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Jean-Claude Garcia-Zamor
Stewart E. Sutin

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THE ASSESSMENT OF COUNTRY RISK: LESSONS FROM THE LATIN AMERICAN EXPERIENCE

Arturo C. Porzecanski

The role of commercial bank lending in the financing of Latin America's economic development has increased dramatically during the past decade. Throughout most of the 1960s, foreign commercial banks constituted a relatively minor source of finance, and thus obligations to them represented only about 10 percent of the region's public medium- and long-term external debt. In contrast, over 60 percent of all obligations were with government agencies and private suppliers in the industrial countries. During the 1970s, however, lending by banks in the United States, Canada, Japan, and Western Europe to Latin America rose to the point where, by the end of 1978, about 45 percent of the public medium- and long-term external debt was accounted for by obligations to foreign commercial banks, and official bilateral and suppliers credits constituted only 25 percent of the total. The exposure of banks to Latin American governments and government-guaranteed private entities through medium- and long-term indebtedness alone was estimated at $45 billion as of the end of 1978, compared with just $1 billion throughout the early 1960s. The overall exposure of banks in the industrial countries to private sector and government borrowers in Latin America on a short- and long-term basis, meanwhile, neared $100 billion.

As Latin America's single most important creditor group, commercial banks are now more frequently and deeply affected by whatever debt-servicing problems arise in the area. The increase in risk entailed by the growth of exposure in Latin America has thus made it imperative for prudent banks to institute systems that can warn of potential debt-servicing difficulties. Lately, many banks in the United States are under added pressure to expand and upgrade their country risk assessment methods because regulatory agencies (namely, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Federal Reserve Board) have instructed bank examiners to include in their reports "an evaluation of a bank's procedures for monitoring and controlling exposure to country risk, the bank's system for establishing limits to lending in a country, and the bank's methods for analyzing country risk."[1]

When compared with more traditional areas of internal bank management, however, country risk assessment often stands out as a relatively primitive art. Since even academic researchers armed with the most sophisticated statistical techniques disagree on the crucial determinants of debt-servicing problems, it should not be surprising to find that the approach to country evaluation varies a great deal among commercial banks—and, it might be added, among government lending agencies and international development institutions. Given this state of affairs, it is easy for the uninitiated to lose sight of the essentials and to fail to note the main lessons from past experience.

To help clarify the issues, the following provides a back-to-basics review of the fundamentals of country risk assessment accomplished through an analysis of recent Latin American history. First, the region's experience since 1960 is surveyed and the principal episodes of debt-servicing difficulties are discussed. Second, the main factors that appear to have precipitated these episodes are identified. Finally, some general comments are made on the key economic policy failures and other exogenous events that frequently were at the root of debt-servicing crises.

THE LATIN AMERICAN CASE

In order to analyze the Latin American experience with debt-servicing difficulties, one must first define what potential difficulties should be of concern to commercial bankers. The most obvious is the risk of nonrepayment, namely, the risk that a government, acting as a borrower or guarantor, will repudiate its debts or wantonly ignore its lawful obligations. As far as debts to commercial banks are concerned, however, in the past two decades there has been no instance of default on public or publicly guaranteed debt in Latin America that was not preceded by arrangements to forestall it or followed by negotiations to settle the obligations in question. Consequently, for practical purposes, the more realistic risk is that debts to commercial banks will not be repaid according to the terms of the original loan agreement. This involves what is commonly known as a rescheduling of obligations, whereby the grace period or maturity structure of the contract are amended to favor the borrower, and some other terms (usually the interest rate) are changed to compensate the lender.

There are two additional types of risks, both of which can lead to an undesired increase in bank exposure. One is the risk that because the borrower cannot meet the terms of a first loan agreement, a second loan becomes necessary to facilitate compliance with the terms of the earlier one. This is what is termed a refinancing, and although it often involves an increase in exposure, the increase can be prevented only if amortization payments due are refinanced and if disbursements are tied to scheduled repayments of principal on the original loan. The other risk is that a general-purpose loan would have to be granted to assist a creditor in meeting a variety of obligations, including those arising from a prior loan. These are known as balance-of-payments-support loans and are the hardest to pinpoint in history because it is difficult to determine whether or not participation was forced on lenders by an explicit or implied threat of nonrepayment of previously contracted debts. Nevertheless, they represent a frequent type of risk that up to now has been inadequately documented.

The Latin American countries provide some interesting examples to illustrate these kinds of risks. During the early and mid-1960s, Argentina repeatedly restructured its external debts to commercial banks, government agencies, and suppliers. The first instance occurred at the beginning of 1961, when two $75-million loans, approved in 1959 by groups of U.S. and European banks, and obligations to official (and mostly European) lenders were rescheduled. The bank loans, which had an original maturity of three years with one year's grace, were extended to five years, with the result that amortization payments due in 1961/62 were halved and became payable during 1963/64. A meeting held in Paris with official creditors, meanwhile, stretched out $120 million in obligations from an earlier (1956) refunding agreement that matured in 1961/62. The result was a lowering of this amortization burden by 55 percent in 1961 and by 50 percent in 1962.

However, debt-servicing difficulties reappeared in 1962, and by August of that year the Export-Import Bank of the United States (Eximbank) was rolling over maturing principal on some of its Argentine exposure. Shortly thereafter, a meeting was held in Paris with European and Japanese government representatives, who agreed to reschedule $15 million and refinance $128 million in payments falling due in 1963/64 on account of past purchases of capital goods. As part of the same debt-relief package, an arrangement was concluded in early 1963 with the U.S. and European banks that had participated in the already rescheduled 1959 loans, with the result that $37.5 million in obligations due in 1963 were postponed until 1965. Finally, the Eximbank formalized its refinancing of debts in mid-1963 with the granting of a facility to cover $65 million due in 1962 and about $2 million owed during the 1963/64 period.

