COPING WITH CAPITAL SURGES

The Return of Finance to Latin America

Edited by
Ricardo Ffrench-Davis
and
Stephany Griffith-Jones

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Preface

This book is based on a research project initially conceived at a brainstorming meeting called by the president of the International Development Research Centre of Canada (IDRC), Keith Bezanson. At this meeting, Roy Culpeper and Stephany Griffith-Jones defined the return of massive private capital flows to Latin America as a key emerging issue both in international finance and for the Latin American region. Soon after, these ideas were further developed in discussions among Ricardo Ffrench-Davis, David Glover, and Stephany Griffith-Jones.

We are very grateful to IDRC for rapidly responding to the need for research on this new, important topic, and for providing both substantive insights and financial support for the project. We thank IDRC's David Glover for helping develop the idea, Gary McMahon for supporting the initial phase of the project, and Rohinton Medhora for very important contributions during the rest of the project. We also wish to express our gratitude to the Economic Commission for Latin America and the Caribbean (ECLAC, or CEPAL) for providing intellectual and financial backing to this project as well as hosting two workshops, and to the World Bank for contributing a paper written by its staff members.

This research project is the fourth in a series of policy-oriented research studies funded by IDRC on key issues for Latin America and developing countries in general. The first, led by Stephany Griffith-Jones, dealt with negotiation of external debt; the second, led by Ennio Rodríguez, dealt with negotiation on adjustment; the third, led by Diana Tussie, dealt with trade negotiations. All the previous projects also resulted in books.

This project—like the previous ones funded by IDRC—has certain unique features. One is the interaction of senior academics and policymakers, of specialists from developing and developed countries. This project benefited additionally from the participation of colleagues from international organizations, particularly ECLAC, the World Bank, the International Monetary Fund (IMF), and the Inter-American Development Bank (IDB).

A second characteristic of IDRC projects that this study shares is the use of several meetings among authors, with invited commentators, to enrich the results and share experiences. A first meeting was held in March 1993 in Santiago at ECLAC to discuss a framework paper for the project prepared by Roy Culpeper and Stephany Griffith-Jones and outlines of papers on case studies. A second meeting was held at the same location in December 1993 to discuss the drafts of papers contained in this book. In the latter meeting, we benefited from valuable contributions from commentators, which included representatives of the Chilean Central Bank and Ministry of Finance, the Federal Reserve Bank of Dallas, the World Bank, IDB, IMF, and private financial institutions (British, U.S., and Chilean), as well as academics.

A final set of meetings in which we presented the results of our project to senior academics, private financiers, central bankers, and journalists was held in London (at the Institute of Latin American Studies of London University), Washington, D.C. (at the Brookings Institute and IDB), and New York (at the United Nations). We are very grateful to Victor Bulmer-Thomas in London, Nora Lustig and Robert Devlin in Washington, and Cristián Ossa in New York for their crucial help in organizing such high-level meetings. We are also particularly grateful to Enrique Iglesias, president of the IDB, and Jean Claude Milleron, Undersecretary-General of the United Nations, for very stimulating and insightful comments.

The chapters in this volume are divided into three groups. The first group (Chapters 1, 2, and 3) deals with sources of flows, distinguishing between North American lending and investing (the main source of private flows to Latin America in the 1990s), European lending and investing (although second to the United States in importance, European flows are more significant than is generally perceived in the Latin American region), and Japanese funding (characterized until now by their rather low level). The first two chapters are written by academics and the third is written by two World Bank colleagues, Punam Chuhan and Kwang Jun. Although our book differentiates among the scale, features, and motivations of investors and lenders based in North America, Europe, and Japan (a distinction that we believe is valuable for a deeper understanding of the different markets), it is worth mentioning the limits of such a distinction, because of the trend toward globalization of financial markets. Each of the chapters on sources of financial flows analyzes separately foreign direct investment, securities (both bonds and shares), and bank lending, as well as examining the motivations of lenders and investors and existing regulations that affect such flows.

