

REAGAN'S
BLACK FREELOADER

APRIL 14, 1986 • \$1.95

Hilton Kramer's Revenge—Robert Hughes

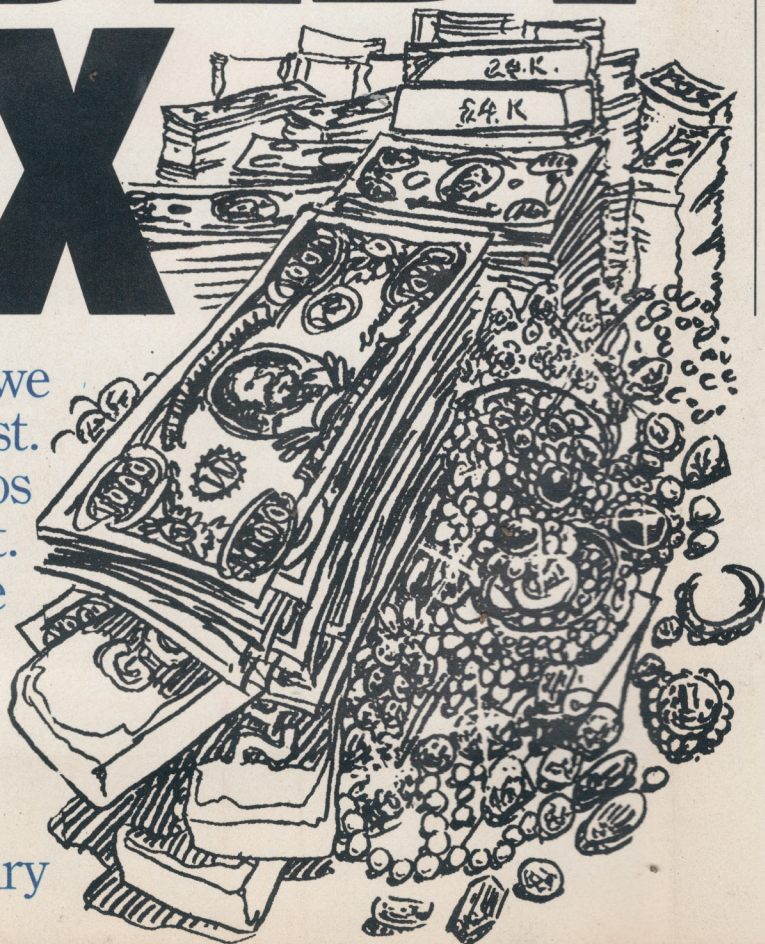
HOT DEMOCRAT OF THE MONTH: MIKE DUKAKIS • THE EDITORS: A CURE FOR LAROUCHIES

THE NEW REPUBLIC

An Economic Detective Story

THE DEBT HOAX

Third world countries owe
billions to the West.
Third world oligarchs like Marcos
have stashed billions in the West.
American banks make huge
profits both ways. Hmmm...



by James S. Henry



Third World debt hoax.

WHERE THE MONEY WENT

BY JAMES S. HENRY

THE toppling of Ferdinand Marcos and Baby Doc Duvalier has focused attention on the wealth that Third World oligarchs have plundered and stashed abroad. The collapse of oil has left countries like Mexico and Venezuela begging for relief from their debts. These two stories—capital flight and international debt—are part of the same story. In some cases, the wealthiest classes of poor countries have actually sent more money out of their countries than foreign borrowing has brought in—and often it's the same money. American banks have promoted, and profited from, both sides of the transaction. Sometimes the money never even leaves the United States. The entire cycle is completed with a few bookkeeping entries in New York.

More than half of the money borrowed by Mexico, Venezuela, and Argentina during the last decade has effectively flowed right back out the door, often the same year or even month it flowed in. Indeed, there are already enough private foreign assets owned by the citizens of major debtor nations to go a long way toward servicing their countries' foreign debts. The most aggressive banks, such as Citibank, have probably accumulated almost as much in assets from poor countries as they have loaned to them. Their real role has been to take funds that Third World elites have stolen from their governments and to loan them back, earning a nice spread each way.

American government policies make it far too easy to transfer and hide financial assets. As a result, the U.S. itself is one of the world's largest tax havens, and the largest for Latin America. Indeed, because of such policies the U.S. is actually a net *debtor* of Latin American countries.

