

THE POLITICS OF THE DEBT CRISIS

The purpose of this paper is to identify the players and the pressures, and to suggest an approach to the debt crisis that addresses the concerns of a diverse constituency of involved parties. I know it is not fashionable nowadays to talk about institutional or comprehensive initiatives, but rather to support proposals which are based on an ad hoc, case-by-case basis. I suspect that is because the various constituencies have been unable to resolve their differences or agree even to the definition of the problem, let alone its resolution. For example, there is considerable difference of opinion whether it is best to opt for "debt forgiveness" or "new money packages;" who, if anyone, should provide credit enhancement or guarantees for loans to debtor countries; how best to assure fundamental economic reform; and who should bear the losses on non-performing loans. Certainly, the formulation of an institutional approach for addressing the international debt question would, by definition, have to deal with and resolve these matters on a consistent and fair basis. Under the circumstances, it is no great surprise that the code words -- a "case-by-case" approach -- are in fashion. It is thought best to go slow, consider the differences amongst countries, and not engage in precipitous action.

This paper attempts to describe the concerns of the various constituencies and the major controversies, and recommends an approach which is designed to respond to them.

My bias is straightforward. It is based on the premise that financial engineering that speaks primarily to the means to "write off" or "forgive" LDC debt in a fashion acceptable to banks (or LDCs), without providing for or facilitating new lending, is of doubtful significance. Indeed, while rhetoric may label such developments as "at least a beginning," I believe it is basically counterproductive to increasing the flows that are so necessary for development and productivity, and so fundamental to encourage the discipline needed for domestic macroeconomic changes. My thesis is as follows: (a) banks are not likely to lend voluntarily; (b) they will lend if there is credit enhancement or guarantees; (c) they will not lend if they are required to formally "forgive" debt; (d) credit enhancement should not involve a call on U.S. taxpayer or the callable capital of the World Bank; (e) a credit enhancement initiative can be developed which will satisfy the banks without running afoul of the constraints in (d); (f) new lending, backed by credit enhancement, will provide maximum leverage for structural economic reform; debt forgiveness does not.

It may be useful first to summarize what happened in the 1970s and early 1980s, for that background is relevant to defining the problem and providing a frame of reference for this paper.

WHY DID COMMERCIAL BANKS LEND TO LDCs?

- o Governments were pressuring, or at least encouraging, banks

to recycle OPEC financial surpluses. They did so -- to LDCs.

- o There was little other investment for OPEC financial surpluses. Clearly banks could not buy U.S. Treasury Bills at 2% less than their marginal cost of attracting deposits.
- o There had been little previous "pain." All "foreign" debt in recent memory had been serviced.
- o General purpose or balance of payment loans were made on the assumption that commodity prices would at least rise at the level of inflation and governments would generate sufficient foreign exchange from traditional exports to service their debt.
- o Herd instinct -- a desire for market share. Japanese banks were moving to London and creating competition at narrow spreads. It was a borrowers' market, with little distinction drawn on the basis of perceived credit standing.
- o The loans were syndicated to non-money center banks -- often the so-called regional banks anxious to participate in international business and affiliate with a rapidly expanding distribution network outside the United States.

- o The dread factor -- the loss potential was so severe, given the magnitude of the lending, that little attention was given to the uses of the funds or the development program of the borrowers.

- o Central Banks, it was assumed, would always be there as a lender of last resort. In short, the financial system would be safe so long as the obligations remained on the books of commercial banks.

It was a scenario that lasted for a decade -- one in which risk exposure increased, credit standing deteriorated, with no market mechanism in place to price risks or value the portfolios. By the mid-1980s, however, virtually all bank lending to highly indebted countries was based on carefully worked out arrangements which were designed to assure that the funds loaned were "recycled" back to the banks to permit them to continue to accrue interest on their loans. Now, after years of ad hoc negotiations, reschedulings, provisioning, confrontations, interruption in debt service, a reassessment is taking place -- part of a continuing process as each of the constituencies seeks to protect its interests.

