The State of Play

by Eugene H. Rotberg

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It seems time 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 new lending.

The reality is that even if the Mexican and Philippine negotiations are concluded successfully, the arrangements simply will not result in a material positive effect on the debtors' foreign exchange requirements to service debt. The reason is 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. That amounts to de facto debt service reduction, irrespective of what the books of the banks (or the debtors) say.

For the initiative to have a positive impact on the debtor, whatever the labels -- provisioning, write-offs, debt reduction,

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or through lower interest rates or new loans, the net outflows from the debtors to the banks must be less than their previous net outflows. Otherwise, the whole business is irrelevant. The reality is that lending is the proxy alternative to showing losses. They are not additive; for the most part they substitute for each other.

The banks clearly expected a supportive response from the U.S. government, perhaps in the form of guarantees, subsidy or favorable tax treatment, or, absent that, a greater commitment from the international lending institutions, either to cushion their losses or enhance the credit quality of new loans. That was naive -- given the political realities in the U.S. Congress and the style of the international institutions.

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 financial and political constraints on the amount of lending or guarantees which can be provided by international financial institutions to lessen the debtors' debt service burden. The U.S. initiative did not remove those constraints. Again, 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. The official

international institutions 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.

My sense is that given the political realities, unless and until the World Bank has the flexibility to provide guarantees (or loans) which are <u>not</u> backed by its callable capital, its role in providing either resources for debt reduction, rate subsidies or guarantees is likely to be modest. I know it is not fashionable nowadays to talk about a structural initiative. Nonetheless, the fact is that the ad hoc, case-by-case approach is inhibited by some basic constraints which limit the intervention of the World Bank. An off-balance sheet affiliate would do much to break the log jam. Or, in its absence, perhaps commercial banks might be obligated to relend the proceeds received from guarantees right back to the World Bank at three-month U.S. Treasury bill rates -- for a long time. It would certainly lessen the probability that LDC debt would, willy-nilly, be shifted from the private sector 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, my assessment is that interventions by the international financial institutions are likely to be modest.

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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 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 and implement an initiative which will break the impasse. That can be done.