

RESEARCH ON MONEY AND FINANCE

Discussion Paper no 32

THE DEBT AS A LEVER FOR ECONOMIC POLICY CHANGE A tale of two continents

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August 2011

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**THE DEBT AS A LEVER FOR ECONOMIC POLICY CHANGE.
A tale of two continents¹**

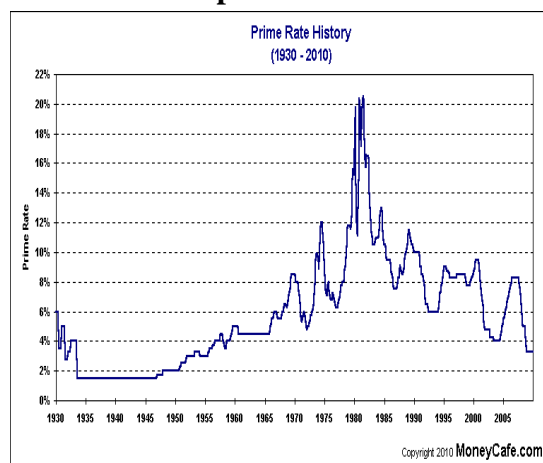
Latin America has had repeated debt problems in the 1820's, 1870's, 1930's and in the 1980's. All of them have had an external origin that combines portfolio theory of interest rates with weak tax revenues. In the 1980's it was a result of the sudden jump in US interest rates in 1979-81 to its highest historical record with a simultaneous depression of commodity prices that strangled the external sector. That external problem became internal as the need for fiscal resources and foreign currency for increased debt service led to reduced public sector wages and expenditures while foreign exchange policies attempted to foster more exports and put a brake on imports while generating inflation. By 1990 the entire Latin American economy had been transformed, the domestic market lost ground, the wage bill on GDP was reduced, welfare policies were substituted by anti poverty policies and social commonsense was won over by the IMF/WB argument that the economy required to be totally opened for international financial investment. The Hayekian view won over the Keynesian, or better over the Latin American structuralist. This meant the demise of the Economic Commission on Latin America and the Caribbean (ECLAC) and the surge of Washington based IFI's as policy makers. In this article we wish to present some comparative elements between the Latin American and the current European debt crisis.

¹ Lecture presented at the Eurodad-CADTM Conference *Debt and Austerity: From the Global South to Europe*. U of Athens, 6-8 May 2011

The Latin American debt problem.

The economic history of Latin America is plagued with debt crises. (Marichal 1989, Eichengreen 1989, Reinhart & Rogoff 2009) Latin American public debt became an international problem since the early 1980's. The debt levels at the time of defaults were in the 50% of GDP range. (Reinhart et al., 2003) The reason was that interest rates in the US jumped from 6% to 18% between 1976 and 1981 bringing about changes in investment portfolios, thus tripping the balance of payments of most countries due to a simultaneous reduction in commodity prices.ⁱ Some suggest the real interest rate jumped to 20% (Devlin and French Davies, 1995, 126). It was an external problem that made its way inside the economies. The domestic side of the crisis was consumption growth using foreign borrowing due to very low international real interest rates in the mid seventies. (Devlin y French Davies, 1995) The simple liquidity problem, caused by the mixture of the Volcker Rule and supply side economics between 1979 and 1981, could have been solved by consolidating the entire external debt of each country into one very long term bond issue, with an international guarantor in 1981-82, much like the 1989 Brady Planⁱⁱ. Instead, at the time it was argued, the problem was corruption, ill administration and low productivity. The switching of the diagnosis of the debt problem from a balance of payments issue into one of rent seeking societies corresponded to the arguments made by A.O. Krueger (1974) and taken up by IMF staff. Using that argument, public debts were rescheduled yearly throughout the decade in an attempt to change the economic policies through conditionality..

Graph 1. US Prime Rate



The recommended solution

The real solution to the Latin American debt problem came when the debt was reduced to a manageable level. This could have been done on day one and saved a continent from a depression. All debt crises have ended with a reduction of stocks and a new issue of consolidated very long term bonds.(Marichal, 2010) The Brady Planⁱⁱⁱ arrived in 1989 after a decade of growing debt, depression, social pain and fiscal adjustments. Creditors were unwilling to swap FRNs for one bond issue at a major discount as Bresser

Pereira suggested in the early 1980's. It was when the US Secretary of the Treasury Brady put the initiative on the table that it finally worked.

A global strategy to achieve this result was already defined with precision: it would combine a process of adjustment and reform with a financial mechanism to convert the debt into new securities — with lower face value, and submarket interest rates — that would permit the highly indebted countries to benefit from the discounts existing on the secondary market. This process of “securitization” would apply globally, but would be implemented on a case-by-case basis, according to the differing needs of the debtor countries.^{iv}

The profits for the international banking system that resulted from this strategy were two fold. The increase in the stock of the debt made the lending business very profitable in spite that involuntary lending was the only operation. Secondly, the financial benefits of privatization and the elimination of the welfare State have served well the international financial community. Stock exchanges in Latin America were deregulated and soared since 1990, the banking industry as a whole became transnationalised, and private pension schemes were taken over, thus putting in private international hands most domestic savings.