It all comes down to one of the largest wealth transfers in history, with a few thousand affluent families and their retainers cackling all the way to the bank, the poor people of these countries indentured for years to work off the debts, the bankers playing a clever double game, and American taxpayers expected to subsidize bailouts that make the 1975 New York City debt crisis look like a rounding error. This is the *real* story of the "debt crisis": the story of what happened to all the money.

Consider Mexico. On March 6, a Mexico City newspaper published a list of 575 names of Mexican nationals, each of whom has at least one million dollars in deposits with foreign banks. The exposure of these "*sacadolares*"—people who take out dollars—caused an uproar because it

comes just as Mexico is once again pleading bankruptcy to its international bankers and the U.S. Treasury. Mexico maintains that it needs another six billion to ten billion dollars of new foreign loans and interest subsidies this year to avert insolvency. This would be the second major bailout for Mexico in the last three years.

One example of the "*sacadolares*" may be the president of Mexico himself, Miguel de la Madrid. A Harvard-bred technocrat, de la Madrid was anointed by the previous president, Lopez Portillo, whom he had served as minister of budget. He had never before held elective office. (But then some say that no one really holds elective office in Mexico.)

Portillo was a stout law professor whose regime was distinguished by profligate spending, wildly optimistic growth plans, and corruption that was unprecedented even by Mexican standards. All of this was paid for on time. Between 1978 and 1982 the country's foreign debt more than doubled, to \$85 billion. Today it approaches \$100 billion, one of the highest debt levels per dollar of national income in the world. Very little of this money went into productive investments. Billions were squandered on non-competitive steel plants, a six-billion-dollar nuclear power plant that still doesn't function, a gas pipeline to nowhere, wasteful development loans, arms, and payoffs to contractors and public officials. (Portillo, who moved to Rome after leaving office, is widely rumored to have absconded with over one billion dollars.)

Western bankers looked the other way as their money was wasted. The loan fees were lucrative, and many of the banks' corporate customers were making bundles on these "white elephants." The banks also complacently assumed that the U.S. government would never allow either Mexico or Citibank to go bankrupt. Furthermore, until 1981 or so, no one at any particular bank knew just how much money the *other* banks were lending to Mexico.

De la Madrid's first promise when he took office was to seek a "moral renovation" and rebuild the confidence of Mexico's investors. He lectured the nation on the need for "belt-tightening." Unemployment grew to over 30 percent and real wages sank to 1963 levels. It was thus a little embarrassing that just as de la Madrid arrived on his first official visit to Washington in May 1984, Jack Anderson revealed a secret U.S. intelligence report that de la Madrid himself had been accumulating substantial deposits in a Swiss bank account—at least \$162 million during 1983 alone. (The deposits were transferred by wire—the Na-

James S. Henry is an economist and writer in New York.

tional Security Agency had been listening. The *New York Times* subsequently confirmed the story.) The State Department issued a curious statement that the "U.S. government applauds President de la Madrid's commitment to addressing the issue of honesty in government."

THERE IS NO WAY to know exactly how much capital has left Mexico. Banks naturally try to keep the figures secret. But there are two accounting techniques that enable us to make indirect estimates. One is to measure the discrepancy between net exports of goods and services and net imports of capital. The difference ought to reflect net short-term capital flows, and subtracting the known capital imports should give us a rough figure for the unknown capital exports. All of these figures are inexact. (Cynics note that Mexico's official balance-of-payments statistics overlook both its biggest import, arms, and its second-biggest export, drugs.) But in the case of Mexico, a second method of calculation produces surprisingly similar results. This is simply to take all the money that's known to have flowed in from abroad, subtract the known ways it's been put to use, and assume that the rest flowed back out again.

Both methods indicate that capital flight soared during the Portillo years, especially from 1979 to 1981, just as Mexico's foreign debt was exploding. For example, in 1981, while Mexico was taking on about \$20 billion in new foreign debt from commercial banks, capital flight was nine billion dollars to \$11 billion. After 1981, capital flight started to decline: there was just not that much more to take out. Growth in new debt also stopped. Over the years from 1974 to 1985, Mexico borrowed \$97 billion and sent about half—\$50 billion—right back out again. Things were even worse elsewhere. Argentina's capital outflow during this decade was over 60 percent of its foreign borrowing, and in Venezuela there was virtually a dollar-for-dollar offset. In contrast, Brazilians (11 percent) and even Marcos's cronies in the Philippines (25 percent) were much less aggressive in moving capital out of their countries.