LDC PROSPECTS FOR SERVICING DEBT

While it is a truism bordering on a cliché that each country must

be examined individually, that solutions must be tailored to the demands and requirements of each country, I would hope there is room for some straight talk. Most heavily-indebted LDCs are not likely to repay principal in the foreseeable future. Virtually all principal falling due in the next ten years, and probably longer, will be rescheduled or refinanced -- the pattern for recent years. The difference, however, between repaying and not repaying principal over a long period -- assuming interest is paid -- is but a few basis points. The issue is perhaps better put:

Can LDCs service their debt and maintain modest growth -- without money packages equal to a substantial fraction of their debt service obligations? I think not. Based on recent experience, however, the amount of lending from commercial banks is not likely to come close to the interest payments due to those institutions. The key, I would suggest, is to provide some form of credit enhancement to encourage commercial bank lending without a direct or indirect contingent liability on the taxpayer. To fashion such a vehicle, however, requires an understanding of the position and views of the various constituencies.

COMMERCIAL BANKS: A CONSTITUENCY

I assume that we will continue to see interest rates for LDC debt set below market rates, prepayments by industrialized countries

for major LDC exports or direct bilateral assistance, and conversion of loans to bonds at discounts from par with selective credit enhancement by borrowers who will collateralize, in a minor way, their new debt. But, as banks begin to sense leverage (as they increase their reserves and capital and sell off LDC debt), they will reduce their lending for round trip interest payments back to themselves. Their leverage comes from the threatened withdrawal of short-term export financing and trade credits unless interest payments are made on a diminishing stock of debt in bank portfolios -- without help from the banks themselves.

Mostly, for understandable reasons, banks want out, and as close to par as possible. They want to reduce their exposure and certainly do not want to increase it, even if by so doing the loans are deemed "current." Understandably, banks would like others to assume or purchase existing loans at as high a price as possible or seek guarantees that interest payments on retained debt will be credit risk free.

They also look for a nod to some creative accounting, a relaxation of regulatory pressures and for ways to "spread out" the loss over a period of time. Banks, in short, want increased leverage in the negotiating process. They may, moreover, be well on the way to achieving it because of the substantial reduction of LDC exposure to their capital, from the fact that some have

already provisioned against the loans -- from sales of loans or swaps -- and from recent financial engineering, which permits them to delay, mask or amortize their losses over time. These developments, I would argue, remove the pressure to lend more. However, from an LDC point of view, it also reduces the pressure to make painful macroeconomic changes as the LDC realizes that "new" money is not likely to be forthcoming.

THE LDCs: A CONSTITUENCY

There are political pressures to service debt and pressures not to. Factions both in and out of power in developing countries find many solutions unacceptable, particularly those which contemplate full debt service linked to the highest marginal cost of funding in a currency over which they have no control. Those costs are borne by poor people often living at the margins of existence in countries with fragile political systems. That produces political pressure for debt forgiveness or moratoria.

There are, nonetheless, also significant pressures to service debt in order to obtain new capital for high priority projects and to maintain even modest growth. Exports must be financed, industries retooled, infrastructure put in place and short-term export credit financing maintained.

If an LDC does not service debt, those short-term credits are at risk. If these are not maintained, the country shuts down. Thus, LDCs, too, are under painful pressures, facing basic choices that affect their viability as sovereign nation states.

The choices are not easy ones. From their perspective, a not insubstantial part of the problem lies outside their borders and relates to matters over which they have no responsibility and little control.

- (1) Protectionism in the West has hurt. It has made it difficult to export, earn dollars and service debt.
- (2) High real dollar interest rates have increased their costs and their capacity to grow. And over the last year, nominal rates have fluctuated more than 250 basis points, with prospects of higher costs as market participants -- increasingly non-U.S. -- rethink how, where and at what cost they should maintain their investments in U.S. dollars.
- (3) Sluggish growth in the West in the past has reduced the demand for their products. A recession in industrialized countries would immediately shut off their capacity to earn the necessary foreign exchange to service debt.

- (4) A deterioration in terms of trade from a wide variety of circumstances in the 1980s produced falling commodity and mineral prices for exports and, more recently, the rising costs of European and Japanese imports in U.S. dollar terms have reduced the generation of foreign exchange to service debt.

Heads of state in developing countries look upon these external matters, essentially outside their control, as seriously affecting their financial and political 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.