The succession of defaults after 1982 (see Table 1) led to the debt rescheduling process which started from 1982 on when debt levels were on average 50% of GDP. The IMF began doing the rounds once a year through most countries in the region with stringent conditionalities which opened a downward spiral of public expenditure and investment, increased indirect taxes and gave way to more IMF money to pay private international bankers and refinance what could not be paid for in the first place while banks capitalised accumulated interests in every round. Each refinancing took the unpaid portion of the debt and lent new resources with a ten year schedule. By the third refinancing, any positive effects a refinancing might have had were lost. Wages fell, the domestic market was affected, GDP contracted, debt rose, the debt/GDP ratio grew worse, and then came the next round of debt negotiations and IMF conditionality.

Table 1. Debt ratios and default

| | Debt/GDP | Year of |
|------------------|-----------------|----------------|
| | % | Default |
| Argentina | 55.1 | 1982 |
| Brasil | 50.1 | 1983 |
| Ecuador | 68.2 | 1984 |
| México | 46.7 | 1982 |
| Perú | 80.9 | 1978 |
| Perú | 62 | 1984 |

Source: Reinhart and Rogoff, 2009

If the debtor Government cannot pay X, lending it Y money so it can pay back X will only lead to a situation where the total debt will grow from X to X+Y. The rescheduling process in Latin America gave way to a reduced wage bill as a share of GDP through IMF conditions of reduced consumption in every turn. It went from an average of about 34% to around 28% of GDP with the exceptions of Brazil and Chile where they remained stable in the 40% range between 1980 and 2000 and of Costa Rica. (see table 2)

Paraguay did not have a debt problem and Chile reduced its debt in the early 1980's buying it back and Brazil did not exactly follow IMF policies.^v For that reason Omhae (1990) in his classic on globalisation said Brazil would never make it to the big leagues. Contrary to his prediction, not following IMF policies allowed Brazil to recover very fast after international conditions recovered and some internal reforms were introduced in the 1990's. Most importantly, wages did not fall and the State kept an active role in the economy. For example the lading development bank in Brazil remains the BNDES with assets larger than the WB and IDB added up in Latin America.

Table 2. Wages/GDP in selected Latin American economies 1980-2010

| Country | 80's | | 90's | | 00's | |
|-------------|---------|-----------|---------|-----------|---------|-----------|
| | Average | Std. Dev. | Average | Std. Dev. | Average | Std. Dev. |
| Argentina/1 | 34.6 | 4.332 | 39.4 | 2.938 | 31.3 | 5.26 |
| Bolivia | 35.5 | 0.641 | 34.5 | 1.232 | 32.4 | 3.726 |
| Colombia | 40.8 | 2.498 | 38.8 | 3.163 | 33.9 | 0.987 |
| Ecuador | 23.6 | 5.32 | - | - | - | - |
| Honduras | 48.6 | 1.243 | 43.9 | 2.786 | 44.5 | 0.9 |
| México | 31 | 3.734 | 31.5 | 2.186 | 30.1 | 1.735 |
| Panamá | 50.9 | 3.105 | 45.2 | 6.726 | 33.8 | 2.685 |
| Perú | 30.1 | 2.2 | 25.2 | 0.83 | 23.3 | 1.59 |
| Venezuela | 38.2 | 3.57 | 32.7 | 3.12 | 31.8 | 2.17 |
| Uruguay | 35.6 | 3.06 | - | - | - | - |
| Chile | 36 | 3.771 | 37 | 2.564 | 38.7 | 2.392 |
| Brasil | 36.6 | 2.634 | 42.2 | 2.153 | 40.2 | 0.661 |
| Costa Rica | 45.7 | 3.091 | 49 | 2.257 | - | - |
| Jamaica | 32.6 | 0.563 | 33.9 | 7.87 | 41.9 | 0.715 |
| Nicaragua | - | - | 32.7 | 1.35 | 35.3 | 0.963 |
| Paraguay | 31.5 | 2.26 | 32.3 | 4.33 | 34.8 | 2.91 |

* GDP at market prices

/1 Data from Juan Grana (2007) 'Distribución funcional del Ingreso en la Argentina. 1935-2005'

Taken from SAE (1955); BCRA (1975); Llach y Sánchez (1984); CEPAL (1991) y EPH-INDEC.

Table prepared by Francisco Josué Martínez Cervantes, OBELA, IIEC UNAM.

