Overcoming Political Constraints to Resolve the Debt Problem

Whitney Debevoise
OVERCOMING POLITICAL CONSTRAINTS TO RESOLVE THE DEBT PROBLEM

Whitney Debevoise*

The focus of this article is on the political aspects of the Latin American debt problem, which have been a largely taboo topic for discussion to date.

Interestingly, in the prepared remarks for his recent appearance before the Senate Foreign Relations Committee, Secretary of State James Baker placed the Americas first on the international agenda of the United States. By comparison, he placed our relations with the Soviet Union and arms control in fourth place. The latter are matters with which the new Secretary of State is less familiar and perhaps he felt less comfortable highlighting them in his prepared remarks. I tend, however, to discount this view. I believe that the Western Hemisphere was ranked first because it will both demand and command more attention in the Bush Administration than it did during the Reagan Administration. Of course, it has never been clear that being the focus of Washington's attention is a positive phenomenon for Latin America. When the United States ignores Latin America, countries complain. When the United States pays attention, it has tended to intervene. Then, Latin Americans yearn for benign neglect.

In any case, the new Secretary of State will probably have to focus more time and attention on Mexico than any other U.S. Secretary of State since the time of the Mexican-American War. The rest of the region will not be far away in his thoughts, because many, if not most, of the issues he will face in Mexico are replicated throughout the rest of the hemisphere. These include such thorny problems as debt and development, drugs, the environment, trade, the consolidation of democracy, and peace in Central America.

One should also not forget that Mr. Baker got where he is today by being a very astute political adviser to President Bush. He

* Arnold & Porter, Washington, D.C.
knows that all politics are ultimately local. He probably already perceives that all foreign relations are also ultimately driven by domestic political concerns. As examples relevant to Latin America in 1989, one can cite drugs and immigration, which will be major issues on the American agenda in the coming year.

The first challenge that Secretary Baker will face is one with which he is all too familiar—the debt crisis. There seems little doubt that, notwithstanding his transfer from the Treasury Department to the State Department, Secretary Baker will continue to play a major role in this area, as he now has assumed responsibility for the closely linked task of consolidating democracy in Latin America.

The Bush Administration has already seen the coming storm on debt. Although Secretary Baker's principal debt strategists, David Mulford and Charles Dallara, remain at the Treasury Department and are fully conversant with the issue, the new administration would have preferred a breathing spell to consider and to perfect evolving policies in this area before it became necessary to face the storm. This, however, was not to be. In late December 1988, Venezuela told its creditor banks that it would not pay principal as provided in the current edition of its restructuring agreements. More significantly, the country's reserves had fallen sharply, and the country approached the Treasury Department and its creditor banks for a bridge loan.

On January 15, 1989, President Sarney of Brazil announced the Summer Plan—an economic plan designed to avert hyperinflation in that country. Brazil also informed the U.S. authorities that its reserves were nowhere near what one might have expected following a nineteen billion dollar trade surplus. In the same breath, Brazil requested bridging assistance from the Treasury Department.

Mexico has received an assurance from the Treasury Department of a $3.5 billion standby facility but has yet to announce any definitive plans, either economic or financial. The country is expected to meet shortly with its bank creditors to request tens of billions of dollars over a period of many years. Another Latin American country, Argentina, has been negotiating with its creditor banks for several months. It continues to see its interest arrearages mount to levels equal to, or perhaps exceeding, its projected trade surplus.
RESOLVING THE DEBT PROBLEM

Thus, in the initial days of the Bush Administration, the four major middle income debtors are now demanding Washington's attention. This is the first time since the onset of the debt crisis in 1982 that the four largest debtors have all needed and demanded help simultaneously. This time there will be no opportunity to play one country off against another by holding one country out as a model debtor.

The politics of debt have changed significantly in the last year in both debtor and creditor countries. From December 1988 through March 1990, a change of power will be witnessed in each of the four major debtors. President Salinas de Gortari has already taken office in Mexico. Carlos Andrés Pérez donned the presidential sash in Venezuela, on February 2, 1989. Presidential elections in Argentina will take place in May 1989. Brazil will hold presidential elections on December 17, 1989 under a new constitution. The newly elected president will take office in March 1990.

In each of these countries, the clamor for new approaches to the problem of debt and development is deafening. The political forces are growing around the proposition that resources are sorely needed for development, and, if a choice must be made between development and the servicing of interest, development will prevail. Although the trade-off is not one for the other, as the Brazilian and Peruvian moratoriums have shown, this truth does not change the terms of the current debate.

The newly installed presidents of both Mexico and Venezuela have served notice that they intend to respond to the challenge facing them by giving the international financial community one last chance. Briefly stated, their position is, "finance our development on generous terms, and we will play ball; if the financing is not forthcoming, however, the jig is up."

