Eugene H. Rotberg
Former Vice President and Treasurer, The World Bank
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Let us assume that China needs to borrow from external sources, that the resources borrowed will be used productively, and that the debt incurred will not make China financially dependent, in an unacceptable fashion, to external financial institutions. Let us assume further that China wishes to borrow safely, with the freedom to curtail its borrowing if it needs to or chooses to, without undue harm to its economy.

Once one borrows, three principles follow:

1. The borrowed resources will contribute to economic growth only if the borrowed funds are used wisely and productively.

2. The borrower places a significant burden on the next generations to repay.

3. All economic and financial mistakes and failures will be visible since interest on external debt must be paid every six months, as well as principal periodically, irrespective of the uses of the borrowed funds or their ultimate real cost after currency changes.

I offer the following comments, suggestions, or recommendations to implement an effective external debt management program:

1. Borrow and open up markets before you need to, i.e., diversify the PRC's funding base to create the flexibility not to have to borrow at any particular time. No one or two markets should be indispensible. Innovate before you have to. A borrower cannot innovate during periods of difficulty.

2. There is just as much risk in not borrowing as there is in borrowing at any point in time:

   - If interest rates are 8% and one does not borrow and the rate rises to 9%, not borrowing at 8% was a mistake. It involves the same risk as borrowing at 9% if rates decline to 8%.

   - Not borrowing at any time means constrained growth, assuming the funds would have been used productively.

   - Not borrowing means drawing down foreign exchange reserves.

   - Not borrowing now may require more borrowing later, and under less favorable circumstances.

   - Not borrowing now means less flexibility later.

   - Not borrowing now means possible lost opportunities.

This does not mean that China should always borrow as much as possible sooner rather than later; it simply means that not borrowing now has the same risk as borrowing.

3. Maintain a high level of liquidity, i.e., create flexibility in an uncertain world. Public and private borrowers should plan for adversity.

4. Provide the financial markets with clear, unambiguous signals and information, i.e., the level of outstanding debt, guarantees, China's export potential, its decision-making process. Monitor leasing, guarantees, export finance, borrowings from external banks, prepare to disclose how China intends to protect itself against currency risk assumed in another country's currency, etc. The PRC also should be prepared to respond to such questions as:

   - The ability of the borrower to repay the bonds: What are the projections for the balance of payments? How are they going to be affected by possible changes in the Government's economic, trade, social, population, immigration, etc. policies or political structure?

   - The willingness of the borrower to repay the bonds: What is the past payment record of the borrower on external debt obligations? What remedies are available in case of default by the borrower?

- China's capacity to respond to factors which can adversely affect its economic projects, but are outside its control.
- The legal basis for the borrowing: Where is the borrower's legal power to borrow specified? What is the link between the borrower and the PRC?

5. Place more emphasis on volume and less on price, i.e., do not always insist on the lowest possible cost. It will create an adversarial relationship with bankers and will damage the attractiveness of your obligations with investors. Below market terms are not sustainable in volume. I will say more about this later.

6. In the bond market, investors typically seek a credit without risk -- always make all payments on time. Rumors about late payments spread quickly. Most bond buyers do not even want to think about credit standing. Creditworthiness is assumed. Investors are prepared to take a risk on the level of interest rates (should they invest now or later), but not on the creditworthiness of the issuer. Speculators, for a price of course, are prepared to take risks on the creditworthiness of the issuer. But, China cannot borrow large sums from those who have doubts about your credit standing.

7. The PRC should borrow in its own name. So should designated borrowers with PRC guarantees. The market, however, expects the PRC to meet the obligations of entities under its "control," whether or not the borrowing entity has an official government guarantee.

8. Use a diversity of borrowing techniques:

   a. Public vs. private vs. silent issues.

   b. Long and short borrowings.

   c. Fixed versus floating rates.

   d. A diverse currency mix.

   e. Evaluate the cost of hedging currency risks.

   f. Use the swap market as an alternative to direct borrowing as a means of avoiding saturating a market.

   g. Place your obligations in different market sectors (savings banks, commercial banks, insurance companies, pension funds, cooperative and agriculture banks, etc.).

   h. Much of what I have said above applies to both external borrowing as well as borrowing within China itself. With respect to borrowing within China, however, it is important to distinguish between borrowings from credit or banking institutions which essentially tap the accummulated savings of individuals versus borrowings in the capital markets. A country which relies on borrowing from banks as the major source of financing is, in effect, allocating individual savings to the government borrower through the intermediation of the banking system. Many countries of western Europe did this in the 19th and well into the 20th Centuries. These borrowings, however, are almost always short term, or with variable interest rates. They, therefore, have an unpredictable cost and, perhaps more important, they reduce the amount that the banking or credit institutions can allocate directly for either housing or loans to non-government productive enterprises since the government is "crowding out" these borrowers from the banking system. It is very important for the PRC, or any national state, to permit institutions which hold savings to have enough left over after government borrowing to fill the needs of non-government borrowers.