Conditionality

In every one of the five debt rounds of negotiations during the 1980's (Devlin and Ffrench Davies, 1995), IMF conditions on economic policy were placed targeted at controlling inflation and improving the balance of payments. Lichtensztejn (2010) suggests they failed as inflation grew worse due to the devaluatory policy and the balance of payments positions did not improve significantly. "Export or die" was the dilemma Latin Americans had to face. Stabilization policies of the 1980's were followed by structural adjustment policies in the 1990's with the Brady Bonds and World Bank adjustment policies. Export led growth was the policy outcome in face of shrinking domestic markets. (Ugarteche, 2000) By then international interest rates had returned to a more normal level,

although still high. Prime rates had fallen from 18% to 6% between 1982 and 1989 at which point there was an initial economic policy agreement known as the Washington Consensus^{vi} that consisted of getting rid of whatever welfare state elements existed including all subsidies, and liberalized all markets: the banking, credit, financial, exchange rate and the labour markets and privatised all Government enterprises. Most of all the aim was to reduce the State in Hayek's spirit.

Protectionism was blamed for the balance of payments problems and for industrial inefficiency which led in the first place to the elimination of industrial policies. (A.O. Hirshman, 1992) There was no transition between import substitution policies and export led policies. No chance was given to export substitution policies in the Asian style. The difference was that the Asians did not have a debt problem and did not have to surrender their economic policy choices.(Agarwal, 2000)

The purpose of having such a protracted period of adjustments was to change the industrialisation policies that had existed in most countries since the 1930's. A "lost" 1980's decade later, Latin America's share of world GDP was halved from 6 to 3%, – regional GDP annual growth was of - 0.4%–, the public debt jumped from 35% of GDP in 1980 on average, to over 67% by 1986 and nearly tripled from 129 billion US\$ to 320 billion US\$ in current USD throughout the decade. By 1990, a new consensus was created that past Keynesian/Structuralist planned import substitution policies were mistaken and that the Hayekian free market led to development. Over a decade later, after 2000, South American Governments began changes towards strengthening the domestic markets again in what some call a swing to the left when realizing that export growth did not bring with it either employment nor income distribution.(Vidal, Guillen y Deniz, 2010).

The mechanisms of coercion for economic policy change went through both IMF stabilization policies and later World Bank structural adjustment policies. It was in the interest of bankers represented by the US Treasury at the IFIs that the debt be paid as much as possible at any cost to the debtor economy while equally pushing for the financialisation and opening of the debtor economy.

The point of the Brady Bonds

When debt service had grown as a result of the continuous refinancing and the debt/GDP ratio become unsustainable, then, and only then, did Secretary of the Treasury Brady suggest that the debt had to be reprogrammed into the very long term and a hair cut be taken. These were the Brady bonds which had US Treasury backing in order to reduce the risk cost. The counter argument was that changes had to be made in US law so that banks could absorb the losses from the debt exposure and this was approved in 1987 only (Griffiths Jones, 1988).

The more than doubling of the debt during the 1980's had two effects: First, the debt/GDP ratio grew since there was an economic depression and the denominator contracted or remained stagnant, while the numerator grew, in spite that no fresh loans were granted. Secondly, it opened the issue of "illegitimacy of the debt" since the 190 billion dollar difference between the 126 bn US\$ original stock of the debt and the 320 USD

billion at the end of the decade was not fresh money entering any country but mainly the capitalisation of interest or anatocism.^{vii}

From a strictly financial point of view, this was not all necessary. A common sense was created that Latin Americans had lived beyond their means. Austerity was the solution and that meant reducing the wage bill. Some argued that as the debt had grown quickly in the last three years of the 1970's, it was because Latin Americans were inefficient, corrupt and lazy.^{viii} (Perez Sanchez, 1995) as the Greeks are also referred to in their crisis.^{ix} The debt level had reached 35% of GDP in 1980, much less than any European economy in 2010 and reached a peak of 64.3% in 1986. Those debt levels were much below contemporary indices for all of Europe including Great Britain meaning that the debt service problem was more related to cost –interest rates– than to volume.

What triggered the problem in Latin America was the sharp rise in interest rates and the shut down of new voluntary credit . Given it was dollar debt, its service depended of two things, a balance of payments surplus and primary fiscal surplus. The first two years of the crises, international reserves fell by 40% between 1980 and 1982 and imports fell by 42% between 1981 and 1983 for the region as a whole. The rate of exchange is what connects the one to the other so devaluations meant to foster exports put a break on imports and on economic growth. As inflation hit hard as a result of devaluations, the domestic side of the economy started to stagnate. Restrictive fiscal policies plus inflationary exchange rate policies led to a depression.

The responsibility of that depression lies squarely in the hands of the IMF and the international community of the time that never gave up pressure. Once the desired result in terms of economic policies was obtained, Secretary of the Treasury Brady announced a plan for debt reduction and the emission of long term bonds with US Treasury backing in order to reduce interest premiums. The launching of the World Bank's 1990's structural adjustment policies came hand in hand with export led growth policies and smaller debt service. This is what is referred to as the “export success” in balance of payments terms.