The need for additional debt relief arose again in early 1965, and consequently a meeting with the country's main official creditors was held in Paris in June of that year. The resulting agreement refinanced about 60 percent of the debts contracted by Argentina with suppliers and governments during 1963/64 (that is, $76 million), with the new amortizations due in 1968-72. In addition, U.S. and European banks agreed to a request to postpone 80 percent (or $30 million) of payments falling due that year on the ill-fated 1959 loans, which thus became payable in 1966.

The specter of severe debt-servicing problems did not reappear again until early 1976, when most of Argentina's creditor banks were made aware that the country was at the brink of default and could not be expected to service its foreign debts unless a certain minimum amount was raised in international financial markets. What followed was a typical balance-of-payments-support operation, which included a four-year, $500-million loan arranged by a syndicate of U.S. banks as part of a $900-million package of credits from commercial sources in Europe, Japan, and Canada, as well as the United States.

Brazil also experienced serious debt-servicing difficulties in the early 1960s. A $200-million loan granted by a consortium of U.S. banks in 1954 was rescheduled in 1958 and had to be rescheduled again in late 1960 to allow for the payment of the first ($25 million) maturity in early 1961. Also, commercial arrears were accumulated in 1960. But the country's external financial position remained problematic, and thus in 1961 generalized debt relief was sought from official as well as private commercial sources. Brazil's official European creditors met in May of that year to consider the refinancing of debts arising from guaranteed suppliers credits and eventually agreed to provide new loans for $135 million to cover payments falling due during the 1961-65 period. The U.S. and Japanese authorities, as well as numerous individual suppliers, also renegotiated amounts due. For instance, the Eximbank refinanced $213 million of 1961 maturities. The group of U.S. commercial banks, meanwhile, had to reschedule the $200-million loan for the third time, converting it into a five-year loan with two years' grace and sparing Brazil repayments of $75 million in 1961 and $50 million in 1962. At the same time, in what was a typical balance-of-payments-support operation, a consortium of U.S. banks granted two loans amounting to $48 million for a three-and-one-half-year term.

Debt-servicing problems persisted in 1962/63, however, as evidenced by a renewed accumulation of commercial arrears and a unilateral, $19-million refinancing of 1963 Eximbank debts. Thus in March of 1964 the country's main official creditors met in Paris to try to regularize the situation. A formal agreement was reached in July on the refinancing of up to 70 percent of the obligations maturing between January 1964 and December 1965 on guaranteed suppliers credits, with the new funds (an estimated $62 million) to be amortized within a six-year period starting in 1967. The Eximbank was present at the meetings and pledged a consolidation credit of $66 million, which was later accompanied by two smaller refinancings totaling $26 million.

Brazil's debt-relief negotiations spilled over into 1965, when refinancing agreements were concluded with the Export-Import Bank of Japan and with a number of individual suppliers in the United States and Canada to resolve the arrears problem. In addition, two balance-of-payments-support loans were negotiated: the first with a syndicate of U.S. banks from which $80 million was obtained for a four-year period and a second with individual banks in Europe in a package cumulating to $58 million. Since the country's external payments situation improved considerably shortly thereafter, both loans were serviced without incident and no new debt-relief operations became necessary.

Chile faced major debt-servicing difficulties in the early and mid-1960s and again in the early 1970s. In 1959, the country obtained a four-year, $55-million loan for balance-of-payments-support purposes from a group of U.S. banks, but in order to service it, additional short-term loans had to be contracted throughout the 1961-63 period with European and U.S. banks. Debt-servicing problems began to deepen in 1962, however, and commercial arrears started to accumulate. In 1963, the Kreditanstalt and a group of German commercial banks extended an $11-million consolidation credit to the Central Bank of Chile to cancel commercial arrears with German exporters. But the situation did not improve in 1964: additional arrears were incurred, another German refinancing loan was approved, and two one-year loans for $10 million each were granted by U.S. banks.

The prospect of renewed difficulties in 1965 led the Chilean authorities to seek generalized debt relief, and in January of 1965 the country's official creditors met in Paris to discuss the request. Their decision was to renegotiate 70 percent of principal payments due in 1965/66 on guaranteed suppliers credits contracted prior to the end of 1964 as well as on some government loans. Overall, debt relief totaled some $93 million, with the Eximbank accounting for $40 million. Although most of the debts were refinanced (with the new loans repayable starting in 1968), about 70 percent of the obligations contracted by the Chilean public sector with the Eximbank ($16.4 million) and with Belgium and the Netherlands ($1.4 million) were rescheduled. Similarly rescheduled were some $14.5 million in debts due in 1965/66 to the German Kreditanstalt, which were excluded from the Paris discussions. Finally, a four-year, $45-million loan was obtained by Chile from a group of U.S. banks in early 1965 for balance-of-payments-support purposes, including the prompt repayment of an outstanding $10-million short-term loan.

Acute debt-servicing problems reappeared several years later, when in November of 1971 payments on the bulk of the country's foreign debt were suspended and Chile requested a meeting in Paris with official creditors. The discussions, which started in February of 1972, were protracted largely because of the issue of compensation for nationalized properties. Eventually they ended with a recommendation to refinance 70 percent of amortization and interest payments (namely, $181 million) due on account of guaranteed suppliers credits and official loans. However, because all of the necessary bilateral agreements were not completed promptly (especially with the United States), numerous obligations again went unpaid. Also refinanced were sizable debts to commercial banks in the U.S. and Europe. The former consolidated obligations outstanding as of March 1972 into three five-year loans: one for $52.2 million covering public sector debts, another for $90.5 million on account of obligations accumulated by Chile's nationalized copper companies, and a third for $17.8 million to cover various private sector debts. Other arrangements included refinancings with European banks for a total of about $60 million, with the international consortium Atlantic Community Development Group for Latin America (ADELA) for $13.8 million, and with some suppliers and governments not included in the Paris discussions.