The second group of chapters (Chapters 4, 5, and 6) deals in depth with the features of capital flows and their macroeconomic impact, as well as the policy response of the economic authorities, in three Latin American countries: Chile, Argentina, and Mexico. All three countries are among those that have experienced particularly large increases in their capital inflows in the early 1990s, with a specially dramatic increase in the case of Mexico. Emphasis is placed on the variety of policy responses of the economic authorities to the massive inflows in the three countries; these policy responses fundamentally relate to attempts (1) to moderate the impact of capital inflows on appreciating the exchange rate (especially in the Chilean case); (2) to reduce the monetary impact of foreign exchange operations; and (3) to moderate capital inflows, particularly of a short-term nature (as was done especially in Chile and Colombia).

The authors of the case studies include senior policymakers, such as the former president of the Central Bank of Argentina, José Luis Machinea; the former deputy minister of finance of Mexico, José Angel Gurría; and the former research director of the Chilean Central Bank, Ricardo Ffrench-Davis; as well as other well-known Latin American economists such as Manuel Agosin, José María Fanelli, and Andras Uthoff.

The third section of the book (the concluding chapter, written by Robert Devlin and the two editors of the book) draws out the policy implications for recipient countries and lessons from the capital markets case studies. An important theme of this chapter is that the return of private capital flows to Latin America is to be welcomed, due both to their potential positive contribution to the recovery of economic activity and development in the region, and to the increased potential profitability for industrial countries' investors and lenders; however, to make the mutual benefits from these flows sustainable, governments, both in source and recipient countries, should take appropriate measures. Among the measures discussed are better monitoring of the flows and appropriate, as well as coordinated, supervision of such flows. Regulatory gaps are identified, such as the global regulation of securities, which urgently need to be filled. Of equal importance, in recipient countries adequate macroeconomic measures need to be taken to make the benefits of the private capital flows sustainable in the long term and to avoid, for example, excessive overvaluation of the currency and bubbles in the stock exchange.

The chapters in this book were written mainly in a time of abundance (and indeed overabundance) of capital flows to Latin America, and the issues of managing such abundance were dominant. At the time of finishing this book, there are uncertainties about the sustainability of those flows at the recent levels. These new trends reflect the volatility of such flows and the significance of policy implications that we have examined throughout this book.

Finally, it should be mentioned that, although this book focuses basically on the return of private flows to Latin America, many of the lessons and issues raised are relevant to other developing countries and to countries—

such as those of Eastern Europe—that are in transition to market economies. Furthermore, several of the monitoring and regulatory issues raised are relevant not just for flows to Latin America, nor just for flows to the even larger category of so-called emerging markets, but are of more global relevance.

We wish to thank Alvaro Calderón and Daniel Titelman for their valuable research assistance and Lenka Arriagada for her most efficient processing of the text.

Ricardo Ffrench-Davis
Stephany Griffith-Jones
Santiago, Chile
June 1994

Contents

Preface vii

1 Resurgence of Private Flows to Latin America: The Role of North American Investors 1
Roy Culpeper

2 European Private Flows to Latin America: The Facts and the Issues 41
Stephany Griffith-Jones

3 Latin American Financing in Japan's Capital Markets 75
Punam Chuhan and Kwang W. Jun

4 Capital Movements, Export Strategy, and Macroeconomic Stability in Chile 99
Ricardo Ffrench-Davis, Manuel Agosin, and Andras Uthoff

5 Capital Movements in Argentina 145
José María Fanelli and José Luis Machinea

6 Capital Flows: The Mexican Case 189
José Angel Gurría

7 Surges in Capital Flows and Development: An Overview of Policy Issues 225
Robert Devlin, Ricardo Ffrench-Davis, and Stephany Griffith-Jones

Index 261
About the Contributors 273
About the Book and Editors 277

1

Resurgence of Private Flows to Latin America: The Role of North American Investors

ROY CULPEPER

The 1980s were a "lost decade" to the people of Latin America because external debt and economic decline combined to reduce living standards and undermine regional aspirations toward a better future. Although no Latin countries formally repudiated their debt, a series of de facto defaults manifested by mounting arrears, even on rescheduled obligations, made external creditors extremely leery about increasing their exposure in the region. Instead, the principal private creditors, commercial banks, reduced their exposure by liquidating their loans, refusing to roll over credit lines, or denying fresh credit as old obligations were amortized. The severity of the debt crisis, when juxtaposed with its historical antecedents, left most observers pessimistic by the end of the decade as to the possibilities of a renewal of private capital flows into the region. Instead, the prevailing expectation was that heavily indebted regions must rely, for the foreseeable future, primarily on official flows, for example those provided by the multilateral development banks. Yet by the end of the decade, a resurgence of external private capital flows toward the Latin American region was under way that surprised even observers in recipient countries, in both its overall volume and composition of flows.