The European debt crisis and the HIRC

The G7 problem of overconsumption comes together with that of the smaller European states. (tables 3 and 4) The only G7 country that does not have a serious debt problem is Canada that has managed its fiscal policy in order to reduce the debt burden by a half from over 70% to 34% between 2000-2010. Very high debt levels precede the systemic crisis of 2007 onwards and must be seen as a part of the crisis of global capital accumulation. It started in the smaller economies but is not limited to those countries as the US and Japanese cases show. Most rich economies saw their public and private debt grow during the first decade of the XXI century with the exception of the Scandinavians, Switzerland, Austria the Netherlands, and Canada in North America. Iceland is the extreme case where private debt grew to 600% of GDP between 2000 and 2007^x. At the beginning of the second decade of the century most rich economies are over indebted if we take the Maastricht Treaty 60% public debt/GDP limit criteria as valid and have turned into Highly indebted rich countries (HIRC), with low levels of international reserves, bleak growth perspectives and a major portion of the national budget assigned to debt payments..

**Table 3. Public debt of leading countries
% of GDP**

| G-7 | 2000-2005 | 2006-2010 | 2010 |
|----------------------|------------------|------------------|-------------|
| Japan | 165.3 | 202.1 | 225.8 |
| United States | 58.4 | 74.1 | 100* |
| Great Britain | 39.4 | 56.9 | 76.5 |
| Germany | 62.8 | 70.5 | 78.8 |
| France | 61.2 | 71.5 | 83.5 |
| Italy | 106.3 | 110.3 | 118.1 |
| Canada | 77.7 | 75.1 | 34 |
| Average | 81.6 | 94.4 | 102.3 |

Source: CIA Factbook, <https://www.cia.gov/library/publications/the-world-factbook/geos/ic.html>
WB, WDI 2010, done by Francisco Josué Martínez Cervantes, OBELA, IIEC UNAM

*NYT

The European debt problem as a whole appeared after 2007.(Panico, 2010) Most EU countries had a public debt ratio of nearly 60% of GDP before the crisis began and fiscal spending grew significantly as countercyclical policies were put in place and bank rescues were held at the same time, taking some countries to debt ratios in the 100% and over ratio. The basic interest rate for European debt was very low at the start of the crisis and then went even lower, while risk premiums grew. This has increased their cost of borrowing as interest rate risk premiums for those countries with high debt ratios have moved away from the average ECB premium.

**Table 4. Public debt % GDP
European Critical Countries**

| | 2009 | 2010 |
|-----------------|-------------|-------------|
| Belgium | 96.2 | 98.6 |
| Greece | 126.8 | 144 |
| Iceland | 113.9 | 123.8 |
| Ireland | 65.5 | 94.2 |
| Portugal | 76.8 | 83.2 |
| Spain | 53.2 | 63.4 |

Source. CIA Factbook.

<https://www.cia.gov/library/publications/the-world-factbook/geos/ic.html>

The increased cost of the debt due to its risk premium and its size led to the first round of debt negotiations in what became a “bailout” while IMF-ECB-EC economic conditions were imposed in order to reduce budget deficits. The result of the first debt bailout was an increase of the national debt while the consequence of the budget deficit reduction was decreased wages, and public spending thus leading to a decrease in GDP growth. This made the debt/GDP ratio larger, much like in Latin America.

Two years on, some countries – e.g. Ireland, Portugal, Spain and Greece - have entered the second round of debt negotiations and discovered that their basic economic indices are worse than at the beginning of the crisis. Looking at the numbers, there is no reason for Spain to be included in the list of critical countries and much less given shock treatments because its debt level is below the critical point of 60% of GDP. These data however does not reflect private debt.

The lesson from Latin America on debt management is that if the stock of the debt is not reduced at once, the economic structure will feel the blow, and economic policies will be changed. In every debt “bailout” in the short term, additional policy conditions are set for disbursement thus leading to long term policy change. As each round of negotiations takes place, the Welfare State erodes further, the wage bill is reduced further, and the economy becomes increasingly privatised, financialised, and with greater income concentration. The debt is a lever to change economic policies from the Keynesian Welfare State to Hayekian policies.

The conditions placed for the European bailouts relate to reduced wages, reduced public spending, the privatization of public enterprises and increased indirect taxes. Given the European problem is not one of external debt (in another currency) but of domestic debt (all in Euros) then all policies are centred on the budget. What was done in Latin America in terms of adjustment through exchange rate policies and fiscal policies is done only through fiscal policies, making the adjustment more difficult. The reduction of fiscal deficits as a first step towards refinancing the debt is a must. The question is how.

