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I want to talk about Banks, and then loans to developing countries, poverty and the developing world, protectionism, politics and public policy, and about financial and geopolitical links. No prepared text. Start with Finance - an esoteric subject.

First players - The Banks - useful to go back to the 70's.

I. Commercial Bank Lending in the 1970s/Early 1980s to Developing Countries: The Environment.

Reasons:

A. Governments were pressuring, or at least encouraging, banks to recycle OPEC financial surpluses. Didn't have to pressure. Investment in dollars is an automatic reciprocal of trade deficits whether cars or oil.

B. Lent about $500 billion. Virtually double the capital of money center banks. Nothing will be repaid. Paid down.

C. There had been little previous pain. All "foreign" debts in recent memory were serviced.

D. Herd instinct -- market share; Japanese banks were moving to London.

E. Excellent rewards.

F. Present pleasure vs. future potential pain and, at the moment, excellent returns on shrinking capital bases as banks intermediated OPEC risk to LDCs.

G. Spin-off risk. Syndicate loans to others -- compete with investment banks. Glass Steagall restraint.

H. The dread factor -- the loss potential was so severe (nothing could go "wrong") given the magnitude of lending. All countries were deemed creditworthy -- whatever the exposure and irrespective of the economic plan of the borrower. Central Banks would always be there as a lender of last resort.

II. What now are the prospects for heavily indebted LDCs. What is financial reality.

A. Mostly, they will not repay principal -- and it really is of no great moment so long as all interest payments are serviced.

B. Virtually all principal falling due over this decade will be rescheduled or refinanced.

C. Over the next several years, the amount of increased exposure of commercial banks, official institutions, including governments will not likely exceed, at the most, the interest payments due to those institutions.

D. There will be, at times, selective rescheduling of interest, a reduction of interest rates, while at the same time there will be pressures to reduce the lending of export credit agencies -- particularly to countries in default.

Banks: A Constituency

Mostly, for understandable reasons, they want out, if at all possible. They want to reduce their exposure and certainly do not want to increase their risk, even if by so doing, the loans remain "current," by lending the funds needed to pay themselves interest. They look at least to a nod to some creative accounting and a relaxation of regulatory pressures. Banks want leverage in the negotiation process, but do not yet have it. They may, however, get it from the substantial reduction of LDC exposure to their capital -- a mostly unpublicized development --

and from the fact that some have already provisioned against the loans. Provisioning increases leverage in the negotiating process simply because the "loss," or part of it, is already contemplated. It makes banks not so hostage to pressure to lend.

Bankers, however, must pretend they could be repaid and lower the level of rhetoric and publicity. Else, trouble with:

(i) stockholders

(ii) press

(iii) cost of funds

(iv) regulatory authorities

It has been suggested that equity investment, received on swap for debt, is a way out.

Switches into equity for large money center banks are not likely to be substantial. The equity markets are small in the context of the amount of debt outstanding. In any event, there are considerable political considerations -- particularly if the equity is in basic industry, raw materials, commodities, or minerals. It smacks of colonialism and is frought with future political uncertainty.

Further, regulatory agencies will be troubled by moving debt from banks into institutions over whom they have little control --

pension funds or insurance companies who can precipitate a much different and less predictable financial scenario if debt is not serviced. These institutions do not reschedule. It is not likely they will be as malleable as commercial banks when it comes to providing new money packages for the good of the "financial system."

And, finally, I doubt whether major banks can take the income hits which would be explicitly recognized upon resale or assignment or their holdings at prices reflecting the debt service risks -- assuming the paper can be sold within the existing legal framework.

What are government concerns:

1. There is the concern that banks, who hold public deposits, in an effort to maintain profitability, may try to offset their LDC debt and their problems in agriculture loans and energy loans, and will find themselves, as a competitive matter, engaging in complex innovative financial operations, with uncertain managerial control. Banks historically train staff to lend; it is not clear to regulators that senior bank managers can cope with risk taking related to interest rates and exchange rates -- the core of most market intervention by investment banks.

2. There is also concern with the twin dilemma of banks having to cope with shrinking returns on assets as better credits move to the securities markets. Banks believe they must either innovate or put more risky assets on their books to maintain profitability. Therefore, change G-S.

3. There is concern about how the leveraged instruments will increase volatility.

4. Credit risk shifts from banks (whom they can control and regulate) to non-banks.

5. Off balance sheet risk makes control difficult. Banks become opaque, and government senses a loss of power.

6. Too many participants between buyers and sellers. Too many diverse interests. Too many loopholes. Too many players. Too much leverage.

7. The domino syndrome. Too many intermediaries of unknown credit quality between buyers and sellers, investors and borrowers. Not the same with security firms.

Let's go back to the LDCs:

For the poorest 2.4 billion people in the world (36 countries), their average per capita Gross National Product in 1984 was $260 per year.