This chapter examines one of the primary source regions of the renewed capital flows, North America (primarily the United States). It addresses such questions as: What is the identifiable magnitude of the flows between the regions? What is the composition of these flows, as between bond issuance, net equity purchases, foreign direct investment, and bank lending? What accounts for the sudden change in attitude of North American investors/creditors toward a region they so recently eschewed? What role does the tax and regulatory framework in North America play in either inhibiting or stimulating these flows? and finally, What is the outlook for future flows between North and Latin America?

North America in World Capital Markets Historically

There is nothing new about international capital flows; indeed, these have been considerably larger in the past relative to the size of the world economy.[1] One estimate states that, in relative terms, international flows during 1880–1914 were perhaps three times larger than in the 1980s (Eichengreen, 1991).

An interesting finding of the historical research is that international lenders seem to suffer from amnesia. For example, in the 1970s bank lenders to Latin American countries appeared to overlook the fact that many previous episodes of active lending (as during the 1920s) turned sour with widespread default (as during the 1930s)—by many of the same borrowers in Latin America and elsewhere. Moreover, there are few indications that there were penalties imposed by creditors upon defaulters (or rewards for nondefaulters) in the form of lesser (or greater) access to the creditors' capital markets. Instead, the evidence indicates that all borrowers (both defaulters and nondefaulters, such as Argentina) suffered loss of access to the private capital markets from the 1930s until the late 1960s (Eichengreen, 1991). This suggests that, other things being equal, it makes more sense for a borrower to default or to declare a conciliatory moratorium during difficult times than to endure the additional hardships of maintaining full debt service.

Over time, the shape and composition of the international capital markets, as well as the direction of capital flows, have all changed profoundly. Some borrowers became lenders in their own right. North America—here connoting only Canada and the United States—was a net debtor to the rest of the world prior to 1914. The United States accounted for 8.0 percent of world gross creditor positions but 15.5 percent of world gross debtor positions in 1914.

The situation changed dramatically, at least in the case of the United States, in the interwar years. In the 1920s, the United States became a net creditor on a massive scale, and New York became the center of international lending, before the 1929 crash (Canada remained a net debtor).

It was in the pessimistic aftermath of the depression that the postwar global economic order was established at Bretton Woods, primarily by the

United States and the United Kingdom. The new order was based on the premise that private international capital flows were not just unlikely—in large volumes they were also downright undesirable, bringing in their wake instability and loss of control over domestic economic policy (Bryant, 1987).[2] Thus, the International Monetary Fund (IMF) and the World Bank were both designed to increase stability, predictability, and the public-sector role in international capital markets. As the IMF Articles of Agreement still indicate, the world in 1945 was not unfriendly to restraints by nation-states on international capital flows.

In order to ascertain why and how private flows to the rest of the world resuscitated during and after the 1960s, it is necessary to appreciate the way in which domestic capital markets evolved within North America and Europe. The postwar foundations of North American capital markets were laid during the Great Depression. Widespread failures in the banking system created financial havoc by undermining the confidence ordinary citizens had regarding banks.

The collapse of the banking system, in turn, contributed to the depth and duration of the economic downturn. Pervasive default by international borrowers in Latin America and in other developing countries added to the financial turmoil by inflicting uncertainty and capital losses on bond-holders. These events gave a large impetus to the U.S. administration and the Congress to enact reforms (part of the "New Deal") to shore up the banking and financial systems.

To begin with, the Federal Securities Acts of the 1930s attempted to create a "firewall" between banking and the rest of the financial sector. The securities legislation had two objectives: first, to provide a safety net for banks to help protect against widespread insolvency during future downturns. Accordingly, government-backed insurance schemes were created for depositors; in addition, limits were imposed on the interest rates banks could offer depositors (via "Regulation Q").

