THIRD-WORLD DEBT

The disaster that didn't happen

Ten years ago Mexico announced to the world that it could no longer service its external debt. Similar news from Brazil and Argentina came soon afterwards. The Latin American debt crisis had begun. William R. Rhodes, vice chairman of Citibank, is the commercial banker most closely identified with managing the crisis. He looks back at the evolution of events and the lessons to be learned

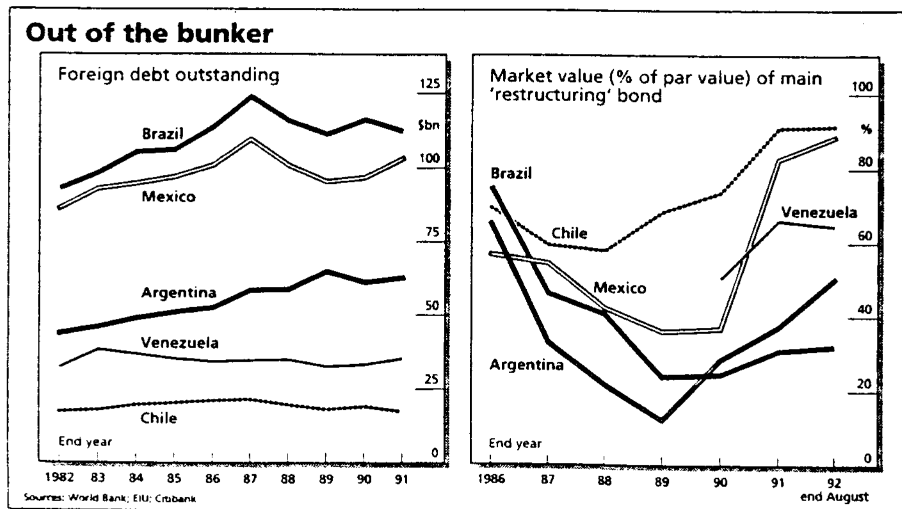
THE philosopher William James once said that "great emergencies and crises show us how much greater our vital resources are than we had supposed". As we now look back on the events of the past ten years, I would point to three aspects of the third-world debt crisis that bear that out.

First, despite all the gloom and doom that surrounded the early stages of the crisis, the international financial system did not collapse. I don't think I have ever been in a more collectively pessimistic setting than the IMF/World Bank meetings of September 1982 in Toronto. The standing joke was that the efforts to contain the crisis amounted to no more than "rearranging the deck chairs on the Titanic".

Such gallows humour was not unfounded. Among the money-centre banks in New York, for example, the exposure to troubled debtor countries exceeded their capital. The real threat was the possibility that a major bank would encounter funding problems in the markets, which in turn could have set off a chain reaction that would have severely shaken the international financial system. It did not happen. The banks were given the time to raise capital and increase reserves, and the debtor countries began reforming their economies.

Second, in the early years, all the major parties—the commercial banks, the debtor countries, the creditor countries and the international financial institutions—temporarily put aside their own interests and worked for a collective purpose. If greed drives people apart, fear brings them together. That was certainly the case then. It was perhaps best exemplified by the then leader of Mexico's economic team, Jesus Silva Herzog, and his chief debt negotiator, Angel Gurria. Both believed that the best interests of all could be achieved by co-operation, rather than confrontation.

Third, the long-term response to the crisis did more than just allow the major countries of Latin America to cope with their debt. It also provided time to put in place the structural adjustments such as trade liberalisation, privatisation, deregulation and tax reform that have now brought both growth and investment to several countries in the region. Success was due in large part to political leaders who rose to the occasion, as in the reform programme implemented by the economic team in Mexico, under presidents Miguel de la Madrid and Carlos Salinas, and the programme for opening the economy enacted by two successive Chilean governments. Chile's reform has succeeded to the point where one of the leading American credit-rating agencies recently gave the country an investment-grade rating, much improving its standing in international capital markets. Argentina, under the leadership of President Carlos Menem and his finance minister, Domingo Cavallo, is containing inflation, returning to growth and recovering access to capital markets.