Hidden capital exports are only part of the story, since these private investments have grown in value since leaving Mexico. Many Mexicans prefer investing abroad in very short-term assets, especially bank time deposits and Treasury bills. These are safe, highly liquid, untaxed, and simple. The volume of U.S. bank time deposits owned by foreigners has grown dramatically in the past few years, driven by Latin American flight capital. The Mexicans are the largest single source. Private bankers and investment advisers who serve this market say that probably two-thirds or more of Mexican flight capital has found its way into time deposits. Now, these experts say, some large Mexican depositors have begun to shift their holdings into U.S. government securities, because of concern about the health of U.S. banks that have loaned too much money to places like Mexico!

Making some reasonable assumptions about the return on these investments, and also assuming that no taxes have been paid—either to the U.S., because there is no tax owed on "portfolio interest" earned by nonresidents, or to Mexi-

co, because of outright tax evasion—we can estimate how much Mexican flight capital is now abroad. These calculations are subject to all sorts of qualifications. But if they are even close to being accurate, they suggest that by 1984 the value of Mexican flight capital exceeded the face value of all commercial bank loans to Mexico, and by 1985 it was closing in on the face value of the country's total external debt. Since these tattered loans to places like Mexico are actually worth far less than their face value, it seems quite likely that Mexico is actually a net creditor. As one Federal Reserve Board member said recently, "The problem is not that Latin Americans don't have assets. They do. The problem is, they're all in Miami."

The U.S. banks' share of loans to the major Latin American debtors has been less than 30 percent. By contrast, our share of the private flight capital from these nations is rumored to be 70 to 80 percent for Mexico and Venezuela, and 50 to 60 percent for Brazil and Argentina. This means that the U.S. as a whole is almost certainly a net debtor of all of these countries, except possibly Brazil. U.S. banks now have about \$26 billion in outstanding loans to Mexico. Estimating the accumulated value of Mexican capital-flight wealth at \$85 billion by 1984, and assuming that 70 percent is invested here, Mexicans have at least \$30 billion more socked away in U.S. banks than Mexico owes to U.S. banks. Total direct investment by all U.S. firms in Mexico, by contrast, was six billion dollars in 1984. Similar calculations for the other Latin American major countries yield a total net balance in favor of the U.S. of \$40 billion to \$60 billion in 1984. By now the figure may exceed \$70 billion. Again, these figures are conservative because they are based on comparing the dubious face value of the debts with the market value of the assets. In the case of Mexico, estimated annual earnings on these assets are already over three-quarters of the annual interest owed on Mexico's foreign debt.

The U.S. Treasury polls American banks, security dealers, and other businesses on their financial transactions with foreigners. These data are riddled with imperfections, most of which lead to underestimates. Still, they do show patterns that are consistent with other things we know. They indicate that between 1978 and 1985 Latin Americans and their Caribbean tax-haven proxies increased their short-term deposits with U.S. banks by at least \$33 billion. At the same time U.S. banks were increasing their loans to Latin America by about \$50 billion. Thus the basic role played by U.S. banks to Latin America was that of a middleman between the short-term deposits of the countries' elites and the medium-term loans demanded by their governments.

ANOTHER very important category of U.S. assets that Latin Americans have been stocking up on is cash. This is a "foreign asset" that is often physically kept at home. From a financial standpoint, it represents a net claim that foreigners have on the U.S. There is no direct measure of U.S. cash held abroad, but "dollarization" is rampant in Argentina, Brazil, and Mexico. It is common practice for people to squirrel away whole suitcases of \$100 bills as a

hedge against depreciation of the local currency. This helps to account for the curious fact that there are now about three \$100 bills in circulation for each man, woman, and child in the United States. A recent U.S. Treasury "guesstimate" is that perhaps \$20 billion worth of them are offshore.

Cash is also a preferred method of transferring money from local to foreign accounts. Venezuelans traveling to Miami reported over two billion dollars of cash in 1981 alone on the Treasury forms that entrants to the U.S. have to fill out. Currency has long poured into the Miami Federal Reserve district because of drug traffic. More recently, though, the El Paso and San Antonio Federal Reserve districts have reported net receipts of currency, reflecting the large cash deposits that Mexicans have been carrying across the border. The explosive growth of San Francisco's receipts during the past two years is apparently a combination of Philippine flight capital and a shift of drug money to the West Coast.

