American governments still have trade-finance and other arrangements, as a short-term source of credit.

Alexandre Lamfalussy, general manager of the Bank for International Settlements, recently gave a speech before the Finnish Economic Association in which he pointed out that an international credit crunch is developing.[2] Rising demands on financial resources are competing with both American and Latin American demands. Furthermore, some of these demands appear to be long-term in nature. One of the key factors is the growing demand for capital from governments. In this regard, the U.S., the U.S.S.R. and Eastern Europe stand out. The Soviet Union and Eastern Europe need credit for investment in reconstruction and development.[3]

The U.S. continues to exert demand on international credit markets because of its inability, or unwillingness, to make progress in decreasing its budget deficit. Far from following the stringent demands of the Gramm-Rudman budget-balancing law, by which the budget deficits for fiscal years 1991 and 1992 would be U.S.$64 billion and U.S.$28 billion,

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[2] "Settlements Bank Official Sees Risk of Credit Crunch," The Wall Street Journal, 16 October 1990, C13.

[3] Ibid.

respectively, the recently projected deficits are U.S.$318 billion and U.S.$281 billion, respectively.[4] These numbers come on top of the budgetary excesses of the Reagan years. Incredibly, the U.S. requires in excess of U.S.$10 billion of capital inflow per **month** from the rest of the world to keep its economy afloat.[5]

A further concern about the U.S. budget arises from the uncertainty surrounding the savings and loan crisis. California Democrat Leon Panetta, chairman of the House budget committee, has called the savings and loan bailout "a black hole."[6] The Bush Administration planned U.S.$55 billion in July of 1990 for the 1991 portion of the bailout cost, but revised that figure upward to U.S.$105 billion in February of 1991.[7]

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[4] John Saunders, "U.S. budget set at $1.45-trillion," The Globe and Mail, 5 February 1991, B1; and the Gramm-Rudman budgetary targets are taken from the 1987 Congressional Quarterly Almanac 100th Cong., 1st sess., (1987), 605. It should be noted that these figures represent revised targets - the revisions were applied to original, lower targets set in 1985.

[5] Congress, House of Representatives, Subcommittee on Financial Institutions Supervision ..., of the International Competitiveness of U.S. Financial Institutions Task Force of the Committee on Banking, Finance, and Urban Affairs, Role of the Financial Services Sector, 101st Cong., 2nd Sess., 24 April 1990, 3; Testimony of C. Fred Bergsten, Director, Institute for International Economics.

[6] Jennifer Lewington, "U.S. facing cuts over deficit crisis," The Globe and Mail, 17 July 1990, B1.

[7] John Saunders, "U.S. budget set at $1.45-trillion," The Globe and Mail, 5 February 1991, B1.

Adding to the governmental contribution to the developing credit crunch are the tight monetary policies of Japan and Germany, which are affecting the supply of credit worldwide. Those countries are raising their interest rates in order to check the potentially inflationary effects of their relatively strong economic growth rates. These interest rate hikes may answer the domestic needs of those countries[8], but they may also be drawing the supply of international credit away from potential use in the U.S. and Latin America.

B) The Current State of the American Banking Industry

The American banking industry, that which had channelled the most credit toward Latin America in the 1970s and early 1980s, is now suffering its worst problems since the 1930s. In an analysis of 1990, SNL Securities, a banking research and publishing company, reported that problem loans, ranging from Latin American to domestic loans, were soaring and profits were plummeting. Earnings, averaged across the industry, were the worst since the Depression.[9] If one takes a close look at the nature and

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[8] Michael Prowse, "Domestic concerns dictate course of monetary policy," The Financial Times, 2 February 1991, 3.

[9] The Associated Press, "1990 Survey On Banking," The New York Times, 12 February 1991, C14.

extent of the problems of the industry, it becomes clear that American banks are not likely to reappear as a major source of credit for Latin America, as the Brady Plan envisioned.[10] Both investors and prudential supervisory authorities view the banks' current progress in reducing exposure to Latin American debt as one of the few positive developments in the industry - any reversal of bank policy might alarm investors and official authorities.

The industry did not suddenly lapse into its present state of affairs, although the current economic environment has been a factor. Rather, momentum has been building for some time - over the last several decades. The banks' experience with Latin American debt is only one strand in the tapestry, but it is both a cause and a reflection of the current malaise.