In Brazil and Argentina (both awaiting elections), the question will probably be presented to the voters. In Argentina, the election is so close at hand that no meaningful debt settlement can be completed before the election, using the existing procedures. The likely prospect, therefore, is that the voters of that country will deliver a stinging rebuke to a political party whose leader has tried to play by the rules of the international financial community.

The politics and personnel of debt have also changed in the developed countries. Paul Volcker and Jacques Delarosiere no longer run the show. James Baker has moved from Treasury to the
State Department and left West German Finance Minister Gerhard Stoltenberg as the institutional memory and strong man of the Group of Seven (G-7). The Japanese have undergone a change of administration followed by a significant political scandal. The resources offered by the Japanese remain largely untapped, and there seems to be no political leader willing to take the lead to release these resources in an expeditious and effective way.

In the United States, there is a growing awareness that the debt crisis has cost the country between thirty and fifty billion dollars per year in exports. Hundreds of thousands of U.S. jobs are tied to those lost exports. Yet throughout the debt crisis, agricultural and industrial interests in the United States seem to have been unable to challenge financial interests successfully. Perhaps this is due in part to the fact that agricultural interests have had their own debt crisis to deal with until they successfully obtained a form of debt relief from the Congress. At the same time, the middle income sovereign debtors were being forced to pay every penny, destroying their ability to pay for U.S. agricultural products as well as other products.

Now, a new financial crisis is upon us—that of the savings and loan industry in the United States. The estimates of taxpayers’ dollars required to deal with this crisis are significant. They far surpass any amount which has been mentioned in connection with any of the more creative proposals for dealing with the middle income debtor countries. Yet if in applying its limited resources, the U.S. Congress is forced to choose between bailing out savings and loans and bailing out debtor countries in Latin America, one can guess which option will prevail.

Therefore, it is no surprise, that the G-7 has convened a meeting for February 3, 1989, largely in order to discuss the debt problem. There almost certainly will be little talk of debt forgiveness and much talk of debt reduction. In other words, there will be evolution in the Baker plan but not a bold, new initiative. Because Bill Rhodes of Citibank and Larry Brainard of Banker's Trust have been telling the world that the 1988 Brazilian financing plan contained a large dose of debt reduction, one can probably expect proposals which build upon that plan.

In my judgment, this will not get the job done, either financially or politically. Latin America requires resources for growth—not just a bare minimum of resources to keep current on interest. Latin America needs resources and economic growth if it
is to consolidate the democratic movement throughout the region. To obtain these resources, an across-the-board political effort is required.

The word "political" has bad connotations in any discussion of debt. For some, it is a buzzword for debt forgiveness. As will become clear in this discussion, this is not the sense in which I use the word. I refer rather to a focus on resource needs for growth as opposed to a focus on minimum resources required to protect the health of the world banking system.

By across-the-board political effort, I mean both domestic political effort and international diplomacy. Domestic constituencies must be persuaded in both debtor and creditor countries. Creditor countries must agree on an approach. Furthermore, debtor and creditor countries must strike their own political deals on a case by case basis.

I have not yet mentioned the commercial banks. This is not because they are to be excluded from the process—far from it. They will participate at two levels—first, in the domestic political debate in their home countries and second, as their home countries negotiate with other creditor countries. In fact, this debate is already underway. The recent Institute of International Finance document on debt reduction can be cited as the opening salvo in that debate. Second, the banks will participate in the separate case by case negotiations with debtor countries to implement the agreed-upon strategy.

Some political discussions must take place in order to open the door to progress on the debt problem. First and foremost is the political struggle within the debtor countries themselves. No serious thinker on this subject—not even the Latin Americans themselves—denies that the countries of Latin America must revamp their development strategies, restructure their economies and effectively integrate them into the world economy. Yet this proposition is loaded with political dynamite, especially the prescription for effective integration into the world economy. Integration is inevitable. The real question is—at what pace? Integration implies a titanic struggle between traditional elites dependent upon the import substitution model on the one hand, and aggressive, entrepreneurial world traders on the other hand. These traders are imbued with a desire to acquire and master the latest technologies and to compete in the world marketplace.
This is the first struggle. Latin America has an abundant crop of bright economists who know how to design economic programs appropriate for each country. They know how to eliminate subsidies, to prescribe both reductions in the public sector and the privatization of state-owned companies. They know how to run a tight monetary policy and maintain an equilibrium in the exchange rate. They also know how to design a liberal trade regime. The real question is—and this is the political question—will they be allowed to do so?

In order to bolster the forces of liberalization in Latin America, the United States and other creditor nations must foster hope and provide tangible proof that liberalization will be rewarded and that countries which are net capital exporters will reverse such flows and become net capital importers. The reversal of these flows can come from new resources or debt reduction or both in combination. In gross terms, the amount of additional net inflows must reach approximately twenty billion dollars per year for several years for the ensemble of the region's largest debtors.

