ORAL TESTIMONY OF EUGENE H. ROTBERG
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before the

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It seems time for some reality testing on the current state of play of the recent proposals of Secretary of Treasury Nicholas Brady for addressing the international debt crisis.

First, most debt relief and debt reduction proposals are not likely to significantly affect how much debtors will pay to creditors. The fact is, in recent years, many debtors have met only about half of their debt service obligations -- the balance comes from the banks themselves. If there is no new lending, therefore, the pressure on debtors will not be reduced by debt reduction schemes. Indeed, debt reduction does not reduce the amounts that debtors pay to the banks out of their own resources -- unless the amount of the reduction is greater than the amount of new lending. In the real world, debt reduction essentially removes the pressure on banks to lend more to pay themselves interest, in return for which, of course, they are not paid full interest and, indeed, may have to show losses on the principal. But these are accounting matters, albeit important ones for the

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banks, with little direct impact on the cash flow of debtors.

I cannot emphasize the point too much. Most commentators on Secretary Brady's initiative confuse two separate aspects: the actual debt service payments by the debtor versus the accounting effect of the transaction on the creditor. They are <u>not</u> reciprocals of each other. The terms "debt relief" and "debt reduction" describe the effect on the creditors' books after a transaction is executed. They are not the before and after actual cash burdens on the debtor.

Second, there are limitations on the amount of lending or guarantees which can be provided by the international development institutions to facilitate the repurchase of debt. These institutions have constrained resources and are subject to competing demands for funding from countries who are not part of the debt crisis and who have performed well. They cannot overcommit their resources to a few countries in Latin America, given the constraints of their capital and financial structure. They will pay close attention to the concentration of country risk and exposure. Indeed, I suspect that much of what the World Bank makes available for repurchase or guarantee of debt, the debtor will receive, by way of direct lending, that much less from the World Bank, almost dollar for dollar, for imports of the goods and services needed to maintain their exports. But it is not all that bad a use of money -- after all, the rate of return can be pretty high if debtors can buy back debt at 40 cents on the dollar with

money that costs about 8%. But my point is there is not much of that kind of money around -- perhaps from the World Bank, $2 billion a year to be divided amongst a dozen or so countries.

Third, although the role of the World Bank is likely to be modest in the most heavily indebted countries, there remains the risk that the development banks' exposure could constitute a substantial percentage of some countries' overall external indebtedness and would, therefore, displace commercial bank risk. From a World Bank and IMF perspective, it is important that commercial banks always remain at risk so that during periods of stress -- high interest rates, recession, deterioration of terms of trade, falling (or rising) prices for oil -- there is a cushion, commercial bank lending, which can be still called upon. Otherwise, the credit risks will all be on the development and official institutions -- a condition they are not likely to find acceptable.

Fourth, the World Bank does not want to be portrayed as "bailing out" the commercial banks. There is no end to that and, besides, the financial markets which support the Bank would find it unacceptable. Perhaps, if World Bank guarantees were actually called upon, the commercial banks might be obligated to relend the funds received right back to the World Bank at three-month U.S. Treasury bill rates -- for a long time. That would silence talk about a bail-out. For want of a better term, since the World Bank has been put in play, as the saying goes, we might call that a

"poison put." It seems fair enough and, in any event, an "opportunity loss" is not recognized as a standard accounting principle and would, therefore, not show up as a loss on commercial banks' books.

Fifth, a technical, but, I believe, an important issue: the issuance of bearer bonds in connection with debt reduction proposals is not free from policy concerns. These bonds would be traded outside the banking system. If interest or principal payments were not made in a timely fashion, the new holders -- pension funds, insurance companies and private individuals -- are not likely to be so malleable as commercial banks in working out the problem. Indeed, these investors are likely to attach the assets of the debtor, or insist on being bought out by the banks. There is, therefore, some discomfort with a lot of LDC bearer bonds floating around outside the banking system in a litigious society like the United States.

But after all is said and done, there is another reality when a transaction is actually executed -- its political effect. The new initiative could forestall calls for moratoria or cessation of payments; it could diffuse radicalized movements in countries with fragile political systems; it could even contribute to the repatriation of flight capital if it takes away the uncertainty of protracted, contentious negotiations for new money packages. It certainly is in the interest of the debtor countries, or at least those in power, to trumpet their negotiations as successful.

That, too, is a reality. Given the expectations, on balance, perhaps the sooner a transaction is executed, the better, irrespective of its significance on the actual cash burden on the debtor.

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