For the richest 18 industrialized countries with a population of 730 million people, the average per capita was $11,000.

The annual consumption per capita of energy for the poorest 2.4 billion people is 288 kilograms of oil equivalent. For the industrialized countries, it is 4,900 kilograms of oil equivalent. Annual per capita energy consumption in Zaire is 77 kilograms; Ethiopia 17 kilograms; Guatemala 178; Thailand 320; Brazil 753; Sweden, Germany, Australia (4,200 - 4,900), the U.S. 7,300; Canada over 9,000; Madagascar 45; France 3,500.

In a score of countries in the world, less than 2% of married women of child-bearing age use contraceptives. In Latin America, it ranges from 25% to 60%. That compares to about 75% in industrialized countries.

Seventy-five children out of 1,000 born die under the age of one in the 36 poorest countries of the world. For Mali, the figure is 176 of 1,000; 135 for Napal; 116 for Pakistan; 51 for Mexico.

For industrialized countries, 9 die under the age of one out of each 1,000 that are born. The death rate of children from the age of one to the age of four in sub-Saharan Africa is 25 times as great as in Italy or Austria and is 12 times that of Korea. The death rate in Pakistan for children up to the age of one is 10 times that of Spain. Children under 5 account for one-half of all deaths in developing countries. Maternal deaths for the poorest are 10 times as high as in industrialized countries.

In sub-Saharan Africa, there is one doctor for every 40,000 people. For all of the poorest low-income 34 countries, excluding India and China, there is one doctor for every 17,000 persons. One doctor for every 2,000 for upper middle-income countries; one doctor for every 550 persons in industrialized countries.

Access to safe water to drink is not available to two-thirds of the entire developing world's rural population. For sub-Saharan Africa, the figure is 80%-90%.

The caloric intake in the industrialized countries is 40% higher than the poorest countries. Yet, for the poorest 36 countries, 36% of their Gross Domestic Product comes from agriculture. For the richest 18, only 3% is committed to agriculture.

In the 36 low-income countries, only 30% of the current school age population is enrolled in a secondary school, with a score of countries having less than 50% of females enrolled in a primary school to age 11; for Brazil only 42% are enrolled in a secondary school; Mexico 55%; Spain 90%.

The percentage in higher education is 4% for the lowest income countries; Africa is now about 1% and 37% for the highest income countries.

Sweden and Madagascar have similar size populations and geographical area. Sweden's GNP per capita is about $12,000; Madagascar's is $260. At birth, Sweden's life expectancy is 77; Madagascar's 52.

Population growth of sub-Saharan Africa is 3% a year; it is 2% for the upper middle income Chile, Brazil, Greece, Israel, etc. It is .7% a year in the United States; .1% in Belgium, Austria and the U.K.

Public expenditures for health in 72 countries for which data is available spend less than $5 per capita on all health expenditures.

In India, the labor force will grow by 180 million people in the period from 1985 - 2000. That incremental growth on people looking for jobs exceeds the total labor force of the U.S.

Hundreds of millions of individual human lives -- with all their inherrent potential -- are threatened, narrowed, eroded, shortened, and finally terminated by a pervasive poverty that degrades and destroys all that it touches. And, though improvements have been made compared to 25 years ago, the population growth, urbanization and inadequate infrastructure, sovereignty, independence and interdependence makes us all -- not just banks -- no longer disinterested bystanders.

There is, too, the frustration -- the anger -- born simply of the awareness that others are different. There is the sense of frustration over energy and elegance; there is that awareness not only of what they do not have, but what you and we have -- an ability to run and work hard and play hard without exhaustion. They are, too, aware of that vague uneasiness that those fortunate few of us feel when confronted by them.

For those with little hope, the reactions may range from a sort of catatonia, to a holding on to a family or children, to a violence born of frustration and anger which accelerates as expectations rise and education just begins to impinge on their lives. There develops, inexorably, that hostility between those who work with their hands and those who do not; between those who work and those who do not or cannot or will not; between those who are born to lead and are comfortable with it and those who have no choice but to compete and be led; between those who own or are owned and between those who have moved -- upwards, toward the class from which they have but recently moved.

The disenchantment has many faces. It shows itself in violence born of hopelessness; in depression or sadness or despair; in sickness or in unproductivity; in migration across borders; in days off; in slowdowns; in strikes; in protests; in terrorism; in guileness; in war; in insurrection; in coups; in riots and looting; and, of course, in self-destructiveness.

But what do they think of us? The fact is we are not comfortable with them. We mix them all up. They are neither elegant enough for us or effective enough or productive enough or too pushy. They raise prices. They get into wars. They have coups, assassinations, oil, copper, bauxite. They vote in the United Nations. They are sovereign. They talk too much and you think they are not faithful allies. They are often undemocratic. They are of a different religion. They have few cultural ties to us. They threaten our sense of superiority. They put pressure on Western hard core industry because of low wage rates. They come across the borders illegally. They may even dump their products in our markets. They threaten, therefore, our economic structure, we think.