One pressure on the banking industry that has existed for some time has been the development of competitors in financial intermediation. Capital markets, such as the Eurobond market, and the explosion in the

[10] There is a critical difficulty in interpreting just what the vision of the Brady Plan was. As Peter Truell explains, there is a contradiction in the Plan, which encourages banks to cut their exposure or lend new money. The problem is that there are enormous pressures for banks to opt for the former, and the record shows that the industry is reacting accordingly. One could argue that this makes a mockery of the Brady Plan's attempt to secure cooperation from all of the actors involved. See Peter Truell, "Brady Strategy: Rest in Peace," The Wall Street Journal, 22 January 1990, A1.

creation of new financial products after the collapse of Bretton Woods and the energy crisis have made it possible for many corporations to finance their operations without recourse to banks.[11] Additionally, and more recently, Japanese financial institutions have become powerful competitors. Finally, the movement of the European Community toward a Community-wide financial services system has removed many barriers to competition there, and as a result, European financial firms have become more competitive.

These forces have put tremendous competitive pressures on the banks, in that they have been driven to seek out new and sometimes riskier lines of business. In turn, the banks have put pressure on Congress to repeal or revise legislation which has restricted the banks from participating in certain domestic geographical and service areas.[12] The success of such pressure has helped to sustain a continuing shift in focus for the banks, toward domestic or OECD-based activities and away from international (including Latin American) ones.

A further pressure on American banks has been the

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[11] Adrian Hamilton, The Financial Revolution (New York: Free Press, 1986), 54-71. David Lascelles, "An end to the years of plenty," The Financial Times, 24 September 1990, 25.

[12] Congress, House of Representatives, Role of the Financial Services Sector, 4-5.

influence exerted by domestic prudential supervisory authorities and international regulatory and supervisory agreements. Domestically, regulators have been persistently pushing banks with outstanding loans to Latin America to set aside more and more reserves.[13] Internationally, the capital standards deadline of 1992, set out in the Basle international supervisory agreements of 1983, is rapidly approaching. Not meeting the deadlines would mean big problems for banks, because they would incur higher costs for credit compared to banks that met the capital standards. For the purposes of this thesis, it should be noted that the agreements characterizes cross-border loans as requiring twice as much capital backing as domestic loans, and this requirement must be fulfilled by 1992. In response, the overwhelming majority of American banks have been forced to either shed many of those assets or raise more equity.[14] This in turn encouraged many to enter equally-risky domestic ventures in order to earn high profits - ventures such as the financing of highly leveraged transactions and speculative real estate investments. With the souring of many of these ventures in the late 1980s and early 1990s,

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[13] Peter Truell, "Mexico, Creditor Banks Complete Talks Covering $48 Billion of Debt," The Wall Street Journal, 11 January 1990, A2.

[14] Karin Lissakers, "Closing the Books on Third World Debt," 142-143.

the banks are under more pressure to raise equity, and under increasing skepticism from credit rating agencies. In addition, their share prices are taking a pounding.[15]

The current recession has further exacerbated the banks' problems. Not only did individual and corporate borrowers not service their debts, thus nullifying the income from those loans as assets, but the recession induced a general devaluation of the assets which were used to secure the original loans.[16] Moreover, the recession has impaired the ability of the banks to expand their asset base, and thus their ability to generate revenue and earnings. In 1990, American banks' loan growth was 1.89 per cent, down from 5.88 per cent the year before.[17]

These problems, which pose a serious challenge to U.S. banks, help to explain why the U.S. government has asked banks only to voluntarily provide fresh credit to Latin America. If the government imposed such a strategy, the banks would be saddled with commitments which would

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[15] There is a veritable mountain of material on this subject. See David Lascelles, "An end to the years of plenty," 25; Edward Clifford, "U.S. banks rank poorly as investment prospects," p.B13, The Globe and Mail, 25 September 1990, B13; and "Bricks Without Straw: American banks and property lending", pp.79-80, The Economist 311, no.7607 (June 24 1989): 79-80.

[16] Peter Matthews, "Recession fuels the U.S. banking crisis," The Toronto Star, 14 January 1991, B3.

[17] The Associated Press, "1990 Survey on Banking," C14.

undermine their competitiveness and threaten their stability. This in turn would require more government effort and resources to rectify the situation once again. Thus, one of the alternative American strategies toward the debt crisis - more private bank lending - seems out of the question for some time to come.

C) <u>The U.S. Government's Support for American Banks</u>

The present state of the relationship between American commercial banks and Latin American debtors is particularly interesting because the position of the commercial banks has been supported by the U.S. government and international financial institutions. Those institutions have played critical roles in catalyzing or immobilizing political and economic support for both sides. Until the late 1980s, both of these entities have acted to protect and support the commercial banks, and to fracture and coerce the debtors. To a great extent, this matrix of forces still exists, and vitally affects the relationship between some banks and debtors.