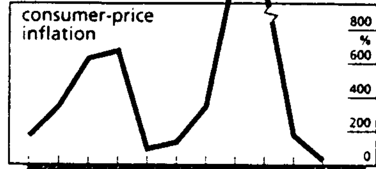
A vacation cut short

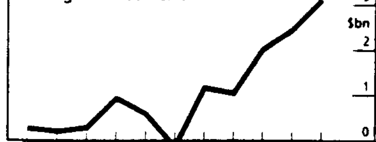
I was on holiday in 1982 when I was called back to New York with the ominous warning that "the Mexicans are in trouble". At a meeting on August 20th at the New York Federal Reserve Bank, the commercial banks learned that Mexico could no longer service its debt. I was struck by two overriding thoughts. First, we had to assume that the crisis could be managed, and, to contain any panic, we had to convince the world's financial community that we could manage it. Second, we were entering entirely uncharted waters. True, there had been earlier debt crises, and several countries were in various stages of restructuring their debt. But with the announcement by Mexico and expectations of more bad news from Argentina and Brazil, we had no formula for dealing with a crisis of this size.

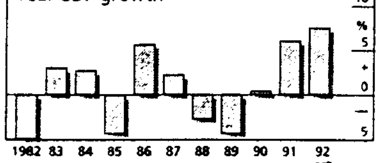
With hindsight, that may have been a blessing in disguise. Not being bound by any conventional wisdom, we were able to respond to the crisis in a much more flexible and focused manner.

One of the principles that came to the fore in the early days is still very applicable: the need for a case-by-case approach. While that is today taken for granted, some bankers and academics at the time were pressing for "global solutions"—a kind of "one-size-fits-all" answer to the debt problem. A look

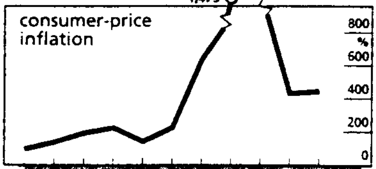
Argentina's:

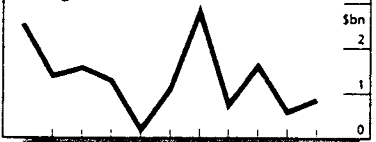


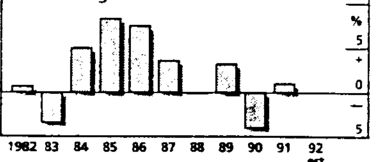




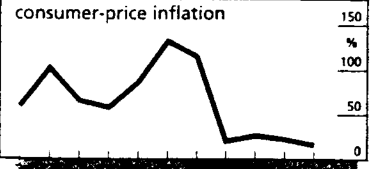
Brazil's:

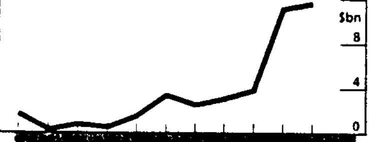


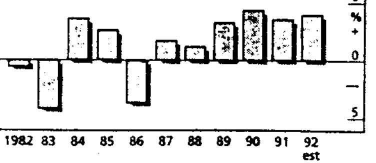




Mexico's:







* Net inflows of direct investment (including reinvested earnings) and portfolio equity capital
Source: Institute of International Finance

at the distinctive varieties of the Brady plan employed over the past three years in Mexico, Venezuela, Argentina, Brazil, the Philippines and Uruguay shows how ill-suited a generic response would have been.

The steps to safety

The crisis passed through several phases. In the first, commercial banks assembled short-term emergency financing packages whereby debt due to mature over the next two years or so was stretched out over five to seven years. In addition, new money was committed to meet borrowers' immediate cash needs, as in the 1982-83 restructurings of Mexico, Argentina and Brazil.

The second phase was aimed at buying time; time for the countries to implement reforms and for the banks to build capital and reserves. At the heart of this was the agreement that the IMF would monitor a country's economic performance over periods substantially longer than it normally does under stand-by arrangements, and that the resultant information would be made available to the commercial banks.

During this phase, in 1984, Mexico and its creditor banks agreed on the first multi-year restructuring agreement. The Mexican restructuring also featured the first use of debt/equity swaps, a concept that the Chileans took even greater advantage of in a deal negotiated the following year.

The third phase began in October 1985, at the IMF/World Bank meeting in Seoul, when America's Treasury secretary, James Baker, announced his plan for world debt. It emphasised growth-oriented structural economic reforms in debtor countries. In return for these reforms, commercial banks were asked to continue to make new loans available—Mr Baker suggested $20 billion over three years. At the same time, the World Bank was brought into the fray; until then, the debt strategy had been dominated principally by the IMF. This phase also saw Mexico and Chile begin to emphasise structural adjustments in the areas of trade and privatisation.