INDUSTRIALIZED COUNTRIES: A CONSTITUENCY

They want to avert a financial crisis in which commercial banks cannot raise equity capital or are considered questionable credit risks. That would seriously damage their influence as international powers.

They want to mitigate an economic crisis in which the underpinnings of government in LDCs, fragile at best, is hostage to an untenable choice: to meet all debt service in the context of no growth, with the resulting transfer of wealth from poor to

rich, which is not sustainable politically, or, conversely, to default, which would, in turn, eliminate external inflows and increase flight capital because of the absence of resources for infrastructure and development.

They want to avert a political crisis. The politics -- the concern for democracy and/or stability -- is primarily a Congressional/Parliamentary one and of direct relevance to foreign ministries. But the fact is these constituencies, while potentially powerful players, are not direct participants, and are ambivalent in their attitude and response to a problem in which domestic constituencies may have little concern for money center banks which have lent to "foreign" states that "dump" products in the markets of industrialized countries.

While industrialized countries clearly want strong banks, they are not prepared to send a bail-out signal to domestic financial institutions, except for very special constituencies. A U.S. Congress, for example, will take steps to support thrift institutions that provide finance for residential mortgages or for farmers. Not so for poor countries.

From the U.S. Treasury perspective, they want to avoid the establishment of a precedent whereby the U.S. taxpayer, directly or indirectly, pays for losses sustained by banks. They are understandably concerned with how or where to draw the line --

are all banks provided with credit enhancement or guarantees? Strong ones? Weak ones? Is it for all LDC debt or just for friendly countries? For those who are trying to restructure their economies or those who can't or won't? Is it to permit the "exit" of banks, or only in connection with banks who supply "new money?" While legislators may provide support or protection for financial institutions who have made unwise loans to farmers, real estate operators, energy producers, these constituencies are politically powerful. Developing countries are not -- irrespective of their geo-political importance to the United States.

Money center banks are not a beloved constituency in a populist society. They do not have the support for 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. Indeed, the recent World Bank capital increase will continue to be under quite close scrutiny during U.S. appropriation hearings over the next several years as a substantial body of legislators in the United States will contend -- and I believe without justification -- that it would serve to "bail out" the banks, while others will contend that no capital

increase is justified unless the bank uses its powers to "alleviate" the debt crisis.

Despite the lack of political support, however, industrialized countries also know they need economically strong LDC markets for their goods and services -- so fundamentally necessary as a means of reversing trade deficits and facilitating the opening up of new markets.

THE MULTILATERAL DEVELOPMENT BANKS: A CONSTITUENCY

The question has often been put: Why don't multinational development institutions address the problem through use of their guarantee power or simply lend more? I expect that Congresses and Parliaments will not encourage those institutions to do indirectly what governments will not, or cannot, do directly. Governments are also likely to find it quite difficult to draw the line, as a political matter, as to who is "entitled" to guarantees, under what circumstances, and how much.

Furthermore, international institutions are not primarily financed by governments. They are owned by governments. It is useful to remember the difference and recall who would be put at risk. The World Bank, for example, is owned by governments. These stockholders, however, have contributed but \$5 billion of a \$100 billion plus balance sheet. The great majority of the

balance comes from bondholders -- the private sector -- who lend to the Bank. These investors in long-term fixed-rate bonds of the highest credit standing, issued in the tens of billions of dollars by the World Bank, do not presently lend on fixed term to commercial banks. They do not expect the World Bank to assume the risks taken or to be taken by commercial banks. Nor do they contemplate that the protection provided by callable capital, designed to protect them in the event of adversity, would be rechanneled or diluted in favor of commercial banks, which have far greater exposure than does the World Bank. But they would be prepared to support policies which leveraged the World Bank's capital if those policies encouraged new private financial flows, increased conditionality and thereby, overall, made the Bank a stronger institution.

Finally, international lending institutions are not likely to provide credit enhancement, directly or indirectly, except as part of a package to provide new funds linked to fundamental structural adjustment of LDCs designed to facilitate growth and development. And, of equal importance, they are likely to look to a certainty of private funding should those guarantees turn out badly, as will governments which provide support in the form of "callable capital," also look to the private sector as a funding source before a call on their capital is triggered.