Determination of the amount, the proper mix, and the conditions on which it will be given brings us to some of the other political struggles which lie ahead. First, the creditor countries must determine what level of debt reduction they and their commercial banks will tolerate. If the pain threshold for debt reduction is too high under current regulations and accounting standards, how can these be safely changed? Should Japan permit greater tax deductions for recognized losses? Should capitalization of interest be tolerated by United States banks? Can losses be amortized over time? Can interest rate risks be hedged? How does debt reduction get reported to the shareholders? Should there be an active promotion of a regularized secondary market? Do primary capital maintenance rules impede debt reduction transactions? How uniform do the rules need to be from country to country? What impact will debt reduction have on the competitive position of banks in world financial markets and in domestic financial markets? As one can see, the matrix is complex.

Then there is the question of the taxpayers' money. Debt reduction resulting in recognized losses may produce tax expenditures on the part of creditor countries. In fact, although James Baker likes to say that he refuses to bail out the banks with public money, U.S. banks have been steadily reducing their exposure to middle income sovereign debtors, charging their loan-loss reserves
and generating tax deductions in the neighborhood of one billion dollars per year. Is more possible? Is more desirable?

Regulatory changes alone, however, just like debt-equity conversions alone, will not provide the incentive for the banks to participate in debt reduction packages. Nor is it likely that debt reduction alone will satisfy the resource gap. Additional elements are needed. Banks will need some assurance that debt outstanding after debt reduction has a higher chance of being serviced than before. In particular, banks are looking for credit enhancement, and they mean an enhancement greater than the debtor countries' improved ability to service debt resulting from an appropriate, coherent economic plan. The banks' wish list includes public sector guaranties—probably guaranties from multilateral financial institutions. As anyone who followed the Brazilian negotiations in 1988 knows, this is a hotly debated subject, although one which may now be under discussion in Washington. Personally, I do not look for significant breakthroughs in this area. For one thing, under existing World Bank rules, guaranties count the same as loans. The debtor countries might as well have full use of the funds, and perhaps some of it could be used as collateral on a rolling basis.

This raises the question of resources. The World Bank has had a seventy-five billion dollar capital increase. This capital needs to be put to work in countries which adopt appropriate economic programs. The impasse at the Inter-American Development Bank (IDB) must be resolved, and an IDB capital increase should follow. This may actually be happening.

Finally, on the multilateral front, we come to the question of an increase in International Monetary Fund (IMF) quotas. The debate here turns, in part, on assumptions concerning the proper roles of the IMF and the World Bank. Since the World Bank approved certain sectoral adjustment loans for Argentina in August of 1988, this has been a hotly debated issue which, unfortunately, is having a negative effect on the debt problem. Yet, the tension may not really be necessary. Each institution has strengths in different types of programs; each has resources; each can enforce necessary conditionalities; and each has the capacity to catalyze inflows of additional resources from Japan and other surplus countries. Rather than trying to resolve arcane philosophical differences, these institutions which are dominated by the Group of Ten, the G-7, and ultimately, the Group of Three should be permitted to get on with their work of supporting desirable economic
programs. Governments can contribute resources directly through Paris Club reschedulings and maintenance of official agency cover. They can also assist with waivers of World Bank negative pledges when necessary.

Also, we must not forget that creditor governments have obligations to address their own economic policies which may distort the world economy. The Organization of Economic Cooperation and Development’s (OECD) growth has held up reasonably well, but the ability to sustain such growth is questionable if U.S. budget deficits persist, and interest rates continue to rise. Finally, of course, trade liberalization must be vigorously pursued on a global basis through the Uruguay Round negotiations.

As one can see, the creditor countries have much to offer debtor countries. If the debtors can provide the political support for economic reforms, it should be possible to begin to make headway on the debt problem.

If the type of arrangements I have been describing can be made, the average inhabitant of Latin America will not experience an immediate, dramatic improvement in his living standards. The overall prospects for growth, however, should rise dramatically and confidence could return. A foundation can be laid for regenerating growth in Latin America and overcoming the dire consequences of the recession of the 1980s. Distortions in investment patterns can be corrected. Investors will adopt longer planning horizons. This will be important both economically and politically.

The basic problem of Latin America’s debt today is political. It is not easy to find a group of politicians who have the courage to stand up and advocate free market policies when those policies threaten traditional elites. Let us all hope that James Baker, the U.S. politicians, the G-7 politicians and the politicians of the middle income sovereign debtors can agree on a program like the one I have outlined to stimulate economic growth in Latin America, and then work together to implement it. In the meantime, for those of us technicians present at a conference like this, it is good to remember that we too can contribute to this process. As technicians, we are uniquely situated to study, propose and appraise the regulatory and accounting changes which would be required to implement components of the debt reduction strategy. As many creative and thoughtful ideas as possible are needed for the suggestion box. So, in closing, I urge participation and contribution toward finding a solution to the debt problem.