But this is not so for all relationships between debtors and banks. There are exceptions. For instance, the U.S. government has pressed the banks to grant relatively favourable conditions and new money to some debtors - Mexico, Venezuela, Costa Rica, Chile - for a host of geostrategic and economic reasons.[18] Mexico has always received the best efforts on this account.[19] Bankers have repeatedly expressed their strongest dissatisfaction with this outside' interference in their private decision-making.[20] Mexico was the only case in which the banks have received direct financial support from the Treasury (U.S.$350 million) to pursue debt reduction. Although that financial support demonstrates the potential which the U.S. government has to facilitate debt reduction, and thus the resolution of the debt crisis, the move was widely criticized within the U.S. The act of providing hundreds of millions of dollars to the banks and foreigners was seen as an unnecessary commitment (especially with an already large budget), and an improper use of taxpayers' money. It is very unlikely that such direct financial support, on any substantial basis, will be provided again.[21]

Even though the U.S. government has failed in general to use financial resources to resolve the debt

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[18] Robert Wesson, "Wrapping Up the Debt Problem," 422; Griffith-Jones, "A history of debt crisis management," 22; and Cohen, In Whose Interest?, 213-231.

[19] Wellons, Passing the Buck, 159-160.

[20] Wesson, "Wrapping Up the Debt Problem," 422.

[21] Alan Murray, "U.S. Plan to Give Mexico a Good Deal Brings Criticis," The Wall Street Journal, 9 January 1990, A2; and Anthony Harris, "The real test of President Bush's ability to lead", The Financial Times, 5 June 1989, 23.

crisis, there are other ways in which the government could pursue that goal. For instance, the U.S. government could use persuasion or bargaining to prod the banks into providing new money or opting for debt reduction. But the U.S. government has not attempted to use these methods. In fact, in the late 1980s, U.S. regulatory authorities have pushed the banks to set aside reserves against Latin American loans. The Federal Reserve and the FDIC have become more critical in their assessment of loans, and quicker to declare loans value-impaired', thus requiring some provisioning. They were performing their constitutional duty of ensuring the safety of the banking system[22], and the possibility of crisis and the need for state financial support. Perhaps they were doing so with particular emphasis because of the perception that the system was strong enough by then to incur the losses.[23] While the loss of profits (resulting from the setting aside of profits for provisions) has undermined the banks' short-term international competitiveness, the reduction of the banks' Latin American exposure was seen as necessary for the banks' longer-term competitiveness.

The banks are going forward with the process of

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[22] Cohen, In Whose Interest?, 222-223

[23] Calverly and Iverson, "Banks and the Brady Initiative," 133.

provisioning. This has given them negotiating power by reducing the potential impact of default. It has also given them the incentive to reduce new lending - provisions for bad loans are an implicit recognition that new lending will not help secure payments on older loans; this recognition of losses may also be a sign that the countries which caused those losses face little new access to credit.[24] This course of action has made the banks more determined and intransigent in their negotiating stance toward the debtors. With little or no new bank credit, the Latin Americans are forced to take steps necessary to conserve cash. One such step is the accumulation of arrears on debt-service payments. This in turn makes negotiations with the banks more difficult, new loans unlikely, and default more probable.

The fragmented structure of the U.S. policy-making structure with respect to economic matters has reinforced the momentum toward conflict between debtor countries and the banks. The efforts of the U.S. prudential supervisory institutions have undercut the aims of the Baker and Brady

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[24] Michael Middlestaedt, "Third World debt crisis threatening again", The Globe and Mail, 30 September 1989, B1; Paul Krugman, "Private Capital Flows to Problem Debtors," 287; and Charles Kovacs, "Banks and rescheduled debt: factors which affect debt holders' policy decisions," in Third World Debt: Managing the Consequences, ed. Stephany Griffith-Jones (London: IFR Publishing, 1989), 93-94.

Plans. Those Plans have urged bank cooperation through lower fees, extended maturities, favourable terms for debt reduction, and continued new lending on a less reckless basis. But the Plans did not involve any power of enforcement[25] or concrete form of economic incentive[26] - apparently the banks were to voluntarily accept their financial losses, and to continue to finance cooperative Latin American nations while they carried out painful structural adjustment. This the banks would only do when the U.S. government and the IMF pressed them to do so, or added economic incentives.

Far and away the most common course of events was for banks to respond to U.S. prudential supervisory institutions, in consideration of the potential costs (such as the downgrading of their credit rating) if they refused. Efforts to build reserves against Latin American loans, while maintaining the drive to build capital, have basically precluded new lending to Latin America on any meaningful scale. The fact remains that this result was met with

[25] Jeffrey Sachs, "Making the Brady Plan Work," 94-96.