* * *

The international debt crisis and the drying up of new funding, I believe, will be a direct cause of political instability in Latin America, the weakening of democracies, the movement of countries to the far left or right, increased reliance on drug exports -- as countries with fragile political systems are faced with untenable choices for their future. And yet, none of us is likely to be held accountable for not taking initiatives which would diminish the likelihood of such unhappy occurrences. Indeed, as we know, gold stars are not, neither now nor later, awarded for taking steps whose only positive effect can be discerned by the absence of untoward events from occurring. It is hard to get credit for bad events which don't happen. And it is particularly so when initiatives are not likely to fully satisfy everyone, where risk and pain will have to be shared and where it is likely to be visible and immediate. The problem is not made easier by the fact that no entity has been given the mandate to allocate that pain and risk so as to avoid worse outcomes down the road.

A DILEMMA: NEW MONEY VS. DEBT FORGIVENESS

It may be useful here to comment on the controversy surrounding the need for "new" money versus debt forgiveness.

Much of the debate on debt crisis initiatives centers around the difficulty of knowing whether it is best to reduce LDC debt

service obligations as a matter of contractual agreement or to lend "new" money. It is generally agreed that debt forgiveness or reduction, for a variety of legal and practical reasons, would discourage further commercial bank lending, thereby forcing the LDCs to come to grips with tough times. They would have to work their way out of a period of negative growth until their domestic economies, without outside support, became sufficiently attractive to encourage new external inflows and investment. Indeed, many LDCs prefer that approach for it is politically quite attractive to point to moratoria, debt service reduction or "forgiveness" to domestic constituencies. The alternative approach is to lend new resources now and to forge links between the banks, the LDCs and the international lending agencies, which would encourage private lending while avoiding the potential pitfalls implicit in providing, directly or indirectly, some form of safety net or credit enhancement to the private sector to facilitate their new lending.

There is uncertainty and debate as to which approach is the wisest one. We, in western countries, endlessly debate the issue. Those in Latin America, however, become poorer and more volatile in the interim.

I personally would opt for that school which would not forgive or reduce LDC debt -- whether or not the remaining debt were "credit

enhanced." The fact is debt forgiveness occurs all the time, with little need for government prompting or support -- and there is little evidence of its effectiveness in encouraging structural economic reform.

For example, of the \$220 billion of debt (which matured during the period 1983 - 1987) owed by the Baker 15 countries, less than \$15 billion was actually paid. The remaining debt -- in excess of \$200 billion has been "restructured" to mature over a 20-25 year period. That is, as a practical matter, debt relief, or, given the prospects for repayment -- debt forgiveness. Indeed, exactly what is the financial value of loans originally made in the 1970s where the principal has been refinanced and rescheduled beyond the year 2000, where the debtor can retire its obligations in the market at fifty cents on the dollar, and where interest usually is paid only in connection with new lending? Is that not debt reduction? The fact is, banks have lent \$45 billion in recent years, and by so doing, have increased their exposure despite the inability of the debtor to meet its principal or interest obligations. Banks have thereby, in effect, capitalized the interest due through the making of new loans. All that adds up to debt relief or forgiveness, since, as a practical matter, it removes the need of borrowers to meet, out of their own resources, their debt service obligations. Further, many countries are now paying no interest at all and still others are paying at a rate well below the current market rates. But my

it matters little that their debts have not been forgiven. Though forgiveness of debt may be politically attractive to the LDCs, unless the resulting loss to the Banks is borne by someone else, say, the taxpayers, its very decisiveness and transparency virtually assures no further new money for growth and no leverage for fundamental reform of the LDC economy. Its primary impact is on the financial statements of a commercial bank -- not on the cash flow of countries who are not meeting debt service obligations with their own resources anyway, whether or not such non-payment is "forgiven." And if, on the other hand, there are guarantees to be handed out, better they should be occasioned in connection with new lending, accompanied by strict structural adjustment, tranching and explicit conditionality.

OBJECTIVES

- o There is new lending to LDCs. By "new," I mean that amount which stems substantial negative cash flows from poor to rich and supports reasonable growth and facilitates trade.
- o LDCs remain politically viable. Whatever the approach, it doesn't prompt a collapse of fragile democratic political processes in the country.
- o Banks continue to attract capital, with the prospect of

earning a reasonable return, and can continue to diversify their activities with broad-based support for their own funding activities.