Who owns these assets? The typical Mexican investor with dollars at home or abroad is really pretty middle class. As one writer recently put it, "Even the Mexican City shoe-shine boys stockpile dollars." But even if everyone has a bit of it, the key fact about flight capital is that it is highly concentrated. At the very top are the bankers' wet dream, the superrich. These are the people of Citibank's "Global Elite," a list of 5,000 or so people from around the world who are supposed to have individual net worths greater than \$100 million. The U.S. supposedly has about 500 to 600 such people, depending on the state of the stock market. In the Latin American context, these people include a lot of names most Americans—and indeed, most of their own countrymen, given their taste for discretion—have never heard of, but they are fabulously rich. These are the happy few that automatically qualify for services like the new American Express "Black Card," the ultra VIP credit card that has a credit line of \$500,000 and offers services such as private planes, bodyguards, and access to Fifth Avenue stores in the wee hours of the morning for "solo shopping." Obviously at this level the key function of the card is not credit, but identity: "Do you know me? I may look like a twit, but I own Paraguay."

Meanwhile, Mexico's income per capita averages less than \$2,000 a year. And since 1982, the debt problem has made things worse. Imports and domestic spending have been slashed to meet the interest bill. For the lower half of the population, this means that real incomes have fallen further from their already low base.

HOW DID Third World elites manage to convert all that foreign debt capital into private foreign assets? There are several explanations that are not mutually exclusive. The "innocent bystander" view holds that the local rich just happened to deploy their own assets abroad at precisely the time their governments chose to borrow heavily abroad to finance attempts at growth. Of course a more sensible approach would have been to fund public spending with taxes or direct foreign investment in the local economy. But local elites are so powerful that serious

income or wealth taxes are almost unheard of, while domestic enterprise is protected by a host of barriers against foreign investment.

FURTHERMORE, local elites do not just react passively to the local governments. In many cases they *are* the local governments, or at least the executive committees. Thus a basic method of taking money out of Mexico has been to exploit overvalued official exchange rates with the help of foreign banks. The preservation of this exchange rate system even in the face of massive capital flight is very hard to understand unless we take into account the profits made from it by people in positions to influence policy.

There's also, of course, plenty of outright graft in converting dollars borrowed by government projects into private wealth. The actual pathways are endless: phony intermediary companies that recontract with foreign suppliers on public projects and take a hefty spread; importers who get permits to purchase foreign exchange for imports that either never get bought or are wildly over-invoiced; developers who get public loans for projects that don't exist; local "consultants" who are paid by U.S. suppliers in New York dollar accounts, and so on.

To what extent were American bankers aware of what was going on? It's a nice question. Some observers feel they must have been knowing, or at least willing, participants, just like the middlemen in phony-asset scams throughout financial history. This suspicion requires an assumption about the intelligence, cunning, and foresight of bankers that, in my experience, is not warranted. What's indisputable is that when wealthy Mexicans invest their own capital abroad, they are much more cautious than the foreign bankers who financed all their country's debt.

It's also indisputable that leading American banks are as involved in ferrying capital out of Mexico as they were in lending money to the country in the first place. The U.S. banks that are the most active in "international private banking" to wealthy Mexicans are Citibank, Morgan Guaranty, Bank of America, and Chase, plus several large regional banks in Texas and California. They all serve a key client list of at least several hundred wealthy Mexican customers. They all have very active calling programs designed to recruit new clients. They all play an active role in helping wealthy Mexicans get their money out of the country. They all help such customers design sophisticated offshore trusts and investment companies to shelter income from taxes and political exposure. They all try very hard to keep the identity of their customers a secret. They are all more or less actively involved in lobbying U.S. authorities to preserve policies toward taxation, bank regulation, and bank secrecy that are favorable to their clients.

"When we go in there," one international private banker told me about his trips to the Third World, "we're not taking any kind of information with us, and when we leave the country we don't have any papers with us either. You know, I tell [my boss] when I leave on a trip to remember my face if anything happens to me. But he says, don't worry, the bank will never admit that you were a part of us."