Earlier, the McFadden Act of 1928 had prohibited interstate branch banking to protect smaller state and single-branch banks against competition from the large city-based banks. Such measures helped to increase the profitability of smaller banks. In addition, the Federal Reserve system (which had been created two decades earlier as a loose conglomeration of regional clearing banks) was transformed into an effective central bank with powers to control reserves, create liquidity, and act as a lender of last resort.

However, the securities legislation had a second objective—to put an end to the insider dealings that had so inflated stock prices in the run-up to the 1929 crash. It thus attempted to put an end to market manipulation of stock and bond prices by taking banks out of the business of underwriting, dealing, and brokering in corporate securities. Legislation in 1934 (the Securities Exchange Act) created the federal Securities and Exchange

Commission (SEC), which sets standards for the public disclosure of information concerning the financial condition and management of firms whose securities are offered on the nation's exchanges. In addition, the SEC initiated regulation of trading behavior on the exchanges, with enforcement powers to apprehend those involved in abuses such as conflicts of interest, price manipulation, and use of insider information (Pierce, 1991).

The shape and structure of the U.S. domestic capital market emerging from the depression set the context for the relationship between the United States as a capital exporter and developing-country capital importers in the postwar period out to 1990. To begin with, the bond market was more or less closed to developing-country borrowers. Bond-holders were chastened by the defaults of the depression, and settlement of outstanding claims lingered in some cases into the 1960s. Moreover, until recently, SEC registration requirements that were put in place to protect investors against high-risk bonds acted as a "barrier to entry" against developing-country bond issuers.[3]

The task of providing external capital to developing countries in the first two postwar decades was thus left largely to official lenders such as the World Bank and the Inter-American Development Bank, which was established in 1959. Private lenders and investors avoided developing-country markets. Eventually, the hiatus in private flows was ended—first, by a resumption of foreign direct investment, and second, through lending from the banking system. The story of why banking came to play such a prominent role in international capital flows is a curious one, and needs to be related to the evolution of banking after the depression.

The New Deal reforms and an unusually long period of economic growth and stability for two decades after World War II created the impression that banks had been rendered permanently safe and immune to failure (Pierce, 1991). But several developments were occurring in U.S. financial markets that threatened the profitability of the banking sector and forced it into high-risk lending activities (including lending to developing countries) not traditionally the preserve of commercial banks.

Precipitating these changes from the mid-1960s was a more inflationary environment due to the funding (via deficit financing) of the Vietnam War. Interest rates were eventually raised by the Federal Reserve in 1966 to curb excess demand. Because of the ceiling on deposit interest rates, however, some depositors withdrew funds to take advantage of higher rates on treasury bills (TBs) and other market instruments. Consequently, it became difficult for banks to meet loan demand from their commercial customers, leading to a "credit crunch." Partly as a result of this, business borrowers began to tap the market directly by selling highly liquid, short-term notes that offered competitive interest rates to investors and to state and local governments. This so-called commercial paper market grew by 50 percent in 1966, and in 1969 had expanded by 250 percent over 1965 levels. So began the trend to "disintermediation," in which borrowers access savers directly without the intermediation of deposit-taking banks (Pierce, 1991).

To stem the loss of deposits, the banks themselves resorted in the late 1960s to the short-term financial markets by developing negotiable certificates of deposit (CDs) in competition with commercial paper. However, banks were still constrained by interest rate ceilings so that they could not offer competitive rates on CDs when market levels rose above these ceilings. But this development marked the inception of "liability management": instead of being passively dependent on deposits for their loanable funds, banks now began to actively seek out the funds they needed by borrowing them in the market.

The "firewall" between banking and financial markets in the United States had begun to melt. U.S. regulators tried during the 1970s to keep these two markets apart through interest rate ceilings on bank deposits, on the assumption that these would constrain the banks' costs, maintain profitability, and obviate the need for high-risk lending. But, as depositors defected to higher-yielding instruments, this turned out to be more of a disadvantage than an advantage, and banks sought to circumvent the ceilings.