External financial difficulties only grew worse in 1973. Numerous obligations went unpaid while government representatives met twice in Paris seeking a renegotiation of debt-service payments falling due in 1973/74, but the meetings failed to produce new agreements. Not until December 1973 was an arrangement finally concluded with the United States to implement commitments made in Paris at the beginning of the previous year for approximately $90 million, including an Eximbank refinancing of $53 million. By early 1974, therefore, it was clear that the virtual suspension of payments to suppliers and foreign governments in 1973 had increased Chile's heavy 1974 debt-service burden by an extra 50 percent, and in the context of a difficult balance-of-payments situation, this led the authorities to seek new debt relief. In March 1974, officials from 14 countries met in Paris and agreed to refinance approximately $380 million, representing 80 percent of maturities on suppliers and bilateral credits falling due in 1974. The Eximbank's portion was $113 million. The remaining 20 percent (or $96 million) was rescheduled, with 5 percent payable immediately, 5 percent in 1975, and 10 percent in 1976.

In 1975 Chile's continued heavy debt-service burden, particularly in view of obligations arising from compensation for previously nationalized properties, again was judged to be beyond the country's payment capacity. The authorities thus sought a further renegotiation with foreign governments with regard to debts maturing in 1975, and by May of that year seven countries had agreed to provide relief by refinancing 70 percent (namely, $147 million) of payments due and by rescheduling the remainder ($63 million) in three installments of 10 percent each due in 1975-77. Obligations to six other countries for $29 million subsequently were restructured on the same basis. The Eximbank, which represented the United States at the former gathering of governments, provided relief worth $33 million. Later on, various other obligations to foreign (government-related) entities, such as those pending since 1973 with banks in the Soviet Union and in Eastern Europe, were successfully renegotiated.

Peru first encountered debt-servicing difficulties in 1968, at which time the authorities sought to restructure obligations to commercial banks and outstanding suppliers credits. The process began in June of that year with a 90-day rollover of numerous debts contracted by a state-owned steel mill and continued with negotiations held with U.S., Canadian, and European banks aimed at refinancing loans, both their own and those granted by various suppliers. Some banks refinanced only their previous loans: for example, a group of U.S. banks refinanced $68 million on account of two loans granted in 1966 and 1967, respectively, and a California-based bank refinanced $8.4 million for principal and interest due on a 1965 loan. Other banks granted loans to refinance both obligations on their books and suppliers credits, as illustrated by a New York-based bank that made a $16.5-million loan (of which $5.4 million constituted a refinancing of its own obligations) and by a Canadian bank that approved a $10.5-million loan ($3.9 million of which refinanced principal payments due on a past loan). Finally, other U.S., Canadian, French, and British banks consolidated and refinanced suppliers credits amounting to over $17 million. Most of these credits matured during the 1970-73 period. In addition, the Peruvian authorities negotiated the refinancing of guaranteed suppliers credits with individual European governments. The Belgian, French, German, Italian, and Spanish authorities agreed to refinance some $48 million, representing over 60 percent of principal and interest payments maturing in the latter half of 1968 or during 1969. Several Japanese suppliers refinanced obligations in excess of $6 million.

The ink was hardly dry on these debt-relief agreements when in mid-1969 the Peruvian authorities began to raise the issue of refinancing or rescheduling obligations falling due in 1970-72. The negotiations that followed with commercial banks were protracted and those with foreign government agencies did not yield an agreement with uniform terms and conditions, although a meeting in November 1969 did conclude with the recommendation to refinance at least 60 percent of government and government-guaranteed suppliers credits maturing in 1970/71. Debt-relief arrangements were finally concluded during the second quarter of 1970, when three Canadian banks consolidated and refinanced their 1968 loans ($19.7 million); U.S., French, and

British banks rescheduled loans totaling nearly $100 million (granting debt relief of approximately $12 million in both 1970 and 1971 plus over $7 million in 1972); and European government agencies refinanced payments of over $50 million. Most of the new agreements essentially stretched out repayments until 1975.

A year later, that is, in mid-1971, the Peruvian government began to explore the possibility of obtaining some debt relief on obligations maturing in 1973. Once again the negotiations were long and carried over into 1972, especially since European lenders and guarantors were understandably reluctant to go along with yet another rearrangement of maturities. In the end the consortium of U.S. banks whose loans had been renegotiated twice before, as well as the group of Canadian banks that had been involved in the 1970 refinancing, agreed in early 1972 to reschedule 85 percent ($30 million) and 75 percent ($5 million), respectively, of total obligations maturing in 1973. In addition, since only a Spanish government agency consented to a $3.1-million refinancing of outstanding suppliers credits, certain commercial banks in the United States and Germany were prevailed upon to consolidate and refinance maturing obligations to suppliers.

The possibility of serious debt-servicing difficulties did not arise again until mid-1976, when Peru's traditional creditor banks were approached for the purpose of arranging a sizable loan. Many of the banks were reluctant, but when the Peruvian authorities agreed to a conditional two-tranche disbursement schedule—with the second tranche to be granted only upon evidence of satisfactory economic performance—the negotiations came to a successful conclusion. The resulting balance-of-payments-support loan was for $330 million and was arranged by banks in the United States, Canada, and Europe.

A year later, however, Peru was still in dire straits. Unable to raise new funds to the degree that was required, the authorities had to devote much of 1978 to an extensive restructuring of the country's foreign debt. It began early in the year with the rescheduling of $65 million in obligations due to the Soviet Union and continued in mid-1978 with a postponement until 1979 of $185 million in payments owed to foreign commercial banks. Later on, two major agreements covering 1979/80 maturities were concluded with Peru's principal government and commercial bank creditors. Meeting in Paris, representatives of 14 governments agreed to refinance or reschedule about $550 million, with the equivalent of 90 percent of payments on bilateral and government-guaranteed suppliers credits falling due in 1979/80. Similarly, the banks decided to refinance some $360 million (or 90 percent) of 1979 maturities and pledged to refinance up to 90 percent of obligations maturing in 1980 (up to a maximum of $349 million). Additional restructuring with Eastern European, Latin American, and other government agencies, as well as certain minor reschedulings, are estimated to have provided a further $320 million in debt relief.