The issue however is not one of adjustment but of size of the debt. With 100% debt/GDP ratios, further adjustments will not make the debts more manageable, they will only lead to further increased debt ratios with the need for further adjustments and “bailouts”. It must be kept in mind that this is happening with very low basic interest rates.(table 5) The European debt crisis has started with extremely low interest rates that will necessarily rise as inflation and economic activity recover. The question is, how will interest rate increases impact on European debt? Discount rates should grow significantly which added to growing risk premiums will make the problem visible not only for those five countries now in the second round of negotiations –Iceland, Ireland, Portugal, Spain and Greece– but also for those that have not entered yet into any negotiations.

Table 5 . Basic Interest Rates

| <i>Entity and country</i> | <i>rate</i> | <i>Since when</i> |
|---------------------------------|-------------|--|
| Bank of Japan YEN | 0.10% | 19/12/08 Was reduced to 1% in 1995 Was further reduced by 0.20% then |
| Euro, BCE | 1.25% | 07/04/11 increased by 0.25% |
| FED US Dollar | 0.25% | 16/12/08 Was reduced from 5.25% in March 07 Further reduced by 1% then |
| Bank of England, Pound Sterling | 0.50% | 05/03/09 Was reduced from 5% en septiembre del 07 Further reduced by 1% then |

Source: <http://www.housepricecrash.co.uk/graphs-base-rate-uk.php> and each country’s central bank.

The lesson from Latin America is that growth cannot be restored until debt levels are reduced to normal levels of less than 40%/GDP. Fiscal revenue improves with economic growth and that will help close the fiscal gap if a proper public spending policy is in place. This will happen sooner or later, as history has shown in the last two hundred years. It can be done if there is political will as the Brady Plan showed. If the object of conditionality and debt restructuring is like in Latin America, to change economic policy overall, then this will not be possible. If it is to restore some growth, then it is a must.^{xi} The cost of the adjustment cannot be borne only by workers but must also be borne by creditors.

Credit institutions and Credit Rating agencies

Historically, international sovereign loans have been done through the London, Paris or New York bond markets. The 1930's changed the instruments in the international sovereign lending business. First bilateral loans were introduced during WWI as the US Government became the lender of last resort to Governments at war that did not properly have control of their own territory. Second, bilateral solutions were found to the debt of these warring countries after the Versailles Treaty in order to allow them economic recovery. Germany as the losing party was not granted these concessions which led to major inflationary problems down river^{xii}. The debt solutions granted warring allied European countries by the United States known as the "inter allied debt" have been a onetime process and have not been repeated yet.^{xiii} Third, after the sovereign bond defaults of 1931 were solved with major haircuts more than fifteen years later, the international bond market shut completely for fifty years. The British Corporation of Foreign Bondholders founded in 1868 by British bankers went into liquidation in 1988. The American Foreign Bondholders Protective Council founded in 1934 by the State Department is still functioning with its records kept at Stanford University. Fourth, the Hoover Year introduced by President Hoover in order to allow European Governments to push ten years down debt payments due between July 1, 1931 and June 30, 1932, led to all non European Governments to seek the same and enter moratoria without any retaliation. Fifth, Bretton Woods multilateral credit agencies were created in 1944 that allowed for the financing of the reconstruction and development of Europe and Japan. Sixth a new bilateral loan was made to both Germany and allied countries for its recovery called the Marshall Plan. International credit to the rest of the world had ceased in 1929 and did not recover until the 1950's. Sixth, a thirty year period of international bank lending began with the development of the Euromarket and ended with the crisis of the 1980's.

After the international banking sovereign debt crisis, bond markets recovered their function. "The sovereign ratings business took off in the late 1980s and early 1990s when weaker credits found market conditions sufficiently favourable to issue debt in international credit markets."^{xiv} Until then very few countries had issued bonds in the international markets after the 1930's crisis. These were mostly Eastern European countries that did not have access to private international bank long term loans due to the trading with the enemy act. Instruments such as credit ratings began to operate much like they had when Moody's invented them in the first third of the XXth century except with more complexity. The sovereign debt rating manual designed by *Euromoney*^{xv} in the early 1980's and revamped in

2002 is a guide to understanding how economic, social and political elements are taken into account in the calculation of credit risk defined as the probability of default on the debt.

Table 6. The Growth of the Sovereign Ratings Business

| Year Rating Was First Assigned by S&P or Moody's | Number of Newly Rated Sovereigns (S&P/ Moody's) | Median Rating Assigned |
|--|---|------------------------|
| Pre 1975 | 3 | AAA/Aaa |
| 1975- 79 | 9 | AAA/Aaa |
| 1980-84 | 3 | AAA/Aaa |
| 1985-89 | 19 | A/A2 |
| 1990-94 | 15 | BBB/Baa3 |

Sources: Standard and Poor's; Moody's Investors Service.