But, they have rising expectations. Their literacy is increasing. They are politicized and aware. They know that they can exercise power from time to time -- both because of their geopolitical position and populations, and not incidentally, because they have zinc and copper and oil and rubber and tin and coffee and cocoa -- and we do not. They understand their potential to exert change; they blame the West for their borrowings and, in a real sense, have leverage, and they are not angry.

And there is another aspect: societies under pressure work -- hard and productively. They trade.

I suspect that societies under the pressures of finding a modest income for survival will work hard and will not take kindly to protectionist measures which limit their export potential. They work very hard in Korea, and the Phillippines and Singapore, Malaysia, China and Indonesia and throughout Latin America, and they do protect their fledgling industry. And they produce a lot of high quality goods and services.

And many countries control and carefully allocate, as perhaps some industrial democracies cannot and should not do, the way savings are used and resources allocated. And, perhaps most important, national leaders know they cannot stay in power with a degradation of the human spirit and a wasting of human capacity in their country. These societies will "do without" to an extent that few of us in this room are prepared to accept. They will slowly educate their citizen; they will provide health care and build roads, and bridges and dams and an infrastructure which begins to provide for a better lifestyle.

Thus, LDCs, too, are under painful pressures, facing basic choices which affect their viability as sovereign nations/states.

From their point of view, a not insubstantial part of the problem lies outside of their borders and over which they have no responsibility and little control.

(a) Protectionism in the West has hurt. It has made it difficult to export, earn dollars and service debt.

(b) High real dollar interest rates have increased their costs and their capacity to grow. And over the last year, nominal rates have risen over 250 basis points, with prospects of higher costs as markets reflect inflationary expectations in the West.

(c) Sluggish growth in the West has reduced the demand for their products.

(d) A deterioration of terms of trade from a wide variety of circumstances has produced falling commodity and mineral prices for exports and rising costs of European and Japanese imports, which have reduced the generation of foreign exchange to service debt.

(e) Rising oil prices in oil-importing countries have drained foreign exchange reserves.

Heads of state in developing countries look upon these external matters, essentially outside of their control, as seriously affecting their capacity to pay. They are asked, nonetheless, to increase the pressures on their domestic society to service debt to money center banks. It is naive to assume that these pressures are painless or irrelevant. It is not useful to simply argue "a deal is a deal; you should have thought about it when you borrowed the money in the first place."

<u>Industrialized Countries: A constituency, but a complicated political environment.</u>

1. They want to avert a financial crisis in which commercial banks cannot raise equity capital or are considered questionable credit risks because of their loans to the developing world. But they don't want to open banks up to risks of the market.

2. They want to avoid an economic crisis in which the underpinnings of government in LDCs, fragile at best, is hostage to the "LDC" debt problem, either because of the pressure to pay, with the resulting transfer of wealth from poor to rich, or the pressures not to pay, which would constrain external capital flows and increase flight capital because of the absence of resources for infrastructure.

3. They want to avert a political crisis. They do not want LDCs to fall apart with the concommittant geopolitical implications. The politics -- the concern for democracy and/or stability -- however, is primarily a Congressional/Parliamentary one as well as one of considerable concern to foreign ministries. But the fact is these constituencies, while potentially powerful

players, are not direct participants. They are ambivalent in their attitude and response to a problem in which domestic constituencies may have little concern for money center banks who have lent to "foreign" states which "dump" products in their markets. Neither foreign countries nor New York City banks are a major political constituency. They are, if anything, a burden.

4. Industrialized countries clearly want strong banks, but are not prepared to send a bail-out signal to their financial institutions. Why not farmers? (Indeed, a U.S. Congress will take steps to support thrift institutions who provide finance for residential mortgages or for farmers.) But, money center banks are not a beloved constituency in a populist society. They do not have the support for a broad-based legislative action which might be perceived as holding them harmless, directly or indirectly, for imprudent lending, particularly to "foreigners." That type of support is probably politically unacceptable. It will be categorized as a "moral hazard" -- a perfectly fair, albeit selectively used, rationale for not obligating governments for the mistakes or failures of the private sector. Industrial governments, further, have to cope with a rising trade deficit caused in part by the failure of LDCs to have the money to buy U.S. goods. If they can't help

the banks, perhaps they will help the corporate sector.