The only other Latin American country with a relatively rich history of debt-servicing problems is Uruguay. During the 1959-62 period, the country's balance-of-payments performance was very poor and required sizable compensatory inflows of foreign capital. The Uruguayan authorities relied extensively on short-term bank loans and lines of credit to meet their needs for external finance. Only in 1963, when their access to additional short-term facilities proved to be limited, did they obtain a five-year loan for $39 million from a group of New York banks in what was a balance-of-payments-support operation. In 1964, Uruguay began to fall in arrears under some suppliers credits and open account obligations to several petroleum companies. Although the country's external situation began to improve in early 1965, a series of bank failures led to heavy withdrawals of dollar deposits from the Uruguayan banking system, emergency intervention by the central bank, and the missing of a payment due to the country's New York creditor banks.

The exchange crisis of mid-1965 set the stage for negotiations with foreign banks and suppliers for the consolidation and restructuring of existing short-term obligations. By the end of the year, the Uruguayan authorities had been able to refinance 85 percent of outstandings to U.S. banks through a $48-million loan to be repaid over a four-and-a-half-year period, as well as $10 million due to Canadian and European banks. U.S. and British suppliers, in turn, agreed to a gradual elimination of arrears during 1966 and 1967. This debt relief proved to be short-lived, however, because Uruguay continued to rely too heavily on bank lines and suppliers credits with short maturities to meet its foreign currency needs. Thus in late 1967 negotiations were again reopened with creditor banks, eventually leading to a refinancing of 1968/69 maturities amounting to $27 million.

The country did not encounter debt-servicing difficulties again until 1971/72, when approximately $26 million in liabilities to suppliers were incurred because the Uruguayan monetary authorities did not release sufficient foreign exchange to cover import payments as they became due. In 1973 these arrears were formally assumed by the central bank and began to clear up. During this time, borrowings from and repayments to foreign commercial banks proceeded without major complications. It was only in 1975, in fact, that a seven-year, $130-million loan was arranged by a consortium of mostly U.S. banks for what can be considered balance-of-payments-support purposes. Although there is no direct evidence that the creditor banks were unwilling participants in the transaction, the loan was fully secured by a pledge of gold—a fact that suggests that without the collateral, the country would have encountered considerable resistance.

In addition to the cases discussed so far, there have been a few other more isolated or less serious incidents of debt-servicing difficulties elsewhere in Latin America. For example, foreign suppliers and banks were affected by Colombia's accumulation of commercial arrears in 1965/66. And commercial banks were not spared involvement in the difficult external payments situation that Mexico went through in 1976. As part of a package of emergency financing obtained by the Mexican government from the U.S. Federal Reserve System, the U.S. Treasury, and the International Monetary Fund, banks (largely from the United States) were prevailed upon by the Mexican authorities to grant a loan totaling $800 million.

A more recent incident involves Nicaragua, which stopped servicing its government and government-guaranteed debts to commercial banks in late 1978 following an outbreak of internal violence that triggered capital flight and closed the doors to most of the country's traditional sources of foreign finance. Ever since early 1979, negotiations with U.S. and other banks have been in progress to restructure obligations falling due in 1979 and 1980.

PRECIPITATING FACTORS

A case-by-case analysis of the debt-servicing problems summarized on the preceding pages reveals that, in virtually every instance, a rather clear-cut reason drove policy makers to seek direct or indirect relief from obligations to foreign governments, suppliers, or commercial banks: a perceived inability to make ends meet. Or, put in other words, it was the perception that foreign exchange resources would not be sufficient to cover immediate or near-term foreign exchange needs that led to requests for debt rescheduling or refinancing or for emergency loans in support of the balance of payments. Consequently, the country risk faced by banks in their international lending activity is basically a foreign exchange risk, as opposed to the essentially political risk encountered by multinational corporations and banks with equity investments abroad. In the latter case considerations of a noneconomic nature usually explain, for instance, the decision of foreign governments to nationalize certain properties. In the former case, it is human judgments about likely balance-of-payments trends that play the dominant precipitating role.

It should be noticed that special emphasis has been placed here on the perceptions and judgments of policy makers and not merely on the blind interaction of economic forces. The reason is that, as is illustrated later on, there have been several instances where government authorities plainly miscalculated the extent or timing of foreign exchange shortages. And there have been other cases where policy makers clearly did not have the same view of the costs and benefits of falling in arrears or renegotiating external obligations that their

counterparts did at other times or in other countries. Thus, given that policy makers have neither perfect foresight of future balance-of-payments trends nor identical ways of dealing with them, there is no valid basis for the expectation of an exact, systematic relationship between specific economic conditions and instances of debt-servicing difficulties.

However, since it is impossible to read the minds of policy makers, a historical analysis of precipitating factors can only quantify the actual, ex post circumstances that may have prompted their decisions. In order to do so, an objective indicator of foreign exchange shortage, the gap between the supply and demand of foreign exchange prior to recourse to foreign borrowing, must be constructed. The evolution of such an indicator can perhaps suggest instances when policy makers may have had an objective basis for seeking debt relief.

Most developing countries register current account deficits; that is, they import more goods and services than they export. This is what usually gives rise to their borrowing needs and thus to the accumulation of external debt. While interest costs are included in the current account, amortization payments are considered to be a capital account transaction and must thus be added to the current account deficit to measure a country's gross borrowing requirements. This concept quantifies how much foreign exchange must be obtained from various sources if outflows stemming from current account and debt-repayment transactions are to be covered.

There are four main ways by which a country can meet its gross borrowing requirements. First, it can stimulate inflows of private direct investment, that is, the setting up of branches or subsidiaries by foreign corporations or the purchase of shares in local industry. Second, it can obtain project-related loans from international organizations (such as the World Bank and the Inter-American Development Bank) or from official bilateral sources (the Eximbank, the Agency for International Development, and their counterparts in other countries). Third, it can utilize previously accumulated reserves of foreign exchange. Finally, it can obtain funds via borrowing from commercial banks, foreign suppliers, and the International Monetary Fund. Consequently, from the point of view of the international banking community, a country's actual borrowing requirements are really the difference between its gross borrowing requirements and its net inflows on account of direct investment, multilateral and official loans, and international reserves usage. For example, if a country's projected current account deficit is $500 million and amortization payments falling due are an additional $200 million and if this $700 million outflow can be offset by direct investment inflows of $100 million, project loans of $150 million, and reserves usage of $200 million, then actual borrowing needs (from banks, suppliers, and the International Monetary Fund) can be said to total only $250 million.

