Bank/Fund Update

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THE STATE OF PLAY

FORMER WORLD BANK TREASURER EUGENE ROTBERG GIVES HIS SPECIAL PERSPECTIVE ON THE BRADY PLAN, THE BANK AND THE FUND

It seems time again for some reality testing on the state of play of Secretary of Treasury Nicholas Brady's initiative for addressing the international debt crisis — particularly in light of recent provisioning by major banks and the uncertainty of continuing long-term lending.

The U.S. initiative basically said four things: 1) it is permissible, if not desireable, for U.S. banks to admit to some losses on their loans to Latin American countries; 2) the banks should provide some form of debt relief or debt reduction; 3) the U.S. government would not provide direct visible support for the banks; and 4) the official international institutions had a green light to guarantee some debt service or otherwise provide support for debt reduction — in a limited fashion under appropriate circumstances. All of these goals have been accomplished; yet there is little sense that the "problem" has been solved.

The reality is that even if the Mexican and Philippine negotiations are concluded successfully, the arrangements will not result in a material positive effect on the debtors' foreign exchange requirements to service debt. The reason is simply because, in recent years, the heavily-indebted countries have typically met only about half of their debt service obligations. The balance, as we know, was provided by the banks themselves, who, understandably, did not want to show losses and therefore paid themselves interest by providing new loans for that purpose. Provisioning simply substitutes for new money; it does nothing for the debtors' cash flow problems. The reality is that formal debt reduction has little effect on cash flow if the debtor has not been paying interest or principal anyway. Commercial bank concern over admitting to losses — the inevitable result of not making new loans — is not likely to change despite the signal from the U.S. Treasury that it's okay to do so, particularly if there is no favorable tax or regulatory treatment in the offing and no possibility for direct government guarantees on new or old loans. Given that reality, for the whole process to have an impact, the provisioning, write-offs, debt reduction or lower interest rates, plus new loans, must be in magnitudes greater than the amount of previous lending. Otherwise, the whole business is irrelevant. Those options, of course, were always available to banks — though without official sanction or formal imprimatur from the U.S. government. My sense is that the banks expected an "activist" response from the U.S. government, perhaps in the form of guarantees or subsidy, or, absent that, a greater commitment from the international lending institutions. That was naive.

Official development institutions cannot — will not — fill the gap between what banks are willing to do and what the debtors are prepared to pay. There are significant constraints on the amount of lending or guarantees which can be provided by international financial institutions (IFIs) to lessen the debtors' debt service burden. The U.S. initiative did not remove those constraints. The reality is simply that the official development institutions have a capital structure which places the ultimate risk of defaults by developing countries on the taxpayers of a few industrialized countries. These institutions also have competing demands for funds from countries who are not part of the debt crisis and who have performed well. IFIs will not be permitted, nor do they wish to overcommit resources to a few countries in Latin America. They will pay close attention to the concentration of country risk and exposure. Indeed, I suspect that whatever the World Bank makes available for the repurchase or guarantee of debt, the debtor will receive, by way of direct lending, that much less from the Bank — almost dollar for dollar.

Further, there remains the concern that in some countries the exposure of the development institutions, if expanded, could constitute a substantial percent of the debtors' overall external indebtedness and, accordingly, could displace commercial bank risk. From a World Bank and IMF perspective, that, too is a non-starter. Both institutions will insist that commercial banks 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, namely, new commercial bank lending, which still can be called upon. Otherwise, the credit risk would be shifted from the private banking sector to the official institutions and thence to the industrialized countries' taxpayers — a circumstance those major shareholders are not likely to find acceptable.

My sense is that given the political realities, unless and until the World Bank has the flexibility to provide guarantees (or loans) which are not backed by its callable capital, its role in providing either resources for debt reduction, rate subsidies or guarantees is likely to be modest. An off-balance sheet affiliate would do the job or, in its absence, perhaps commercial banks might be obligated to relend payments received from guarantees right back to the World Bank at three-month U.S. Treasury bill rates — for a long time. 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 would certainly lessen the probability that LDC debt would, willy-nilly, be shifted to the World Bank and, accordingly, would considerably lessen the event that taxpayers of industrialized countries might be stuck with the bill. Unless initiatives are taken along these lines, the interventions by the international financial institutions are likely to be modest.

The commercial banks, the industrialized countries and the debtors all need to satisfy the demands of pressing constituencies: the commercial banks want to lift the spirits and prices for their stockholders; the industrialized countries and the debtors all need to satisfy the demands of pressing constituencies: the commercial banks want to lift the spirits and prices for their stockholders; the industrialized countries want to maintain the credibility of their banking systems — without appearing to "bail out" yet another sector of the financial community while at the same time fending off pressures from parliaments and legislatures to do both more and less; the debtors, their leadership under intense political pressure, need to say that they have extracted meaningful concessions from their bankers. The key is to fashion an initiative and implement one which will not be vetoed by the key constituencies. That can be done.

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