- o The initiative is not, in fact, nor is it perceived as, bailing anyone out.

- o It is politically workable/practicable. That means accounting professionals, stockholders, legislators in industrialized countries, and a broad range of the body politic in LDCs find it fair.

The objective in the context of the foregoing is designed to increase the comfort level of commercial banks and provide a sense of equilibrium of risk-taking amongst the constituencies.

The key is to create an institution which can provide credit enhancement for new bank lending to LDCs without putting taxpayers at risk or drawing on the World Bank capital. That would quite simply provide a vehicle for new commercial bank lending specifically linked to World Bank/IMF structural adjustment loans and projects.

I would not suggest a World Bank guarantee as the vehicle for credit enhancement. I would use, instead, the guarantee of an affiliate. The difference is extremely important, and unless the

difference is recognized, outcomes of new initiatives are likely to be minimal. The setting up of an affiliate institution of the World Bank would not entail a call on the U.S. callable capital (the World Bank guarantee is counted precisely the same way as a loan by the Bank, and is, therefore, an extremely inefficient use of scarce guarantee capital). It is suggested that the affiliate be funded out of the liquidity of the Bank and from its own independent borrowing power and use its resources to support long-term guarantees of principal payments on new loans by commercial banks. That type of facility could be leveraged with considerably greater flexibility, less potential adverse financial market impact on the Bank, and be far more politically acceptable than World Bank guarantees backed by callable capital. The key is to fashion an entity which is strong enough to encourage the banks to lend with such guarantees under programs linked to IBRD and IMF structural reform, without creating an unwise public policy precedent whereby the U.S. taxpayer or the World Bank callable capital is put at risk. It is not all that complicated a matter, and provides a way to break the current impasse which exists between the banks, the U.S. government, the LDCs and the multilateral agencies.

At this juncture, unfortunately, there is an undercurrent of loss and frustration in the developing world, a sense that there is not much chance for growth, or a decent living standard for the younger generation.

That environment is the fundamental proof of the existence of a debt crisis as our neighbors -- tens of millions of people -- feel hopeless, with little positive prospect for the future or a sense of expectancy. That is not consistent with the contention that the debt crisis is alleviating. Clearly, the fact that banks are gaining power in their confrontations with LDCs is not the proof of a diminution of the crisis. If anything, it is evidence of the opposite, as it hardens positions and relegates the LDCs to the prospects of no growth. Let me summarize in one sentence: What must be done is the implementation of initiatives which are specifically designed to break the impasse which now exists between the U.S. government, the commercial banks, the LDCs and the international development agencies. I am convinced that can be done.

#####

EUGENE H. ROTBERG is an Executive Vice President of Merrill Lynch & Co., Inc. He previously served for 19 years as Vice President and Treasurer of the World Bank. The views expressed herein are those of the author and do not necessarily reflect those of Merrill Lynch or the World Bank.

point is not that borrowers have an easy time of it through the magnanimous action of their creditors. It is simply to point out that (a) there has been debt relief/reduction by any operational definition of the term; and (b) little of it has been linked to structural economic reform. The reason is simply because countries who "save" money by not paying interest or principal, or who receive "new" funds as balance of payment support to facilitate commercial bank accruals of income, are not easily amenable to leverage or pressures for economic reform. The savings from debt reduction, debt relief, or debt forgiveness (these labels are of great consequence to bankers and to political leaders in developing and industrial countries; they are modestly relevant in addressing a problem when the country isn't paying in any event) are "lost in the rounding," providing little possibility for multilateral entities to exercise leverage for economic reform -- particularly if the international lending agencies are bickering amongst themselves over the need for more conditionality and bilateral assistance is provided over the weekend.

While it is true that, strictly speaking, debt forgiveness involves a rewriting of contractual legal obligations (and a lot of publicity), that surely cannot be a sticking point.

"Forgiveness" is, I would argue, a theological concept (albeit, with profound legal implications), not a financial one. And so long as interest is not paid from the countries' own resources,