From: *Richard Cantor and Frank Packer* (1995) "Sovereign Credit Ratings", *Current Issues in Economics and Finance*, Federal Reserve Bank of New York, Vol. 1 No. 3, June, pp.1-6
http://www.newyorkfed.org/research/current_issues/ci1-3.pdf

If credit risk analysis is an important parameter for pricing an asset, it also is an instrument used in the transfer of risk from one investor to another. The case of the US subprime mortgages is one to be taken into consideration. The three credit rating agencies—Moody's, Fitch's and Standard & Poor's referred to as *NRSRO* - a *Nationally Recognized Statistical Rating Organization*— gave AAA ratings to the subprime mortgages transferred from lending banks and financial corporations to investment banks. These in turn packaged them into innovative financial vehicles that contained a mix of instruments and risks and sold them in the market. When U.S. Congress investigated into how those junk mortgages had passed from the lenders to the end buyers, and how they had been flogged into customers who had no idea what they were buying, it turned out that the NRSROs had rated them as highest quality financial instruments partially because they were paid by the lending banks or financial corporations in the first case, and the investment banks in the second. They actually emitted an opinion without doing the full work required to classify credit risk. NRSRO function on the basis of the "issuer pays" business model. "The agencies are paid for their ratings by the issuers of the securities and this account for approximately 90-95% of their annual revenues."^{xvi} This creates a conflict of interest as the client that has issued a financial asset asks for an opinion on the financial paper it has issued already in order to sell it in the markets. Their "opinion" makes or breaks the markets. Equally there is lack of independent verification of information and faulty and inaccurate quantitative models according to the 2010 US Congress report on credit rating agencies.^{xvii}

Table 7. Rating Symbols for Long-Term Debt

| Interpretation | Moody's | Standard and Poor's |
|---|----------------------|---------------------|
| INVESTMENT-GRADE RATINGS | | |
| Highest quality | Aaa | AAA |
| High quality | Aa1 Aa2 Aa3 | AA+ AA AA- |
| Strong payment capacity | A1 A2 A3 | A+ A A |
| Adequate payment capacity | Baa1 Baa2 Baa3 | BBB+ BBB BBB- |
| SPECULATIVE- GRADE RATINGS | | |
| Likely to fulfill obligations, ongoing uncertainty | Ba1 Ba2 Ba3 | BB+ BB BB- |
| High- risk obligations | B1 B2 B3 | B+ B B- |

Source: *Richard Cantor and Frank Packer (1996), "Determinants and Impact of Sovereign Credit Ratings"*
<http://www.newyorkfed.org/research/epr/96v02n2/9610cant.pdf>

The role of these three US based NRSRO in the international sovereign bond markets is major. For example, the timing of the announcements of the rating of sensitive countries can affect the markets and result in an influence leading either to over or under pricing according to market sentiment on the particular instrument. This element did not exist in the 1970's for bank loans. Banks had their own credit risk analysis and structured the cost of the loan according to Libor or Prime rate plus a risk premium. Once it was lent, that was settled and only the basic interest rate could change in Floating Rate Notes (FRNs). Today both the basic interest rate and risk premium can vary making the cost of borrowing much more volatile and unpredictable.

For example, there is little evidence that Spain has a major debt problem according to the data above, however, once the NRSRO decided that Spain was a problem country, then its announcement of its rating immediately upset the cost of borrowing that brought with it the ECB IMF conditionality for a "rescue". The Spanish premium jumped from 0 (Aaa) to 0.75% (Aa2)^{xviii}. Belgium that has a more severe debt problem than Spain and a very complicated political scenario has a better grading (Aa1) and was rated up in July 2011, in spite of not having had a Government for over a year. Iceland (Baa3) is doing better than Ireland (Ba1) and has a very similar yield curve over the mid 2010 to mid 2011 period in spite of having defaulted on its debt. The point made is that apparently NRSRO reports affect prices more than they ought to and that they do not reflect fairness –an independent view– but vested interests.(see yield graphs 3-7 below)

In the 1970's banks held the loans they made and were responsible for them. In the unregulated bond market, no one is responsible for bad loans thus making negotiations more complicated. It is investors in bonds that ultimately become responsible for the paper they hold. Underwriters pass the risk on completely to their clients with the aid of credit rating agencies and credit default swaps.

Graph 2. Spain bond yields



Graph 3. Greece bond yields



Graph 4 Portugal bond yields



Graph 5 Belgium bond yields



Graph 6 Ireland bond yields



Graph 7 Iceland bond yields



Source of all: Bloomberg. Based on 10 year Government bonds

Stakeholders

The Latin American debt of the 1980's held by international commercial banks, denominated in Floating Rate Notes (FRNs) and denominated in foreign exchange had mostly three sets of actors: The London Club made up of creditor banks, the debtor Government and the IMF. Without an IMF agreement and green light no negotiation was possible.

The European debt is more complex. Bond markets have underwriters that issue Government instruments. This issue is done with the aiding and abetting of the three credit rating agencies that price them. They are sold and buyers, mostly investment banks and pension funds, place them with their own customers. Other buyers are commercial banks.