[26] In fact, the Treasury has backed an Internal Revenue Service decision that provides an financial incentive not to participate in international debt reduction: "... U.S. banks will not be allowed to offset any losses incurred in international debt reduction against the profits of their domestic operations for tax purposes." Anthony Harris, "The real test of President Bush's ability to lead," 23.

little resistance from the U.S. government. It was even encouraged by the Brady Plan's basic premise: "The plan implicitly recognizes that many debtor countries will be unable to repay their commercial bank debts in full, even if repayment is stretched out over time."[27] The implication of this premise is that new money will not help to increase the value of old loans.

American commercial banks continued to reduce the flow of new money continuously throughout the 1980s, and on into the early 1990s. This action, in combination with restrained transfers from the IMF and World Bank, has made the debtors transfer resources out of the region by the tens of billions. This process has been continuing since the early 1980s, and until 1988 the figure has averaged around U.S.$25 billion per year.[28]

3. Debt Crisis Resolution Through U.S. Leadership

The IMF and the World Bank have taken important steps to reduce the bargaining power of the banks. For instance, the IMF and the World Bank no longer require debtor countries to have agreements with private creditors

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[27] Sachs, "Making the Brady Plan Work," 87; The Associated Press, "Doubts about Brady debt plan arise before Washington talks," The Globe and Mail, 22 September 1989, B19.

[28] Sachs, "Strengthening IMF Programs in Highly Indebted Countries," 104-105.

in place before disbursing loans. This is known as the decoupling of negotiations.[29] The IMF and World Bank have aided some debtors with some financial transfers, in spite of the existence of debtor arrears on payments to private creditors. This has raised the strength of some debtors in their relationship with their bank creditors, and the latter fiercely oppose such transfers (even if the transfers might improve the chances that debtors will service their debts). The recent case of a $2 billion IMF loan package to Brazil, which had virtually halted interest payments since 1987, gives the strongest evidence that the IMF is prepared to assist debtors in their struggle to achieve structural economic adjustment. But such assistance is not likely to be large or widespread. The IMF still insists on a strong commitment to painful structural adjustment; it still does not have the financial support from its largest creditors, the G5 governments, to satisfy Latin America's financial requirements; and it opposes usurping that role from private international financial institutions.[30]

Indeed, there is little hope that international financial institutions such as the IMF and the World Bank

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[29] Michel Camdessus, "Strengthening the Debt Strategy: The Role of the IMF and of the Banks," 180; and John Calverly and Ingrid Iverson, "Banks and the Brady Initiative," 137-138.

[30] Michel Camdessus, "Strengthening the Debt Strategy: The Role of the IMF and of the Banks," 181-182.

will play a decisive role in the resolution of the Latin American debt crisis. The reason has to do with the power structure within these institutions. Ultimately, these institutions depend on the G-5 governments for their resources and policy parameters. As Philip Wellons argues:

> The strength of the IMF varies with the support of its principal shareholders, the G-5 governments. In this sense, the IMF is a player with independence at the margin, powerful when the country it deals with is not important to the G-5, such as a Sri Lanka, or when the G-5 governments are not united.

Wellons has noted that in times of crisis it has been one of the G-5 governments, with one or two of its banks, which has acted to provide leadership.[31]

In this case, however, the U.S. has displayed little leadership. The U.S. has formulated several broad strategies to manage the debt crisis, but large elements of the strategies (particularly those which threaten the largest banks' broader interests) inhave been undermined by the actions of U.S. prudential supervisory authorities, and by the lack of commitment of direct financial resources. The explanation derives largely from the fact that the U.S. considers certain domestic priorities, such as the international competitiveness of its banks and budgetary constraints, too imposing to take on such a role. The fact

[31] Wellons, Passing the Buck, 244-245.

of the matter is that the Brady Plan included no U.S. money. The Plan calls on international financial institutions <u>and Japan</u> to help finance debt reduction. "The Brady Plan is being financed by the Japanese - U.S. ideas but Japanese money."[32]

With this void in the supply of international credit, which is expected by some to last at least several years[33], several Latin American debtors have opted to conserve foreign currency by accumulating interest payment arrears. Among the most important of the debtors, Argentina, Brazil, and Peru have either fallen far behind on their contractual payments, or ceased to make them all together.[34] One aspect of the logic of this action was explained very briefly by Zelia Cardoso de Mello, Brazil's economic minister: "If we make a payment of part of the arrears now, in three months' time we'll have arrears again." In effect, the continuation of debt service will not measurably reduce the economic burden in the near future. Moreover, making substantial payments might undermine their

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[32] Congress, House of Representatives, Subcommittee on International Economic Policy and Trade ... of the Committee on Foreign Affairs, <u>America's Services Trade Deficit</u>, 101st Cong., 1st Sess., 2 November 1989, 16; Testimony of C. Fred Bergsten, Director, Institute for International Economics.