Protectionism won't work because (1) there are too many in this room and throughout the industrialized world who find it against their own best economic interest; they thrive on low cost exports; (2) it is not in the self interest of countries who are politically important to the United States; (3) it is inflationary if implemented; (4) it keeps the inefficient in business; (5) it will only put off retraining and re-educating; (6) it misallocates resources domestically; and (7) it dries up world markets and world trade. In short, it simply doesn't make sense; and, if it occurs, it will be short-lived, with more pain than pleasure. And finally, I would argue that we must offer markets for developing countries to sell their products. Only by selling their products to us can they earn the foreign exchange needed to buy what we produce and to service their debt. In short, we should encourage Mexico to develop its products so that incentives are created to work in Mexico, to produce and to sell their goods around the world. Better to take the goods and products of developing countries than to implicitly encourage unplanned and random immigration across national borders of countries who are not prepared to absorb the influx. It is rather simple -- countries can only buy <u>our</u> goods and products, and thereby help their standard of living, if they can ship their goods and products to earn the dollars necessary for such purchases and to enable them to service their debt to us.

Protectionism, as a financial matter, blocks the capacity to earn foreign exchange. And the resultant stagnant economic growth increase the pressures not to pay financial institutions the debts they are owed.

I certainly do not mean to suggest that the problems of poverty and the relationships of the United States with the Third World, or with the world powers, can be resolved or substantially changed by a more forthcoming posture towards trade. But certainly it doesn't take any great wisdom to recognize that poor countries are vulnerable -- that many are unstable. The response of the U.S. and other countries -- a detached disinterest in the LDC's economies, can only put us at greater risk in our world. For, apart from morality, poverty is a breeding ground for superpower confrontations. Instability breeds in poverty and invites, even consciously, that confrontation.

Let me summarize: LDCs are under great political pressure and will be under increasing pressure to limit their transfers of wealth from their countries to us, which is now occurring. Their negotiations with Western financial institutions cannot be perceived domestically in <u>their</u> countries as less tough than their neighboring countries. The fact is the developing world knows that the annual increased lending from banks does not nearly approach the interest they pay out. That is not a sustainable situation for them or us. Second, our financial institutions, pressured by regulatory agencies and stockholders, and given the alternative investment opportunities and the lessons from past experience, understandably are reluctant to lend more. Third, there is great reluctance of regulatory agencies to let them off the hook, or to permit them to expand their activities. Too much risk. Not enough controls.

We know the old standby is that economic development is necessary for political stability. We also know, however, the truth that economic development can be a destabilizing phenomenon itself, that countries may go through a variety of stages in their political development as they cope with rising expectations and increased demands on government. So perhaps we can be more precise. While there is no single recipe for political stability, there is, however, an open invitation to instability -- if we cut off hope in a lifetime, let people think their children will have no more than they have, freeze privilege and opportunity in small pockets of the society. Then, most assuredly, we will have unstable regimes and unhealthy political outcomes.

There is, therefore, vulnerability at every level, but little public policy response. Little integration or recognition of links; little awareness of the implications of lack of control -- how vulnerable is the financial system, the implication of poverty for geopolitical military confrontations. Few global thinkers, fewer still in power. As you know, public service and public policy have a bad name. Not fun and games. High risk; lots at stake; very difficult; we must understand finance, political economy, social historical trends, and must know how to recommend, act and implement. There will be little use for "should" thinking. The world should get along, spend less on defense, protect human rights, reduce poverty, not support dictatorships of left or right, reduce nuclear weapons, facilitate trade, not crush it. Not because these may not be fine goals, but because they take you just a short way, if at all, on <u>how</u> to do it.

And to know <u>how</u> to make better policy, one must have a position of responsibility, authority and knowledge of how the world works, what can be done by whom and how fast and how much <u>cannot</u> be done. It involves a knowledge of what one does not know, and the implications of mistakes -- an awareness of our own fallibility and uncertainty. That is the subject of public policy, not politics.

Robert Kennedy wrote about the beauty of what rational man can do. I quote him:

> "Think how our world would look to a visitor from another planet as he crossed the continents. He would find great cities and knowledge able to create enormous abundance from the materials of nature. He would witness exploration into understanding of the entire physical universe, from the particles of the atom to the secrets of life. He would see billions of people, separated by only a few hours of flight, communicating with the speed of light, sharing a common dependence on a thin layer of soil and a covering of air. He would also observe that most of mankind was living in misery and hunger, that some of the inhabitants of this tiny, crowded globe were killing others, that a few patches of land were pointing huge instruments of death and war at others. Since what he was seeing proved our intelligence, he would only wonder at our sanity. It is this monstrous absurdity that must be the target of the modern revolution."

But there is another, perhaps more fundamental, basis for our concern for our fellow man. The poet John Donne put it simply:

"No man is an Iland, intire of it selfe; every man is a peece of the Continent, a part of the maine; it is Clod bee washed away by the Sea, Europe is the lesse, as well as if a Promonterie were, as well as if a Mannor of they friends or of thine owne were; any man's death diminishes me, because I am involved in Mankinde; And therefore never send to know for whom the bell tolls; it tolls for thee."

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