"Pouch" services or their equivalents—helping clients move money secretly—are among the most important services that private bankers provide. If handled discreetly this can be a real competitive advantage, because among other things the bank learns enough about a customer's "private parts" to lock him in. The standard image of money-laundering is a bunch of shady characters trucking suitcases of cash through airports and depositing it in obscure banks in the Caymans, Florida, the Bahamas, or Switzerland. Although some of this obviously goes on, especially at the "drug-related" end of the business, this is not really first-class money-laundering at all. One banker recently described to me the challenge of helping rich clients to get money out of Mexico without leaving a trail: "You can buy dollars in Mexico from the Central Bank, no problem. The problem is that you are basically registering yourself, exactly what you don't want. You could go to a local bank, buy a \$100,000 check there with pesos, and then send it to the States. But then when you deposit that check, it's going to show [what account] it went to. So what happens is . . . the customer would go to his own bank, draw a cashier's check in the name of [XYZ Foreign Bank], and deposit that in an [XYZ Foreign Bank] account. So his name is not on that check at all. Or deposits are made in a customer's peso account in a Mexican branch of a U.S. bank, and credits are made to the customer's dollar account in New York." Since November 1985 the Mexican government has restricted the use of the foreign banks' "peso windows" in Mexico in order to curtail such transfers. However, the more aggressive banks have already begun to help their private customers evade even this restriction by setting up parallel foreign exchange swaps that avoid the banking system entirely, leaving virtually no records. Again, the major banks have played a central role in disarming the new restrictions.

The really clever private bankers also have devised methods so that Mexicans can use their foreign capital without leaving home, much less being taxed on it by their own governments. The favorite method is the so-called "back-to-back" loan, whereby the bank "loans" the client his own money. This not only reduces the client's taxes even further, but helps him take more money out of the country.

These international private bankers are not malevolent or obtuse. They are doing exactly what they get paid to do. Theirs is not a labor of love, but a very profitable business, with returns on assets of two to three percent and pretax returns on equity of 100 percent and more. In an era when most other low-cost sources of bank funds have dried up, private banking to Third World countries looks pretty good. In fact, this was just how lending to Third World governments looked in the 1970s, relative to commercial, retail, or housing lending at home.

CITIBANK is clearly the most aggressive American bank in international private banking ("IPB"). It appears to have over 1,500 people dedicated to this activity worldwide, and over \$26 billion in IPB assets. In Latin America, Citibank probably has over 50 direct IPB em-

ployees in offices inside Mexico, Argentina, Chile, Venezuela, and Panama, where it also owns banks with local branches. Since discretion is essential, most of these employees are officially connected to other parts of the bank. Because of its nearly four billion dollars of loan exposure to Brazil, Citibank prefers to serve the Brazilian flight-capital market out of an office in Montevideo, Uruguay, where bank secrecy laws are very stiff.

OVERALL, at least half of Citibank's \$26 billion or so in IPB assets probably belongs to Latin Americans. This compares with Citibank's total loan exposure to the "Big Four"—Brazil, Mexico, Argentina, and Venezuela—of about \$10.3 billion. Thus, even allowing for loans to the rest of Latin America, Citibank probably comes very close to owing more money to Latin Americans than it is owed.

Banks are required to report large loans outstanding to individual countries. But there is no requirement to report the country origins of private banking assets. This secrecy is probably no accident. In the case of several major banks and other financial institutions, the truth might be a little embarrassing—they are not really net lenders to these countries at all. The aggregate balance of loans and deposits is a little clearer. Our best estimate is that U.S. banks as a whole probably now manage international private banking assets of roughly \$100 billion to \$120 billion, 60 to 70 percent of which comes from Latin American private banking assets, compared to total U.S. bank loans outstanding to Latin America of about \$83 billion. Not only is the U.S. economy as a whole probably a net debtor of Latin America: our commercial banks alone are close to being net debtors of Latin America.

But this is the kind of debtor anyone would love to be. Combining what we know about capital flight and private lending, a reasonable estimate of the banks' profits on the "round-trip" for Mexico alone is \$2.4 billion in 1984. On an equity base of four billion dollars, that's a return of 70 percent. One can quibble about the precise assumptions behind such estimates, but the basic findings are robust. U.S. banks have so far reaped a bonanza from their own disastrous international lending policies of the last decade.

As Third World leaders and international bankers warm up for another chorus of moaning about the debt crisis, they need a forcible reminder that the solution may lie in their own hands. Countries like Mexico should get no more money until they have enacted reforms to ensure that the dollars we lend them don't come right back again in the bank accounts of rich private citizens. The United States should take steps of its own to correct policies that encourage capital flight—especially laws that make us a haven for foreigners flouting their own nations' tax systems. Finally, international banks must take responsibility for the impact that "international private banking" is having on the poor nations where it operates. The easier it is for these nations' ruling elites to smuggle assets abroad, the less incentive there is to clean up at home. The capital flight these banks are promoting and facilitating in the 1980s is just as irresponsible as the loans they were peddling in the 1970s. □