The State of Play: The International Debt Crisis

by Eugene H. Rotberg

The United States Secretary of the Treasury, Nicholas Brady, has recently suggested that the International Monetary Fund and the World Bank could provide funding "for debt or debt service reduction purposes" in order to strengthen the credit standing of heavily-indebted countries. Secretary Brady also urges that the Bank and Fund "collateralize a portion of interest payments for debt or debt service reduction transactions" and consider loans which "could be used to replenish reserves following a cash buy-back." These proposals followed news reports about unrest and violence in Latin America -- much of it attributed to the drain on the debtor countries' resources from servicing their huge foreign debt. There are also calls for debt forgiveness or a moratoria on interest payments and, from others, a loosening up of the "reform" conditions imposed by the IMF and the World Bank. My purpose here is to share some thoughts on the state of play, as I fear, as the saying goes, the World Bank has been put in play.

The Constituencies

The positions of the main constituencies are straightforward.

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Banks would like to receive higher than current market value for the sale or conversion of loans on their books. They also want official guarantees on the remaining debt, and they don't want to lend anymore. Debtors would like to buy back their debt at low prices (if a White Knight provided them with the money), cancel part of the debt and pay interest at below market rates on what remains.

Obviously, there is a gap between what banks want and debtors are prepared to pay. The issue is who bears the loss, how much, and through what mechanism. Industrialized countries, understandably, have been reluctant to stick it to the taxpayer -- even indirectly, though Secretary Brady's proposals suggest that a part of the loss and future risk might be borne by taxpayers in industrialized countries, or the World Bank and its bondholders, or the IMF. However, policy makers remain concerned about some basic issues. Is official support for the benefit of bank stockholders or their depositors? Is it on behalf of those countries who succeed in restructuring their economies, or for those who can't or won't and fail? And perhaps most contentious, is it to facilitate the "exit" of banks and the substitution of pension funds, insurance companies and middle America to finance LDC debt, or is it designed to encourage increased commercial bank involvement? These issues are troublesome and now are the subject of interdepartment and agency discussion in the United States and among other industrialized countries.

There are several explanations which account for the broad support for the United States initiatives:

- Each constituency apparently reads the carefully chosen words as offering only benefit and no pain to them alone.

- There is great political advantage in merely using the phrase "debt relief," so great that it masks reality, "...glowing Embers through the room Teach light to counterfeit a gloom..." and lifts the spirit -- without changing cash flows.

- There is, in fact, real cost and risk to constituencies who are waiting to see what the numbers look like.

- The proposals could provide a vehicle to permit a flexible and controlled way to present and account for losses on LDC debt.

Under the circumstances, it is not surprising that most of the commentary refers to "first steps," and "moves in the right direction," particularly as the initiatives are perceived as diffusing, even temporarily, some of the violence and passions surrounding the subject.

Lending vs. Debt Relief

Banks are in no mood to lend. Indeed, many have "provisioned" against the loans, sold them off and implemented financial engineering which permits them to mask or amortize their losses over time. These developments, inevitably, have removed, for some, the pressure to lend. The threshold question -- is it best to encourage the reduction of LDC debt service obligations, or to provide incentives for lending "new" money -- has not been resolved, nor is it clear which approach is more likely to result in structural economic reform of debtor countries. Indeed, some would argue that the distinctions between debt relief and new lending is meaningless except for the compounding of interest on new lending. Nonetheless, the latest initiatives focus primarily on debt reduction or debt relief -- not new lending. In the rush to embrace debt relief, however, there has been little note that debt service relief occurs all the time.

For example, of the $220 billion of maturing debt which was due and payable during the period 1983 - 1987, owed by the so-called Baker countries, less than $15 billion was actually paid. The balance -- in excess of $200 billion -- was rescheduled to mature over a 20-25 year period, and there are few, if any, who expect it to be paid at maturity. That is debt relief, and, given the prospects for repayment -- debt forgiveness. Indeed, what other label would more accurately describe the status of loans

originally made in the 1970s where the principal has been refinanced and rescheduled beyond the year 2000, and where interest on remaining debt is paid, in large part, out of new lending packages from the same creditors?

Specifically, banks have made about $45 billion in new loans since the early 1980s to the highly-indebted countries in order to facilitate the payment of interest. All that, as a practical matter, adds up to debt service relief, since it reflects the reality in which the debtor does not meet its debt service obligations from its own resources. Further, some countries are not paying any interest at all and still others are paying at rates well below the market. That, too, is debt relief. My point, however, is not that borrowers have had an easy time of it or that they can now afford to make the payments they are making. They cannot, either financially or politically. Indeed, they have suffered a great deal and have made changes and, indeed, structural adjustment of their economies is painful and often borne by the poorest in a society. It is simply to observe that there has been substantial debt relief by any reasonable operational definition of the term, and yet there is little evidence that it has resulted in appreciable improvement of the conditions of highly indebted countries. What we have not had is a sufficient critical mass of either savings or new money which might provide incentives for far-reaching reform.