Interest rate ceilings could not be imposed on offshore markets, so by the end of the 1960s banks sought the funds they needed by offering CDs in the burgeoning Eurodollar markets centered in London. Moreover, domestically, large banks formed "holding companies," technically not banks, which could issue CDs not subject to the interest rate ceilings. All of these developments were accelerated by large-scale computerization, which made it easier for all operators in the financial markets, banks and nonbanks alike, to standardize their borrowing and lending procedures and to cut costs.

Hence, by the time of the first oil price shock (1973–1974), banks were well positioned to mop up excess international liquidity in the form of petrodollars, which flowed in large quantities from oil-exporting countries to the Euromarkets. In the new era of liability management, banks could float CDs in the Euromarkets, offering savers highly liquid and safe financial investments. The banks used the proceeds to make loans to developing-country borrowers, many of whom were plunged into acute balance-of-payments deficits by the oil price shock.

As is now well known, the banks were encouraged in this behavior by government officials throughout the world and by international organizations such as the IMF. It seemed urgent to remedy the international payments disequilibria caused by the two oil price shocks of the 1970s by recycling the petrodollar surpluses to deficit countries. The commercial banks rose to the task. What was peculiar, as far as banking was concerned, was the nature of most of the lending: unsecured general-purpose sovereign loans provided for balance-of-payments support, far removed from the usual custom of commercially tied and collateralized bank credit.

Another critical development, which broke down the barriers between banking and the rest of the U.S. financial sector, was the advent in the 1970s of money-market mutual funds (MMFs) as deposit-taking intermediaries. Technically, MMFs offer shares to the public in a fund that invests in high-yielding and low-risk securities, such as TBs, CDs, and commercial paper. In practice, the shares are used as checking accounts, very similar to interest-bearing demand deposits. The intense competition for deposits from the MMFs ultimately led banks to pressure for the introduction of interest-bearing checking accounts and the effective termination of Regulation Q in 1982 (Litan, 1991).

But the resulting competition for deposits simply intensified during the late 1970s and early 1980s. Added to escalating liability management, the result was a spectacular growth in assets and growing competition for borrowers. So banks found themselves faced with competition on both sides of their balance sheets, with regard to liabilities (borrowed funds, including deposits) as well as assets (loans). Competition for clients led to a binge in lending domestically to energy, agriculture (because of booming commodity and energy prices), and real estate. Internationally, there was another surge in lending to Latin American and other developing countries after 1979, associated with the second oil price shock. International lending was regarded by the banks as part of a portfolio diversification strategy. The lack of any international regulation, however, led to excessive bank lending to some countries and insufficient concern with risk. Both factors were to be abruptly reversed in the 1980s, as banks abruptly ceased lending and became acutely risk averse (Devlin, 1989).

Developments in Financial Markets Since 1980

The story of the subsequent debt crisis after 1982, precipitated by high interest rates and recession in the countries of the Organization for Economic Cooperation and Development (OECD), is now well known. The debt crisis, especially in its initial stages, appeared to threaten the solvency of the U.S. banking system, although it did not at any point lead to the insolvency of any particular U.S. bank.

Indeed, the rapidly rising failure rate of U.S. banks in the 1980s was due more to their exposure to domestic borrowers in crisis—in agriculture, energy, and real estate development—all victims of price deflation in the latter half of the 1980s. By 1989, the fraction of U.S. bank assets devoted to real estate loans had climbed to 37 percent (IMF, 1991). Moreover, a growing portion of the lending portfolios of larger banks was concentrated in risky domestic transactions such as leveraged buyouts (LBOs); by 1990, more than 35 percent of the domestic commercial loans of money-center banks supported LBOs (IMF, 1993a). Total losses from failed banks over the next several years are estimated at between U.S.$15 billion and U.S.$88 billion, centering around U.S.$30 billion. These losses are concentrated in the larger banks, which tend to have riskier loan portfolios and are less well capitalized than the smaller banks (IMF 1993a: 19).[4]

In contrast, the banks were never as vulnerable to default by their Third World borrowers as by their domestic borrowers. When the debt crisis broke out in 1982, the exposure of U.S. banks to developing countries was around 11 percent of total assets; this proportion fell continuously thereafter, due to liquidation of developing-country loans and a rapid buildup of lending to the domestic sectors. Problems in the banks' developing-country portfolios surfaced a few years before their loans to domestic borrowers ran into trouble. It was thus easier for banks to take remedial measures to protect themselves (e.g., through loan-loss reserves) during the boom years of the mid- to late 1980s and to reduce foreign exposure in favor of domestic clients.