This rather simplified view of the balance of payments of a typical developing country implicitly assumes that there are no sizable short-term capital inflows or outflows to augment or reduce borrowing requirements. As will be seen, however, this is an assumption that does not always hold. Indeed, capital flight has at times triggered an earlier or more severe foreign exchange crisis than the other more permanent sources of foreign currency outflows (that is, the current account and amortization payments) would have suggested.

In order to reconstruct the foreign exchange situation faced by government officials in a sample of Latin American countries—most of which encountered debt-servicing difficulties sometime during the 1960-79 period—their borrowing requirements have been quantified and are shown in Table 3.1. It should be noted, first of all, that actual (as opposed to projected) current account, direct investment, and project loan figures have been utilized in every case. This follows from the inability to obtain the ex ante estimates made by policy makers in each country with regard to these external flows. Therefore, the figures fail to capture the overly pessimistic or optimistic assessments that at times prompted policy makers to initiate debt-relief negotiations prematurely or belatedly.

Second, the amortization figures employed refer only to repayments of government and government-guaranteed medium- and long-term obligations, since no consistent statistical series on private sector and short-term debt repayments exist. Only in the case of Chile do the amortization statistics include repayment of private sector medium- and long-term indebtedness. This means, in general, that the countries' debt burdens are underestimated—and, consequently, so are their annual borrowing needs. The available amortization data are also deficient in that they measure only what was paid, as opposed to what was due. Therefore, estimates of obligations falling due but not fulfilled because of arrearages or debt rescheduling have been incorporated into the statistics on amortization payments. Nevertheless, the lack of complete information on amounts rescheduled indicates that instances of debt renegotiation do distort the available debt-servicing data and result in a further underestimation of the foreign exchange gap faced by policy makers.

Finally, the potential usage of international reserves as a financing item has been quantified by making two basic assumptions about Latin American central bank authorities: (1) that they have a reserves target of two months' import cover and (2) that gold holdings are not part of reserves because they usually are not or cannot be utilized for intervention purposes. In other words, policy makers are assumed to be willing to utilize their reserves of foreign exchange as long as they are in excess of one-sixth of the coming year's total import bill and, by the same token, are assumed to want to rebuild

TABLE 3.1

External Borrowing Requirements and Foreign Debt-Servicing Difficulties

Year	Argentina (1)	Argentina (2)	Argentina Debt Relief	Brazil (1)	Brazil (2)	Brazil Debt Relief	Chile (1)	Chile (2)	Chile Debt Relief	Colombia (1)	Colombia (2)	Colombia Debt Relief	Ecuador (1)	Ecuador (2)	Ecuador Debt Relief
1960	3.5	*	—	5.1	4.6	A/BS	5.3	2.1	—	3.8	0.5	—	2.3	*	—
1961	5.9	3.9	BS/OS	3.4	2.7	BS/BP/OF	8.6	6.2	—	4.2	2.2	—	3.4	0.7	—
1962	4.7	3.1	BS/OSF	5.2	4.0	A	8.9	6.7	A	4.4	3.2	—	2.0	*	—
1963	0.5	*	—	2.2	2.0	A/OF	9.0	7.2	A	4.0	2.3	—	1.7	*	—
1964	1.7	0.6	—	1.2	0.7	A/OF	6.2	5.1	A	3.7	1.8	—	3.2	0.4	—
1965	0.5	0.5	BS/OF	0.5	*	BP	4.6	3.3	OSF/BP	2.3	1.0	A	2.7	*	—
1966	0.8	0.2	—	1.7	*	—	5.6	4.2	A	7.3	5.2	A	2.6	*	—
1967	1.4	0.9	—	1.5	*	—	4.1	2.2	—	3.2	0.6	—	4.5	0.2	—
1968	2.2	*	—	2.4	1.6	—	6.5	2.1	—	4.2	1.5	—	7.6	3.3	—
1969	2.6	0.1	—	1.6	0.6	—	3.6	*	—	4.4	0.5	—	6.9	3.6	—
1970	2.0	0.6	—	2.7	0.5	—	5.1	2.0	—	6.2	1.7	—	8.3	1.7	—
1971	2.4	0.8	—	3.9	0.9	—	5.7	3.7	A	7.6	4.2	—	11.7	*	—
1972	2.0	1.8	—	3.6	0.2	—	5.2	4.6	A/BF/OF	4.1	0.9	—	5.9	0.3	—
1973	*	*	—	3.4	*	—	6.2	6.5	A	2.3	*	—	2.0	*	—
1974	1.0	*	—	7.7	1.6	—	5.2	9.5	A/OSF	4.6	0.4	—	1.1	*	—
1975	5.3	3.2	—	6.3	1.9	—	13.0	14.4	A/OSF	1.8	*	—	5.8	*	—
1976	*	*	BP	5.1	2.3	—	5.1	5.9	—	*	*	—	1.1	*	—
1977	*	*	—	4.2	*	—	9.8	8.8	—	*	*	—	6.7	0.5	—
1978	*	*	—	4.9	0.8	—	11.9	10.2	—	0.4	*	—	4.3	*	—
1979	*	*	—	6.3	0.5	—	10.9	7.1	—	1.0	*	—	6.5	*	—