[33] Middlestaedt, "Third World debt crisis threatening again," B1.

[34] Truell, "Brady Strategy: Rest In Peace," A1.

economic reform efforts, by leaving them with insufficient foreign exchange reserves with which to defend their currency against speculation.[35] It seems to be a case of deciding not to sacrifice in the present if there are no brighter prospects for the near future. One consequence of that decision to forego that extra sacrifice is the greater likelihood of confrontation with the banks.

If greater confrontation between the banks and the debtors is to be avoided, and if the U.S. will not apply strong pressure on its banks to pursue debt reduction, the U.S. government might intervene with financial resources, either directly or through international financial institutions. This view will probably be opposed by the Treasury and the prudential supervisory institutions, for reasons already mentioned. As was stated in the introduction of the chapter, support for substantial intervention must come from a determined administration.

Any administration faces large obstacles in attempting to appropriate public funds for the resolution of the debt crisis. To begin with, many Americans consider such purposes unworthy: the money would only go towards rescuing banks from the costs of their mistakes and debtors

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[35] Peter Truell, "Third Word Interest Payments Arrears Have Surged Since Bush Plan Began," The Wall Street Journal, 3 October 1990, A4.

from the costs of their corruption. Moreover, how could Americans be sure that the money was not going to be wasted on profligate governments, with further requests for money just around the corner? When would it stop? Finally, the concrete rewards from pursuing such a path of action are not clear and immediate for most Americans. How would the economic rehabilitation of Latin America directly affect Americans' lives?

The debt crisis had a major impact on the entire US economy. However, in the US it was often conceived of as a problem for the banking system. How much money would the banks lose if the debtors default? What would happen to the banking system? Most analyses do not thoroughly explore the opposite,"the damage that will be done to the US economy if the Latin American debtor nations seek to implement the severe austerity policies that would be needed to pay market rate of interest."[36]

There are at least three ways in which the Latin American debt crisis has affected the non-financial sectors of the U.S. economy. First, the crisis has been instrumental in turning the U.S. trade balance with Latin America from a surplus to a deficit. From 1981 to 1984, the trade balance deteriorated by U.S.$23 billion - from a

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[36] Watkins, Till Debt Do Us Part, 9.

surplus of U.S.$7 billion to a deficit of U.S.$16 billion. This development was brought about in part by Latin American efforts to cut imports and boost exports. These policies have been necessary in order to earn dollars and service their debts.[37]

Second, and related to the trade deficit, the export sector of the U.S. economy has suffered remarkably due to the debt crisis. Between 1980 and 1983, 70 per cent of the worldwide decline in overseas sales can be attributed to falling demand in Latin America. Between 1981 and 1985, the U.S. farm sector's level of exports to Latin America fell U.S.$1.4 billion. In addition to the loss of markets in Latin America, many U.S. exporters have been challenged by increased competition from Latin American exporters. " ... as their debt service difficulties mount, they are pressed to produce and export still more which, in turn, generates additional price declines and increases the financial strains on U.S. [producers]." This has affected U.S. farmers, as well as producers of petroleum, tin, and copper. Furthermore, Latin America's recession has affected a wide range of U.S. exports, from computers to business machinery,

[37] Ibid.

and from iron and steel to agricultural machinery.[38]

The results of these developments has affected a great deal of people. Depending on the way the studies were done, estimates of the effect of the debt crisis on unemployment in the U.S. ranged from 400,000 to 1.4 million. In addition, the losses incurred by farms contributed to a rise in farm bank failures by nearly 900 per cent between 1982 and 1985.[39]

This sad state of affairs contrasts with the potential which exists in the U.S. economic relationship with Latin America. Abraham Lowenthal, Executive Director of the Inter-American Dialogue, points out that the mutual advantages to be gained from providing more leadership are rather clear. For one, more effective U.S. leadership might help Latin America become one of its larger trading partners. Latin America was becoming an extremely important market for American exports in the 1970s, before the advent of the debt crisis and its related recessionary effects.[40]

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[38] Congress, Joint Economic Committee, Staff Study, The Impact of The Latin American Debt Crisis on the U.S. Economy, 10 May 1986, 5-7. Watkins, Till Debt Do Us Part, 10.

[39] Watkins, Till Debt Do Us Part, 11-12. Congress, Joint Economic Committee, The Impact of the Latin American Debt Crisis on the U.S. Economy, 14.

[40] Abraham Lowenthal, "Rediscovering Latin America," 34-35; Cohen, In Whose Interest?, 213. Cohen backs up Lowenthal's assertions in this, and other ways. For example: "By 1982, the region had surpassed all but West Europe as a market for U.S.