Once issued, bonds take on a life of their own in the derivatives market through credit default swaps, bought at the same time just in case the debtor Government is unable to meet its payments. Major investors in credit default swaps normally are underwriters and insurance firms. Underwriters tend to know the smallest details of the debtor Government they are handling, so they can place bets against those debts with the highest knowledge in

the market on the probability of default by their clients. An example is Goldman Sachs with Greece.^{xix}

Finally, while the Latin American debt problem of the 1980's was related to international interest rates, the European debt crisis is related to volume. Basic interest rates are in a historical low level at the ECB, and the Bank of England. This suggests that there has been overconsumption at least from the fiscal sector side that must be properly financed. It also suggests problems with fiscal policy. Some suggest that multinational firms and wealthy individuals are evading and avoiding paying direct taxes to a significant amount^{xx} and this might be at the root cause of this problem.

This means any solution to the debt problem must also be market based and cannot be only an official negotiations exercise as it was in the 1980's. This leads to buybacks and aggressive buybacks. The first are done with the knowledge of the parties involved, the second are not. Chile did a buyback in the 1980's. Argentina and Ecuador did aggressive buybacks in 2005 and 2009 respectively. Others Latin countries did the same in 2006.^{xxi} In the Argentine case bond prices had crashed as a result of the 2001 default and the market was forewarned.^{xxii}

In 2005, after prolonged, contentious, and unsuccessful attempts to find a mutually acceptable solution to restructuring the debt, Argentina abandoned the negotiation process and made a onetime unilateral offer on terms highly unfavorable to creditors. Although 76% of them accepted the offer, a diverse group of "holdouts" opted instead for litigation in hopes of achieving a better settlement in the future. Argentina still owes private bondholders \$20 billion in defaulted debt and \$10 billion in past-due interest. It is also in arrears to the United States and other governments on \$6.2 billion in loans. Although Argentina succeeded in reducing much of its sovereign debt, its unorthodox methods have left it ostracized from international credit markets for nearly a decade and triggered legislative action and sanctions in the United States. (Hornbeck, 2010: Summary)

In spite that they also took up private debt publicly guaranteed, the act of the onetime unilateral offer created litigation problems with Argentina which has not been able to return to international credit markets and has instead been using peso denominated bond issues.^{xxiii} In the Ecuadorian case, prices were sent crashing down as news were released on the likelihood of default due to the conclusion of the debt audit.^{xxiv} In aggressive buybacks, the issue that remains is that of hold outs, e.g. minority bondholders that decide not to exchange their bonds for newer bonds for a much reduced amount. In the Argentine case, those holdouts ended up in lawsuits that remain and prevent the normalisation of credit. The solution that derived from that case was the introduction of collective action clauses (CACs) that force minority bondholders to follow what the majority has agreed upon. This has eliminated the vicious role vulture funds played in Latin America after the Brady Bonds settlements.^{xxv}

While Latin sovereign bonds issued in New York have CACs after the Argentine 2005 buyback and problem with the minority, it is unclear that European bonds issued in London have the same clauses.

In conclusion

ⁱ Ugarteche, O. (2007) *Genealogia de la arquitectura financiera internacional*. Tesis doctoral, U de Bergen, Chapter V

ⁱⁱ <http://www.emta.org/template.aspx?id=35>

ⁱⁱⁱ see Vásquez, I. "The Brady plan and market-based solutions to debt crises", *Cato Journal* Vol. 16, no. 2 , The first Brady Plan with Mexico paved the way. Says Vasquez, "An advisory committee, consisting of the Mexican government and representatives of more than 500 banks, negotiated a "menu," or set of conditions that banks could choose from to reduce or increase their exposure. Three options were on the menu. Existing loans could be swapped for 30-year debt-reduction bonds that would provide a discount of 35 percent of face value (the bonds would have an interest of 13/16 percentage point above the London Interbank Offer Rate, LIBOR). Existing loans could also be swapped for 30-year par bonds that would effectively reduce Mexico's debt service on those loans through a below-market interest rate of 6.25 percent. Banks could also provide new loans at market interest rates over a four-year period of up to 25 percent of their 1989 exposure, taking into account any discount or par bonds obtained. The three options allowed creditor banks to set their exposure to anywhere between 65 to 125 percent of its pre-Brady level (Unal, Demirguc-Kunt, and Leung 1992: 3)."

^{iv} Bresser Pereira L.C., (1988) "A Concerted Solution For The Debt Crisis",

<http://www.bresserpereira.org.br/Works/PrefacesReviews/88.ConcertedSolutionForDebtCrisis.pdf>

^v See Thomas M. Landy, (1990) "From Miracle to Crisis: Brazilian Foreign Debt and the Limits of Obligation", (Case Study #9) Carnegie Council

^{vi} Williamson, J. (1989) "What Washington Means by Policy Reform",) in: Williamson, John (ed.): *Latin American Readjustment: How Much has Happened*, Washington: Institute for International Economics.