Though the Baker plan is often attacked for not having raised sufficient new money, a study by the Institute for International Economics showed that banks disbursed over $13 billion in net new loans to the Baker countries over the three-year period envisaged. That the $20 billion mark was not reached says as much about the inability of some countries to make the necessary structural adjustments as it does about the banks' occasional unwillingness to lend.

With the Argentinian agreement in 1987, the role of the market increased, as the list of restructuring options was substantially expanded. The longer menu included co-financings with the World Bank, trade financing facilities and new-money bonds. This was the first time that an exit bond with a fixed, below-market interest rate was of-

fered in an attempt to stimulate debt-reduction. Though this Argentinian bond was a failure, it helped set the stage for the next phase, voluntary debt-reduction.

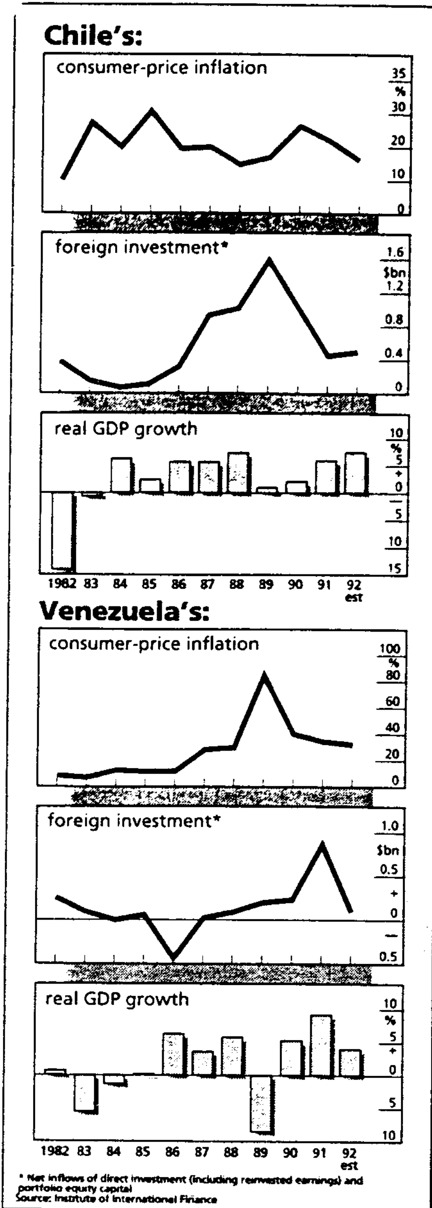
In the same year Citibank, motivated by Brazil's moratorium on its medium- and long-term commercial-bank debt, raised its reserves (provisions) against doubtful third-world debts. Many American, British and Canadian banks followed suit. These higher reserves gave banks greater flexibility to manage their loan portfolios, through such debt-reduction options as exchanges of debt for equity and cash buy-backs of debt.

1987 also saw the deal between J.P. Morgan and Mexico, which attempted debt-reduction by offering banks the chance to exchange loans for bonds, at a discount, with the principal collateralised by United States Treasury zero-coupon bonds. This did not produce the results that some had hoped for, but it did become one of the bases of the Brady plan, named after Nicholas Brady, who succeeded Mr Baker at the Treasury.

In September 1988 Brazil signed a medium-term financing package to bring it out of its moratorium. Although the Brazilians never fully implemented this agreement, it demonstrated for the first time that new money and voluntary reduction of existing debt were not mutually exclusive. Both the banks and the debtor countries were now looking to voluntary debt-reduction as a big part of these financial packages. The package itself contained $5.2 billion of new money. As with Argentina, the original debt was exchanged at par for fixed-rate bonds paying below-market rates. Unlike the comparable Argentinian bonds, these ones succeeded; they were the forerunner of the par bonds in the Brady-plan agreements. Some 100 banks subscribed a total of $1.1 billion. If the Brazilian government had not initially restricted participation, we probably could have obtained two or three times as much. It is notable that, although Brazil later suspended interest payments on its medium-term debt to commercial banks, it never stopped paying interest on its bonds.