Many Americans have an interest, then, in trying to bring about a reformulation of the administration's view of America's self-interest with respect to the debt crisis. These views have been presented to Congress through hearings, but the lack of action by the government in this regard suggests that the political weight of banking interests is still larger than that of non-banking interests. It is this particular configuration of political interests which helps to prevent change in the U.S. debt-management strategy.

4. The Grand Failure of Current U.S. Strategy

In a sense, then, we have witnessed the continuous development of a breach in the international flow of credit between the commercial banks and debtors. This breach in turn has engendered momentum toward confrontation, as banks refuse to grant new loans without the elimination of arrears, while debtors tacitly refuse to service debt without continued access to new credit. The potential impact on the international, and even American, financial systems arising from this breach are greatly reduced from what they were in the early 1980s. Even so, for many banks, Latin American loans represent liabilities in a portfolio

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goods; Mexico, on its own, was now America's third largest customer."

crowded with other bad loans, at a time when supervisory pressures are forcing more provisioning and recapitalization. Beyond the banks, there are a host of other American interests, both economic and political, which suffer from the effects of the debt crisis. What is more, with long-term, strategic planning and an investment of financial resources, the U.S. could increase the quality of the banks' remaining assets, further U.S. agricultural and manufacturing interests and gain foreign policy advantages in relations with Latin America.

The fact of the matter is that, with continuing weakness in the international competitiveness of the U.S. banking sector, there is little momentum in the U.S. for a fundamental review of the debt strategy. The government is still guided by a predisposition to favour banking and other financial interests over other domestic and international interests. In effect, the U.S. strategies for dealing with the debt crisis succeeded in helping American financial interests escape from vulnerability to the crisis; the other interests, both American and Latin American, have been left to absorb the largest costs the debt crisis on their own.

5. Conclusion

It is plain to see that the Latin American debt crisis is still a large problem in the international economy, and that the U.S. debt-management strategy is not aimed at resolving the crisis. The problem with the debt-management strategy is that it is premised on a view of the national self-interest which focuses exclusively on the interests of the largest U.S. banks, to the detriment of a wide variety of other American economic interests and the Latin American countries. Whereas this hierarchy of interests may have been necessary at the outset of the crisis, it may not be the case today. Although the largest U.S. banks still face many problems, their problems no longer stand out starkly in comparison to problems being experienced in other sectors of the U.S. economy. It may be time for them to begin to share more of the burden for the debt crisis, for the benefit of other American national interests.

This transition in U.S. government policy will not come about, however, as long as banking interests continue to hold the upper hand when it comes to making their views and demands known to the government. Put another way, there will not be a transition in government policy toward the debt crisis so long as non-bank interests fail to adequately pressure the U.S. government to adopt significant changes in the way it views the national self-interest.

Conclusion

Most broadly, this thesis has demonstrated the importance of the relationship between private and public actors. The relationship between the U.S. government and the largest American commercial banks has imposed a critical constraint on the development and evolution on the Latin American debt crisis. The fact that the banks were protected from the potentially disastrous effects of the debt crisis is proof that the American government effectively pursued some goals in the management of the crisis. However, other goals were not accomplished. The current, confrontational state of relations between the banks and the Latin American debtor countries is a sign that the debt crisis is not over. So long as Latin America is burdened with an overhang of debt, it is likely that the region will adopt a confrontational negotiating stance with American banks, and perhaps even the U.S. government.

In addition, the failure of the U.S. government to resolve the debt crisis is a reflection of the government's view of the national self-interest. The debt-management strategy has helped a very politically powerful economic group, the banks, and has hurt others, such as many American producer and exporter groups, and the Latin American debtor countries. The political pressures acting on the U.S. government, from within, from domestic economic groups, and from abroad, have led it to manage the debt crisis but not resolve it. Until the pressures on the U.S. government are altered, the Latin American debt crisis will persist for a long time to come.

This thesis gave arguments and evidence to support the statements made above. Specifically, the U.S. government and U.S. commercial banks have been central actors in the supply of external finance to Latin America in the postwar period, and in the management of the debt crisis in the 1980s and 1990s. As well, U.S. domestic interests have been integral to the development of the Latin American debt crisis, and the U.S. strategies which have been formulated to resolve it.

The development of the crisis begins in the 1950s, with the American undermining of the Bretton Woods arrangements. The U.S. persisted in running balance-of-payments deficits and sending dollars abroad as payment. While accumulations of dollars were welcomed by most countries after the war, they became a liability by the late 1950s for both Japan and West Europe. The impending conflict over the excess of U.S. dollars was postponed by the development of the Euromarkets, private markets where dollars could be held offshore' without inflationary consequences for America's major economic partners.