	Mexico			Nicaragua			Peru			Uruguay			Venezuela		
	(1)	(2)	Debt Relief	(1)	(2)	Debt Relief	(1)	(2)	Debt Relief	(1)	(2)	Debt Relief	(1)	(2)	Debt Relief
1960	4.2	1.2	—	3.0	*	—	1.8	1.3	—	6.6	8.3	—	*	*	—
1961	3.1	0.2	—	2.5	*	—	1.7	2.4	—	1.5	2.5	—	*	*	—
1962	3.0	0.5	—	3.3	*	—	2.6	1.6	—	4.4	5.4	—	*	*	—
1963	2.8	0.2	—	3.6	0.2	—	4.2	4.1	—	0.9	0.1	BP	*	*	—
1964	4.3	1.4	—	4.7	*	—	0.6	*	—	2.4	2.8	A	*	*	—
1965	4.0	1.5	—	4.9	*	—	4.4	2.0	—	0.4	0.5	A/BF	*	*	—
1966	3.4	1.2	—	9.4	*	—	5.9	4.8	—	*	*	A	0.3	*	—
1967	4.4	2.4	—	12.8	3.7	—	6.8	7.0	—	2.8	1.6	—	*	*	—
1968	4.5	2.5	—	7.3	2.0	—	3.5	2.7	BF/OF	0.8	0.2	BF	2.4	*	—
1969	3.5	1.3	—	8.7	1.3	—	1.5	0.5	—	3.4	2.1	—	2.4	*	—
1970	4.7	2.5	—	8.8	1.4	—	*	*	BSF/OF	4.9	4.7	—	0.8	*	—
1971	3.7	1.6	—	8.0	1.7	—	3.1	*	—	4.1	4.0	—	*	*	—
1972	3.7	1.5	—	0.5	*	—	3.0	*	BS/OF	1.5	1.0	—	1.3	*	—
1973	4.4	2.1	—	11.4	5.6	—	7.1	2.3	—	2.1	0.2	A	*	*	—
1974	5.4	3.3	—	18.6	13.0	—	9.3	4.6	—	7.9	6.0	—	*	*	—
1975	6.1	4.3	—	13.3	8.3	—	13.0	4.0	—	10.8	10.3	BP	*	*	—
1976	5.8	3.9	BP	4.3	*	—	10.4	7.3	BP	6.4	6.0	—	*	*	—
1977	5.7	3.7	—	10.5	6.2	—	10.4	8.8	—	7.4	5.6	—	7.5	*	—
1978	6.7	5.2	—	3.3	*	A	8.5	5.0	BSF/OSF	3.6	*	—	13.0	*	—
1979	4.6	3.3	—	9.7	13.4	A	9.0	4.8	—	5.6	2.1	—	7.4	*	—

Note: (1) = current account deficit plus amortization payments, as a percent of GDP; (2) = (1) less net direct investment inflows, noncompensatory official and multilateral loans, and "excess" foreign exchange reserves (as defined in the text), as a percent of GDP; A = arrears; OF = refinancing of official debt; OS = rescheduling of official debt; OSF = OS and OF; BF = refinancing of bank debt; BS = rescheduling of bank debt; BSF = BS and BF; BP = bank balance-of-payments-support loan; and * indicates that the amount is zero or negative.

Sources: For external borrowing requirements, International Monetary Fund, International Financial Statistics; Inter-American Development Bank, External Financing of the Latin American Countries; Banco Central de Chile, Boletín mensual; and World Bank, World Debt Tables. Information for debt relief was compiled by the author from various sources. The figures for 1978/79 are estimates subject to revision.

their stock of foreign currency reserves whenever import coverage falls below two months.

Turning to an analysis of Table 3.1, it will be noticed that the two measures of borrowing requirements here discussed are expressed in relation to the gross domestic product (GDP) of each country. The purpose of this is to place the various financial gap statistics in perspective, thus allowing for some degree of comparability over time and across countries. In essence, this assumes that a $300-million gap is far more difficult for a small or poor country to fill than it is for a large or higher-income country.

A word of caution is in order about the pinpointing of debt-servicing incidents as they appear in the table. The discussion in the first section of this study should have made clear that such an exercise is an approximation and can be misleading. In many cases, between six and eighteen months elapsed from the start to the successful conclusion of a debt relief arrangement, yet because of insufficient information only the latter date is usually recorded. In addition, in some instances policy makers sought debt relief a year or two ahead of a projected difficult external financial situation—which sometimes never materialized—while others met it head on, often through heavy reliance on short-term borrowing, and only sought relief once the foreign exchange gap proved too large or too persistent to be bridged without it. Consequently, matching debt-servicing incidents with particular calendar years should only be interpreted with adequate allowance for the various leads and lags that may have occurred.

In the case of Argentina, for example, the debt-servicing difficulties encountered in 1961/62 appear to correlate well with the country's sizable foreign exchange gap (3.9 percent and 3.1 percent of GDP, respectively). In 1961 Argentina had a current account deficit ($585 million, the equivalent of 4 percent of GDP) that was by far the largest ever registered (in absolute as well as relative terms) throughout the 1953-74 period. It was followed in 1962 by yet another deficit ($273 million, or 2.1 percent of GDP) and, more important, by a massive flight of capital. Indeed, if such speculative capital outflows were to be included in the calculation of the 1962 borrowing requirements coefficient, they would increase it from 3.1 percent of GDP (as shown in Table 3.1) to about 5.5 percent of GDP. These adverse trends generated a foreign exchange imbalance that inflows on account of direct investment, project loans, and reserves usage could not possibly bridge. Argentina's reserves of foreign currency dropped, in fact, from over $400 million at the end of 1960 (providing four months' import cover) to half as much a year later and to only $50 million by late 1962. In light of political instability and a deteriorating domestic financial situation, the authorities were unable to raise sufficient foreign funds in international capital markets and had to seek relief from external obligations.