Rapid and profound changes continued to shake U.S. financial markets during the 1980s. The postwar financial order, created out of the shambles of the depression by the New Deal reforms, more or less disappeared. The privileged position of banks had been eroded by technology and the forces of competition. The turmoil that engulfed all the deposit-taking institutions (banks and the savings and loan associations, or "thrifts") illustrated the quandary facing these intermediaries, formerly the bedrock of the financial sector. Despite liability management, banks and thrifts are in part still passively dependent for their funding on deposits; and their main assets—custom-made commercial loans and mortgages—are illiquid. Bank loans, by their very nature, are assets held to term, and unlike other financial assets are not generally tradable on secondary markets. This imbues the banks' asset portfolios with considerable inflexibility.

Technology and market forces conspired to undercut the banks and thrifts at their own business through the innovation of standardized borrowing and lending, and via the process of "securitization." As the term suggests, the end product of such financial innovation is generally a financial asset that can be traded on secondary markets. Investors who buy tradable securities enjoy a degree of liquidity that banks, investing in loans, cannot. Securitization originated in U.S. financial markets when mortgages were pooled by federal agencies and sold to investors in the form of certificates collateralized by the underlying loans. This practice was later extended to consumer credit by private creditors such as General

Motors Acceptance Corporation (GMAC) and G.E. Capital. The ability to sell such assets to investors enables the creditor to extend credit to a much wider pool of borrowers, substantially enhancing lending capacity. Consequently, finance companies such as GMAC had more equity capital than any U.S. bank except for Citicorp. Indeed, in 1990, GMAC's assets exceeded those of all the banks except the two largest (Litan, 1991).

Banks eventually rose to the challenge of securitization during the Third World debt crisis. A secondary market in bank loans to developing countries, was, in fact, organized after about 1985 by investment dealers who found purchasers (often speculators or agents for debt-equity swaps) for banks wishing to unload or swap portions of their Third World debt portfolios. Although bid and offer prices eventually were published, this was largely a "distress" market heavily influenced by large individual transactions. This market was initially thin and lacked liquidity; nonetheless, the fact that bank loans could be bought and sold by third parties marked an important transition toward the securitization of bank assets.

Eventually, a part of the overhang of bank lending to the developing countries became "securitized" via debt conversions and the Brady Plan. The latter involved a negotiated conversion, under the auspices of official agencies including the IMF, the World Bank, and the U.S. Treasury, of bank debt into bonds. By mid-1993, eight debtor countries had reached agreements with their creditor banks, resulting in the conversion of their bank debts into bonds, which either reduced the principal outstanding or reduced interest costs. Six were Latin American debtors: Argentina, Bolivia, Costa Rica, Mexico, Uruguay, and Venezuela.

Other debt conversions did not take place under official sponsorship but utilized the secondary market for bank loans. These featured purchasers of discounted bank debt who negotiated with debtor countries to transform their claims into portfolio equity, local debt, or the purchase of real assets. Privatization of state-owned enterprises became a major vehicle for the conversion of bank debt into claims on real assets in Mexico, Chile, and Argentina. When the purchasers were foreign investors, as they were to a great extent, such debt-equity swaps also constituted one of the main channels of foreign direct investment. The secondary market grew substantially: turnover (including "Brady bonds" and new instruments) was estimated at U.S.$200 billion in 1991 and as much as U.S.$500 billion in 1992 (IMF, 1993b).

But in the final analysis, the Brady Plan and the conversion of bank claims into other assets represented variations of options whereby banks could "exit" from their positions in developing countries. The real significance of securitization and the conversion of bank debt is that they paved the way back for developing-country borrowers into the international bond and other markets. Brady bonds enabled them to establish an international