The Euromarkets, and the pool of dollars located there, were largely unregulated, making it attractive for banks and there customers to conduct business there. The U.S. did not mount a challenge to these markets, and even left a regulatory loophole whereby American commercial banks could participate in the markets and remain competitive with other banks in the Euromarkets. The oil crises caused vast balance-of-payments imbalances, and these imbalances were intermediated through the Euromarkets.

As governments resorted to borrowing from Euromarkets, the Latin American governments became prized customers for the banks: their recent record of economic growth was relatively good, their demand for finance was strong, and they were willing to pay relatively high fees and spreads to obtain funds. Moreover, if their economic growth continued as it did in the 1970s, and the inflation of the 1970s persisted (keeping real interest rates in check), there seemingly was little to worry about. Finally, it was a common belief that governments could not go broke, and if they did, OECD governments whiich had encouraged the banks to recycle OPEC surpluses would have to come to the rescue.

The second oil shock set in motion two forces which would finally trigger the debt crisis. First, as banks recycled ever-larger amounts of funds to debtors, the debt took on critical proportions. The banks were exposed to debtors to the point of vulnerability. Second, the inflation which ensued (on top of the inflationary forces of the rest of the decade) from the oil crisis catalyzed anti-inflation political forces in the U.S. Two responses of those forces were to pressure the Carter administration to appoint Paul Volcker to the Federal Reserve, and elect the Reagan Administration on its tight money platform. Years of tight money raised the returns to investors, but it also pushed borrowers, and thus their creditors, to the brink of insolvency. This included Latin American sovereign borrowers and their U.S. creditor banks.

The response from the U.S. in the 1980s took the form of three strategies, each slightly different from the other. Two themes remained constant, however. First, the Federal Reserve and the Treasury maintained pressure on the debtors to continue debt service, and adopt policies which would facilitate that end. Second, U.S. regulatory authorities constantly pushed the banks to reduce their exposure, including new lending, to the debtors. International financial institutions such as the IMF and World Bank assisted these processes by monitoring debtor adjustment, providing financial resources, and linking their transfers of financial resources to debtors to the latter's successful agreements with private creditors.

The most visual results of the American strategies have been the rescue of the banks from insolvency, the insulation of the American banking system from Latin America's debt problems, and the constant under-financing of Latin America. This in turn has meant the perpetuation of the debt crisis. Two other and less obvious results have been produced. On the one hand, a clearly confrontational situation has arisen, wherein the banks have demanded faithful debt service without providing new loans, and more and more Latin Americans have demanded access to new loans before providing faithful debt service. On the other hand, concrete U.S. economic interests, especially in the non-financial sectors, have been hurt by both the debt crisis and the U.S. government's continued support for the banks: the money with which the debtors paid interst to the banks came partly at their expense. The final argument of the paper is that the U.S. government, with strong leadership from an internationally-minded administration, could pursue a more balanced strategy. By overcoming short-term concerns about the budget, and reconsidering the importance of the banks to the national self-interest, larger amounts of effort and resources could be dedicated to the reduction of

Latin America's debt service stream and outstanding debt. This would help them to undertake important economic reforms, and reward them for doing so. The economic growth which would likely ensue would help revive American exports to the region, and thus generate economic activity and employment in the U.S. It would also help to improve the U.S. balance-of-payments deficit. Finally, banks might be rewarded in the long run with the increased creditworthiness of Latin American debtors, renewed business with them, and perhaps increased value of the loans outstanding. As it stands today, however, the U.S. government remains committed to the old debt strategy, and to delivering the benefits of that strategy to the largest American banks.

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Annex **1**

Latin America and the Caribbean: Ratio of Total Interest Paayments to Exports of Goods and Services (a)

(Percentages)

	1979	1980	1981	1982	1983	1984	1985	1986	1987**(b)**
Argentina	12.8	22.0	35.5	53.6	58.4	57.6	51.1	53.0	56.2
Bolivia	18.6	25.0	34.6	43.4	39.9	50.0	46.8	42.6	40.0
Brazil	31.5	34.1	40.4	57.1	43.5	39.6	40.0	41.4	34.5
Chile	16.5	19.3	38.8	49.5	38.9	48.0	43.5	38.6	26.7
Colombia	9.9	11.8	21.9	25.9	26.7	22.8	26.3	19.7	25.2
Mexico	24.5	23.3	29.0	47.2	37.5	39.0	36.0	37.9	27.9
Peru	15.5	18.4	24.1	25.1	29.8	33.2	30.0	26.7	22.4
Uruguay	9.0	11.0	12.9	22.4	24.8	34.8	34.3	24.7	24.0
Venezuela	6.9	8.1	12.7	21.0	21.7	20.1	26.2	32.8	26.3

(a) Includes interst earned, as well as interest payments on short-term debt. Services exclude factor services.
(b) Preliminary estimates.
Source: 1979-1987: ECLAC, on the basis of official data.