I suspect the reason why the past debt relief or debt reduction

hasn't led to significant economic improvement is first, because it hasn't been sufficient and, second, because debtors who "save" money by not paying interest or principal are not easily amenable to pressures for economic reform. The debtors perceive that creditors lend each year only enough to pay themselves a part of the interest due or reschedule maturing debt. Under the circumstances, there is little room for leverage by international development institutions to provide enough of a carrot for economic reform by debtors. And whatever leverage there is has been dissipated on occasion as the lending institutions bicker among themselves over the need and character of the reform, bilateral government assistance is offered to the debtor virtually over the weekend, and banks press the international institutions for faster and increased disbursements, irrespective of the economic performance of the debtor.

Though formal debt reduction is clearly politically attractive to the LDCs, unless the accompanying visible loss to the banks is borne by someone else, its very decisiveness and transparency virtually assures no further lending. I reluctantly conclude it also lessens the incentive for basic reform of the debtors' economy. Accounting entries of creditors which reflect the true value of loans may be politically attractive for debtors and add much to the integrity of the creditors' books. But they do not change the reality of the burden on the debtors. Of greater concern, debt reduction typically has a "quid pro quo" -- official guarantees for banks on the remaining balance of their "written

down" debt -- in order to soften the burden of the visibility of the loss. These guarantees clearly help the banks, since it assures that the remaining debt will be serviced (without their putting up the money), but, by definition, it removes the pressure to provide a critical mass of funding necessary for growth and investment.

Apparently, however, the theory goes that if banks no longer were to lend to pay themselves interest, agree to receive interest on a reduced amount of debt, the servicing of which would be guaranteed by the IMF or the World Bank, the debtors would be more amenable to structural economic reform. But for that to happen, the "savings" would have to be so large it would go far beyond the financial capacity of the international institutions. In fairness, though, Secretary Brady's proposals are not yet fleshed out. Understandably, they remain imprecise and, at this writing, it is not clear who pays or guarantees whom, for what intended benefit, how much, and with whose money. In the world of politics, language counts; in the world of finance, however, someone has to pay interest every six months -- or at least agree to pay it, after compounding -- later. My simple suggestion at this juncture is that if there are to be guarantees, they should be leveraged in conjunction with actual lending, accompanied by structural adjustment and explicit conditionality -- not wasted on purifying the credit quality of old bank debt.

The Role of the World Bank

A wiser approach, I suggest, is to encourage commercial bank lending to LDCs linked to economic adjustment of the debtor. The key is to create a facility, however, which can provide credit enhancement for such lending without putting taxpayers or the World Bank at excessive risk. Otherwise the viability and vitality of a great institution is at risk.

Development institutions are not primarily funded by governments. They are owned by governments. It is useful to remember the difference and recall who would be put at risk. While the World Bank, for example, is owned by governments, its stockholders have contributed only $6 billion of a $120 billion balance sheet. The great majority of its resources comes from bondholders -- the private sector -- who have lent to the World Bank. They do not expect to assume the risks taken by commercial banks. Bondholders look to the callable capital of industrial countries as a kind of guarantee for their benefit and for no one else's in the event of adversity. They would not find it appropriate if these already limited guarantees were used to facilitate the banks' graceful exit or to provide them with "credit enhanced" paper as a carrot to compensate them for losses occasioned by the accounting consequences of formal debt reduction. (The use of IMF resources, also suggested by Secretary Brady, of course, does not raise the same issues as World Bank support. Unlike the Bank, it is

"funded" by governments directly, and does not have a private market constituency it must satisfy.) Besides, a World Bank guarantee is an extremely inefficient use of scarce guarantee capital since it is "counted" against its permissible risk exposure -- just like a loan. My sense is that a World Bank loan, which is conditioned on specific structural reforms in the debtor's economy, is simply more likely to have value (and the reforms implemented) than a guarantee of the debtors' already outstanding commercial bank loans. I am concerned that the latter would simply substitute the banks' risk for that of the World Bank, with little potential leverage on the debtors' economy.

This is not to say that the World Bank should not use its guarantee power; I would only urge that it be used only in connection with new money from banks, on the principal risk only, and in a manner in which the World Bank's capital and its bondholders were protected. I have suggested, in other writings, the guarantees of an affiliate facility funded by the Bank's liquidity, from possible investment by commercial banks and others (Japan comes to mind. Japan comes to everyone's mind!), and from its own independent borrowing power. If banks exercised those guarantees, they might well be required to relend the proceeds received back to the affiliate at U.S. Treasury Bill rates.

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At this point, unfortunately, there is a lot of tension in the

developing world, a sense that there is not much chance for growth, or for a decent living standard for the next generation. Many debtors face the prospect of no growth, high unemployment and runaway inflation -- for a long time. At the same time, expectations are being raised by the recent initiatives, though it is not at all certain who will take the risks and put up the money. I would hope that the latest proposals of Secretary Brady are implemented in a way which encourages new lending for growth and a chance for debtors to achieve a decent standard of life. It is seductive to offer code words which lift spirits, but if they turn out to be without substance or do not fairly allocate pain and risk, they will not work. Given the raised expectations that, in turn, will put the military and the populace back into the streets.

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