In contrast, the 1965 renegotiation of foreign debts seems odd in view of a foreign exchange gap of only 0.5 percent of GDP. But this follows from a severe distortion of the underlying current account data, which registered a $223 million surplus (or 1 percent of GDP) on paper. The reason is that in late 1964 and early 1965, in anticipation of untenably strong demand for foreign exchange, the Argentine authorities blocked profit remittances, restricted private transfer payments, cut tourist exchange allocations, and curtailed merchandise imports via the imposition of a 100 percent advance deposit. Debt relief negotiations were thus initiated to obtain sufficient foreign financing to meet a backlog of transactions that in the absence of controls would have generated a borrowing requirements gap of over 2 percent of GDP. Yet the successful conclusion of debt relief arrangements and the lifting of exchange controls in the second half of 1965 coincided with a domestic recession that depressed import demand and was followed by an unscheduled change of government that inspired public confidence and triggered a reflux of capital. Consequently, Argentina's balance of payments showed dramatic improvement (for example, reserves of foreign exchange rose from under $50 million in mid-1965 to $600 million two years later), which if foreseen by the authorities would have obviated the need for any debt relief.

Finally, the relevance of lags in some instances is exemplified by events in Argentina during 1975/76. A foreign exchange gap equivalent to 3.2 percent of GDP developed in 1975 as a result of a major deterioration of the balance of payments. Unable to obtain sufficient long-term financing to cover it, the authorities turned to short-term borrowing (largely via swaps), raising approximately $1.4 billion (equal to 3.8 percent of GDP). While this may have seemed a good alternative to debt renegotiation, it merely postponed the problem until the second half of 1976, when the obligations began to fall due. It was at that point that the Argentine government approached foreign banks for a sizable balance-of-payments-support loan with which to cancel debts incurred a year earlier. This need for foreign financing is not revealed by the 1976 coefficients shown in Table 3.1, however, because the underlying data include only repayments of long-term obligations. When proper allowance is made for the burden imposed by short-term debts, Argentina's borrowing requirements in 1976 exceed 4 percent of GDP.

The importance of taking into account policy reaction leads and lags, speculative capital flows, and forecast errors cannot be overemphasized. The Brazilian authorities sought debt relief from official lenders in mid-1964 and balance-of-payments-support loans from commercial banks in early 1965 for a reason not fully conveyed by the foreign exchange gap calculations shown in Table 3.1: The need to liquidate payments arrears and swap obligations totaling $830 million

(3.4 percent of GDP) in the context of depleted foreign currency reserves (averaging $100 million in 1964) and what was anticipated to be a balanced 1965 current account performance. Yet merchandise imports fell 13 percent in 1965 (following a drop of 16 percent in 1964) and exports rose by 12 percent, and thus the current account turned strongly positive, registering a surplus of $284 million, the largest (in absolute as well as in relative terms) recorded in at least three decades. This surplus led to a sudden accumulation of foreign exchange reserves, which quadrupled (to over $400 million) by the end of 1965. Had the Brazilian authorities been able to anticipate this quick turnabout, they would have had no objective reason for seeking extraordinary financial support from U.S. and European commercial banks.

Other incidents of this nature are not uncommon. Unexpected capital outflows played the leading role in triggering a major deterioration of Mexico's balance of payments in mid-1976 and were solely responsible for the Nicaraguan foreign exchange crisis that broke out in the second half of 1978. In addition, the accumulation of short-term debts and the need to repay them were aggravating factors in the Uruguayan debt refinancings of 1965 and 1968.

The only instances of debt relief that cannot be explained by making reference to the country's excessively large borrowing requirements are those of Peru in 1970 and 1972. In both cases the Peruvian authorities sought (and eventually achieved) a renegotiation of future obligations largely as a gesture of displeasure with the international organizations, official agencies, and commercial banks that had adopted a cool attitude toward new loans to the government of Peru because of its policy of nationalizations without adequate compensation. In other words, political rather than economic considerations are the relevant ones here. But this is an exception not likely to be repeated in the Latin American context now that most countries have nationalized or otherwise gained better control over foreign-dominated activities considered to be in the national interest.

The general conclusion to be drawn from Table 3.1—after making some ad hoc adjustments for the inadequacy of the available data as well as for the relevant leads, lags, and ex ante perceptions of policy makers—is that large foreign exchange gaps are a necessary condition for the emergence of debt-servicing problems. A critical minimum value for gross borrowing requirements adjusted for inflows on account of direct investment, project loans, and reserves usage appears to be 2.5 percent of GDP, although a higher threshold (of approximately 4 percent of GDP) seems relevant whenever estimates of short-term debt repayments or of short-term capital outflows are included.

However, an equally important conclusion to be derived from the table is that a large foreign exchange gap is a necessary but by no means sufficient condition to signal the onset of debt-servicing difficulties. A casual review of Mexico's external borrowing requirements or of those of Chile since 1977 or of other countries at various points in time should be sufficient to illustrate the point. The reason is that an analysis of borrowing requirements focuses only on a country's demand for foreign finance and fails to measure the supply side of the relationship, namely, the willingness of the commercial banking community (and the International Monetary Fund) to provide the required sums. This is where confidence (in the government, the economic team, and their policies) enters as a key determinant of the viability of any given foreign exchange gap. Experience demonstrates that a generalized perception of creditworthiness can validate a country's large borrowing requirements, whereas in the absence of confidence even a relatively small foreign exchange gap may prove untenable.

THE FUNDAMENTALS

Having established that debt-servicing difficulties arise when a country's borrowing requirements are large and exceed what lenders are willing to provide, our attention must focus on the fundamental economic and political factors that determine the severity of external imbalances and that give rise to confidence crises that curtail access to international capital markets.

With regard to the Latin American experience of the past two decades, the available evidence suggests, first of all, a strong relationship between the direction of demand-management policies and the condition of the current account of the balance of payments. Overly expansionary monetary policies, often caused by fiscal imbalances, have tended to generate excess demand for goods and services, including imports, to the detriment of exportable surpluses. Such stimulative monetary and fiscal policies generally have been a reflection of attempts to accelerate economic development and to relieve social pressures by increasing current and capital outlays of the public sector, while failing to transfer sufficient resources from the private sector to the government through taxation and other legitimate means. In addition, credit to the private sector has sometimes grown excessively in an effort to stimulate investment and production, generating, in the short run, inflationary pressures that have weakened the balance of payments.