Annex 2

Latin America: Share of Exports to the U.S. and Imports from the U.S. in Total Trade of Each Country, 1984

(Percentages)

Exports		Imports	
Argentina	10.0	Uruguay	10.9
Bolivia	23.8	Bolivia	16.2
Chile	26.0	Brazil	16.6
Brazil	28.5	Argentina	18.5
Colombia	34.1	Chile	23.4
Uruguay	34.7	Peru	29.4
Peru	38.2	Colombia	35.0
Venezuela	40.2	Venezuela	49.3
Mexico	59.2	Mexico	67.2

Source: IMF, Direction of Trade Statistics, Yearbook 1985.

Annex 3

The Real Price (a) Of Commodities: 1950-87

1950-1954	124	1975-1979	104
1955-1959	113	1980-1984	94
1960-1964	106	1985	85
1965-1969	108	1986	69
1970-1974	115	1987	64

(a) Index 1980 = 100, period averages.
Source: Rudiger Dornbusch, "Debt Problems and the World Macroeconomy," Developing Country Debt and the World Economy, ed. Jeffrey Sachs, (Chicago: University of Chicago Press, 1989), table 16.5, 309.

Annex 4

Indicators Of Bank Lending To Problem Debtors

Latin America	1982	1983	1984	1985	1986
Private debt	291.9	292.1	303.2	303.8	308.0
(growth rate)	---	.0	3.8	.2	1.4
Bank debt (growth)	6.1	3.1	-.1	2.7	.9
Current account	-42.4	-10.9	-2.6	-4.7	-16.1
Resource transfer	-8.1	21.7	32.1	28.3	12.4
Debt/GDP	42.9	47.3	47.6	46.8	48.5
Debt/exports	273.8	290.3	277.1	295.5	354.7

Source: Paul Krugman, "Private Capital Flows to Problem Debtors," Developing Country Debt and the World Economy, ed. Jeffrey Sachs (Chicago: University of Chicago Press, 1989), table 15.1, 289.

Annex 5

Latin America: Net Financial Flows By Source (a)
(percentages)

Year	Multilateral	Bilateral	Total	Suppliers	Banks	Bonds	Direct Investment	Other	Total	Grand Total
1961-65	19.4	40.7	60.1	7.9	1.6	5.1	25.3	...(b)	39.9	100
1966-70	16.6	26.9	43.5	11.7	8.1	2.6	33.2	.9	56.5	100
1971-75	13.5	11.2	24.7	4.0	42.4	2.2	25.8	.9	75.3	100
1976-80	8.5	4.5	13.0	1.3	58.3	9.0	18.6	-.2	87.0	100
1981	10.4	5.4	15.8	...	53.5	6.4	24.6	-.3	84.2	100

(a) Information is for developing country members of the Inter-American Development Bank; includes only medium- and long-term capital flows to the public sector.
(b) ... = zero or not large enough to quantify.
Source: Robert devlin, Debt and Crisis in Latin America (Princeton: Princeton University Press, 1989), table 2.4, 24.

Annex 6

The Top Five US Banks According To Their Exposure (a)

(Millions of US dollars)

Capital (b)	Bank	Brazil	Mexico	Total	Exposure as % capital
5989	Citicorp	4402	3270	7672	128
4799	BankAmerica	2299	2500	4799	100
4221	Chase Manhattan	2402	1688	4090	97
3107	J.P. Morgan & Co.	1687	1081	2768	89
2592	Manufacturers Hanover	2014	1729	3743	144
20708	Total top nine U.S. Banks	12804	10268	23072	111

(a) In the two principal developing country debtors, end-1982; includes all cross-border loans in foreign currency.
(b) The sum of shareholders' equity, subordinated notes, and reserves against possible loan losses.

Source: United Nations, ECLAC, "Transnational Bank Behaviour and the International Debt Crisis," 1989, table 10, 44.

Annex 7

What Latin Loans Are Worth (a)

	October 1988	October 1987	% change
Argentina	22.5	36	-38
Bolivia	11	10	10
Brazil	46.5	42	11
Chile	59	52	13
Colombia	65	74	-12
Costa Rica	12	25	-52
Ecuador	16.5	33	-50
Mexico	46.8	51	-8
Nicaragua	5	5	0
Panama	20	45	-56
Peru	5	8	-38
Venezuela	46.5	50	-7

(a) Secondary market debt prices in U.S. cents for a dollar of debt.

Source: Paul Knox, "Latin America debt problem thrusts under the gun," The Globe and Mail, 27 December 1988, B1.