^{vii} ANATOCISM, civil law. Usury, which consists in taking interest on interest, or receiving compound interest. This is forbidden. Code, lib. 4, t. 32, 1, or receiving compound interest. This is forbidden. Code, lib. 4, t. 32, 1, 30; 1 Postlethwaite's Dict. 30; 1 Postlethwaite's Dict. 2. Courts of equity have considered contracts for compounding interest 2. Courts of equity have considered contracts for compounding interest illegal, and within the statute of usury. Cas. t. Talbot, 40; et vide Com. illegal, and within the statute of usury. Cas. t. Talbot, 40; et vide Com. Rep. 349; Mass. 247; 1 Ch. Cas. 129; 2 Ch. Cas. 35. And contra, 1 Vern. 190. Rep. 349; Mass. 247; 1 Ch. Cas. 129; 2 Ch. Cas. 35. And contra, 1 Vern. 190. But when the interest has once accrued, and a balance has been settled But when the interest has once accrued, and a balance has been settled between the parties, they may lawfully agree to turn such interest into principal, so as to carry interest in futuro. Com. on Usury, ch. 2, s. 14, principal, so as to carry interest in futuro. Com. on Usury, ch. 2, s. 14, p. 146 et eq. p. 146 et eq.

<http://www.law-dictionary.org/ANATOCISM,+civil+law.asp?q=ANATOCISM%2C+civil+law>

^{viii} Perez Sánchez, A (1995) "Deuda externa de América Latina. Balance de una década (1980-1990)" en Cuadernos de Estudios Empresariales No. 5, U Complutense de Madrid, pp. 243-269

^{ix} <http://arcade.stanford.edu/corruption-and-orientalism>

^x CIA Factbook.

^{xi} "Grecia ahorraría 20 mil mde si compra sus bonos: ministro alemán. Este es el escenario que más adeptos podría concitar "en Europa": Der Spiegel",

<http://www.jornada.unam.mx/ultimas/2011/07/16/1329763-grecia-ahorraria-20-mil-millones-de-euros-si-comprara-sus-propios-bonos-ministro-aleman>

^{xii} See Keynes, J.M., (1920) *The Economic Consequences of the Peace*, Harcourt, Brace and Howe, New York and *The Treatise on Money* (1930)

^{xiii} Ugarteche (2007), Chapter 2. Chew, O. (1927) *The Stroke of the Moment. A Discussion on Foreign Debts*. J.B. Lippincott & Co. Philadelphia

^{xiv} Cantor and Packer (1995) , p. 2

^{xv} L'Anson, K., Fight , A., Vandenbrouke, P., (2002) *Banking and Country Risk Analysis: Workbook*, Euromoney-DC Gardner workbooks, Euromoney Institutional Investor PLC, London.

- ^{xvi} Roberts, P (2009). “Credit rating agencies: their role in the financial crisis and the regulatory price that they must now pay”. Aide Memoire. Bryant, Burger, Jaffe & Roberts. http://www.bbirlaw.com/2C0296/assets/files/News/Rating_Agency_Article.pdf
- ^{xvii} “Wall Street And The Financial Crisis: The Role Of Credit Rating Agencies.” Hearing before the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, United States Senate. One hundred eleventh congress, Second session, Volume 3 of 5. April 23, 2010. <Http://www.gpoaccess.gov/congress/index.html>
- ^{xviii} “Country Default Spreads and Risk Premiums”, last updated 7/2011, http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html
- ^{xix} “Banks Bet Greece Defaults on Debt They Helped Hide”, NYT, Feb 24, 2010-. <http://www.nytimes.com/2010/02/25/business/global/25swaps.html>
- ^{xx} Fighting tax evasion http://www.oecd.org/document/21/0,3343,en_2649_37427_42344853_1_1_1_37427,00.html
- ^{xxi} *IMF Western Hemisphere Regional Economic Outlook: 2006 Midyear Update*. “Brazil, Colombia, Ecuador, Mexico, Panama, and Venezuela announced buy-backs or exchanges of their foreign currency bonds.” P.15 <http://www.imf.org/external/pubs/ft/reo/2006/eng/01/wreo0406.pdf>
- ^{xxii} Hornbeck, J. F., “Argentina’s Defaulted Sovereign Debt: Dealing with the “Holdouts””, Congressional Research Service, April 28, 2010, 7-5700, www.crs.gov, R41029
- ^{xxiii} http://www.emta.org/uploadedFiles/New_Developments/Documents/ND_Int_Fin_Arch/CreditSuisseCommentary.pdf
- ^{xxiv} “Calling Foreign Debt 'Immoral,' Leader Allows Ecuador to Default”, Washington Post, December 13, 2008. <http://www.washingtonpost.com/wp-dyn/content/article/2008/12/12/AR2008121204105.html>
- ^{xxiv} Congreso del Perú, Comisión Investigadora de la Corrupción, Caso Elliot. <http://www.congreso.gob.pe/historico/ciccor/infofinal/deudaexterna.pdf>

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