Enter the Brady plan

In a speech to the Bretton Woods Committee in March 1989, Mr Brady proposed voluntary debt-reduction by commercial banks, and—though this was largely overlooked—urged further flows of new money. As part of the Brady plan, the IMF and the



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World Bank agreed to offer resources to back debt-reduction programmes for countries with viable economic programmes.

All this set the stage for the Mexican debt package that was signed in February 1990. It included most of the debt-reduction techniques used earlier, such as debt/equity conversions, interest-rate reductions and principal-reduction bonds. It also incorporated many of the new-money techniques, including bonds, trade finance and on-lending facilities. In addition, the package introduced two new techniques: collateralised interest for debt-reduction bonds, and value-recovery, which allowed the banks to receive additional payments if the price of Mexico's oil exceeded an agreed level. At the same time as the Salinas administration was negotiating this agreement with the commercial banks, it was also accelerating the pace of structural reform.

Since the Mexican agreement, the Brady plan has been used to restructure the commercial bank debt of Venezuela, Uruguay, the Philippines, Costa Rica and Nigeria. It also forms the basis of the debt agreements with Brazil and Argentina.

Back to normal?

Some people have been suggesting that the debt crisis in Latin America will be wrapped up almost exactly ten years after it started. Certainly there has been a fair amount of progress. Signing of the Argentinian package is expected some time in October, and, despite the political volatility in Brazil, the Brazilian senate is still expected to approve that country's restructuring by the end of September, after which it can be sent to its creditor banks. The completion of these two agreements will signal the phase-out of the debt saga among the major economies of Latin America. Although it is outside the region, the signing of a Brady-style agreement by the Philippines this July was another very positive sign.

There are still Latin American countries, however, that have yet to put the problem behind them, notably Peru and Ecuador (though Ecuador's new government has already announced a new economic-reform plan and initiated discussions with individual members of the bank steering committee). And, beyond Latin America, several countries in Africa and in Central and Eastern Europe need to address both their debt problems and the issue of structural reform.

Compelling motivation

In any circumstances there are good reasons for a country to regularise relations with its international creditors. Foremost is the need for access to capital markets, access that is severely limited for countries not meeting their external obligations.

In today's world there are still more compelling reasons. A rough estimate of the amount of capital needed for privatisations in Latin America, South-East Asia and Central and Eastern Europe is $500 billion, and as much again for the former Soviet Union. The resulting $1 trillion is all the more striking when one considers that privatisations in the developing world are financed, in large part, through just one type of capital, risk capital. At the same time, both developed and developing economies also have a broad range of other capital needs, adding to the overall demand. Meanwhile, two of the largest providers of risk capital in the past decade, Japan and Germany, have their hands full in their own backyards.

Given the strong demand for capital around the world, the countries best positioned to get it are those that have become genuinely competitive and creditworthy. It was no coincidence that the pace of the Mexican privatisation programme was accelerated after President Salinas spent a state visit to Europe listening to senior officials there talk about the direct-investment opportunities in Central and Eastern Europe. That same motivation also accounted, in part, for his decision to initiate discussions on the inclusion of Mexico in the North American Free Trade Agreement.

Lessons for reformers

Just as great crises reveal the full extent of our resources, they also hold important lessons. A close look at the experiences of Mexico, Chile and, to a great extent, Argentina shows that all three met the following criteria in successfully implementing their respective economic-reform programmes.

- A head of state who demonstrates political will and strong leadership.
- A viable, coherent and comprehensive economic plan that is implemented in a proper sequence.
- A motivated and competent economic team, working together, not in rivalry.
- Belief in the plan from the head of government, his cabinet and other senior officials involved, who must have the conviction to stay the course.
- An integrated programme to sell the plan to all levels of society through the media. The plan is often difficult to implement, but people will accept it, if they see that there is light at the end of the tunnel.
- Continuity in implementation of reform from one administration to the next.

These criteria are notable for two reasons. They are drawn from the actual experiences of the countries involved. Second, they are applicable not only to the countries of Latin America, but elsewhere in the developing world as well. Adherence to them will help greatly, in any country, in implementing economic reform.

Only time, though, will tell if the trend toward reform in Latin America is permanent. I am confident that much of the progress made so far will stick, in most countries. But reform can be fragile. The cost of economic adjustment should never be underestimated, and there is still a great need to convince all levels of society that opening up the economy will bring with it the long-term benefits of sustained growth.