Second, distortions in the structure of prices prevalent in the economy have often caused or contributed to balance-of-payments problems in Latin America. For instance, low administered prices of food and energy have at times imposed disincentives to domestic producers and have spurred undue reliance on imports. Ceilings and restrictions on the payments of interest have discouraged domestic savings and encouraged capital outflows in response to international interest rate differentials. And, to be sure, inadequate exchange rate policies, in view of existing and anticipated current account deficits, have been a notorious source of external imbalances. These and other distortions usually have come into being because governments wished to minimize the cost to consumers of certain vital commodities, but they tended to worsen over time because of the difficulty of effecting changes in pricing policies because of political considerations.

Third, current account difficulties have been fostered by strategies of economic development entailing a poor allocation of available resources. Policies of so-called import substitution, which established import-competing industries through tariff protection and fiscal and credit incentives, actually promoted greater dependence on certain import categories (for example, raw materials and capital goods), increased the cost of industrial inputs to local producers of other commodities, and represented an inefficient use of scarce capital and managerial talent. At the same time, policies that failed to promote exports (whether of traditional or nontraditional goods) resulted in a lackluster export earnings performance that created foreign exchange bottlenecks to rapid economic growth.

Finally, political instability and inept economic management have been major determinants of short- and long-term capital outflows. Political systems or economic policies that generated a great deal of uncertainty led to speculative attacks on the prevailing exchange rate that sometimes succeeded in depleting, in a matter of weeks or months, even large precautionary reserves of foreign exchange.

Surprisingly, perhaps, the Latin American experience fails to suggest that factors such as the paucity of natural resources, a low level of per capita income, or adverse exogenous developments related to international trade can trigger an external payments crisis. It is what governments are able to do with the available natural and human resources that seems to matter. It is also the ability of countries to live within their means, however modest or ample they may be, that is relevant. And it is the willingness to adjust to a sudden decline in the volume or world price of exports or to an unexpected increase in the price of imports that seems to be critical. All of the above are related to the quality of economic management and to the flexibility inherent in the political system.

Concerning what influenced the degree of confidence in a country and its government on the part of the international financial community, there are at least three somewhat intangible factors that appear to have played a leading role. First, confidence required that there be a consensus among creditors that the authorities of the borrowing country would "play by the rules," namely, that they would honor contracts and pledges in both letter and spirit. Actions considered to be arbitrary, whether against individuals or domestic corporations or especially against multinational enterprises, tended to destroy confidence by raising doubts about the borrower's respect for the laws and the eventual fulfillment of other kinds of obligations.

Second, financial institutions seem to have been favorably impressed by coherent foreign borrowing programs. They included, for instance, centralized control over the amounts, terms and purposes of new loans; careful coordination between borrowing and stabilization or economic development plans, so that the end use of foreign credits was evident and supplementary fiscal, monetary, and other measures were adopted; and a healthy reliance on a variety of lenders (suppliers, multilateral development institutions, and so on).

Third, sensible economic policies and good economic performance prospects appear to have been additional keys to gaining and retaining the confidence of creditors. For example, hostile relations between the government of a country and its private sector or between national authorities and the officials of international organizations (particularly the International Monetary Fund) were taken to be bad omens. On the other hand, good relations plus the prospect of high rates of economic growth and of low, or at least predictable, rates of inflation were considered to be sound reasons for being confident.

SUMMARY AND CONCLUSIONS

The history of Latin America during the past two decades reveals that countries can encounter debt-servicing difficulties and that these disrupt the timely flow of repayments or result in undesired increases of exposure to countries deemed not creditworthy. Argentina, Brazil, and Chile experienced severe difficulties in the early 1960s, Uruguay and Peru in the mid- or late 1960s, Chile again in the early 1970s, and Peru and Nicaragua in the late 1970s. However, some other countries have come close to having serious difficulties or have had isolated problems some time during the 1960-79 period. The accumulation of arrears, the arrangement of reschedulings and refinancings, and the need for new loans to repay a variety of prior obligations were the manifestations of debt-servicing difficulties or the forms of debt relief. The parties affected were commercial banks, multilateral financial institutions, suppliers, and government agencies, that is, all sources of external finance available to the developing countries.

With only two exceptions (and both in the same country, Peru), all episodes of debt-servicing difficulties have taken place in the context of large external imbalances. There are instances when the effect of one upon the other is not apparent now, because the conditions of the times and the expectations of policy makers cannot be recreated or ascertained. In addition, the limitations of the available data on short-term obligations and on speculative outflows of capital tend to minimize the vital role they played in triggering or aggravating external imbalances.

However, the evidence also demonstrates that not all instances of large current account imbalances or heavy amortization burdens necessarily lead to debt-servicing crises, not even if a country's reserves of foreign exchange are low and inflows of capital via private direct investment or project loans are inadequate. The confidence displayed by international lenders and their willingness to step forth with the required sums have often broken that seemingly inevitable link and have given countries time to improve their external performance. Consequently, debt-servicing difficulties have arisen only when a country's borrowing requirements have been large _and_ have been considered excessive by the international financial community.

No assessment of country risk is complete, therefore, unless it focuses both on likely external payments trends and on the potential reaction of creditors to them. The former entails an analysis of demand management, resource allocation, and other policies that will affect the current account of the balance of payments. It must also take into consideration future political developments and government attitudes toward interest rates and the exchange rate, for they influence the direction and magnitude of private sector capital flows.

Predicting the lenders' degree of confidence in a certain country is, admittedly, a difficult task. One must judge, for example, whether the government involved is likely to draw up and persevere with economic development or stabilization plans, to maintain a favorable climate for private sector and foreign investment, to refrain from borrowing at terms and from sources that are inappropriate from a long-run perspective, or to rely on competent individuals to manage the economy. And yet, taking these confidence-building factors into consideration is truly the only way to assess country risk.

NOTE

1. Federal Reserve Board, _Press Release_, November 8, 1978, p. 3.