An alternative way to create a domestic capital market, other than through the banks, is to encourage the development of pension funds and insurance companies since these are the major investors in longer term debt. It would be extremely difficult to create a long maturity capital market without the development of these kinds of institutions since they are the primary institutions which have long term actuarial liabilities and therefore can afford to have long maturity debt as assets on their books.

9. Maintain a dialogue with investors. Most important, make sure all Chinese entities are meeting all obligations on time. Rumors about payment delays spread quickly.

   a. Describe China's strength and financial prudence.

   b. Describe the financial plans, the economic growth plans, and its export and import policies to the financial markets.

   c. Present no surprises to markets.

   d. Learn what investors want and respond to their concerns.

   e. Choose bankers you can trust and who are prepared to bring you bad news.

10. At the PRC level, implement internal controls to allow centralized monitoring of the nation's overall external debt and how the PRC expects to cope with currency risk. A central authority should monitor all external debt. The debt, irrespective of its form, should be divided into four categories:

    a. The debt representing a direct obligation, including formal guarantees of the PRC itself.

b. The debt of other PRC-owned institutions (national banks).

c. The debt of other public entities, such as provinces, cities or regional borrowers whose obligations are not guaranteed by the PRC.

d. Private or mixed public and private entities .

The PRC must have clear and articulated policies indicating whether or not it wishes to control the external borrowings of each of these entities. The markets will assume that if China exercises control over such entities, then the PRC itself will be obligated, as a practical matter, to assure that all principal and interest payments are made on time. Control over whether an entity can borrow externally, as a practical matter, therefore means that the PRC itself will be responsible for the creditworthiness of the borrower. To the extent that the PRC does not exercise control over whether a given entity can borrow externally, then the market will not expect the PRC to meet that borrower's obligation should there be a default. Clearly, however, any entity which is substantially owned or directed by the PRC will be looked upon by the market as being a PRC entity. Irrespective of whether the PRC controls the borrowings of a given entity, it should set up a monitoring system which lets the PRC know precisely which entities have external debt requirements in another country's currency.

The PRC should have an explicit policy on the requirements of hedging an external borrowing in another country's currency. This does not mean that the hedges should be required; it simply means that a careful consideration as to the costs, advantages and disadvantages should be articulated. For the PRC itself, hedges can be accomplished by (a) keeping some of the proceeds in the currency borrowed as part of the reserve management; (b) if the borrowings facilitate exports of a particular product earning foreign exchange, these can be maintained in such foreign currency in order to service the debt; (c) an office can be set up to monitor and maintain a portion of all earnings in another country's currency to offset debt service of the PRC itself; and (d) explicit futures or options transactions can be used to hedge the external debt.

For borrowers not under PRC control -- whether public or private -- they should be required to have an articulated, publicized policy with respect to whether or not it hedges its foreign currency debt. As a practical matter, if the PRC has considerable control over activities of a borrower, then the PRC itself will have to assume the losses and obligations caused if the local currency devalues against the foreign currency borrowing. One cannot exercise control over the business affairs and avoid responsibility for negative financial consequences.

11. Avoid saturation of one market:

a. Use swaps extensively instead of borrowing.

b. Use lines of credit.

c. Borrow when you do not need to. Borrow <u>before</u> you have to. Borrow before everyone knows you have little choice. If you do so, you will have more choices. Do not rely on one source, one market, one currency. Have more choices than you could possibly use at one time. For, assuredly, the time will come when some of the markets will disappear or be closed. You should not take the risk of relying on so few places or markets that when one disappears or becomes hostile or too expensive you have no choices left. And a borrower cannot broaden its choices <u>after</u> matters become difficult. Borrowers cannot innovate or expand or look for new sources during a period of stress. Then it is too late. Borrow opportunistically. When you believe rates are low, borrow <u>more</u> than you need. Build liquidity. <u>Hold</u> reserves. Do not use them for unproductive purposes. If you believe markets are receptive -- either because of cost <u>or</u> because of your standing -- borrow. And by building liquidity -- reserves -- the market will want to lend even more. And on better terms. Manage your reserves.

12. Be careful of too much reliance on bond markets. Borrowing in the securities markets may reduce flexibility if you need to reschedule or refinance. Loans and syndicated credits and private placements from external sources should predominate a large borrowing program. These can be rescheduled. Bond issues cannot be rescheduled.

13. Mistakes will be made many times in executing a borrowing plan. All of us make mistakes. We borrow too soon, too late, too short term, too long term. We borrow the wrong currency. No one can predict interest rates or exchange rates. Every decision will turn out to be a mistake -- compared to what you could have done. It does no good to penalize mistakes. If you do, managers will be unable to make decisions. Or they will learn to hide them. Or blame others. They will be afraid of making choices. Admit to error, vulnerability, uncertainty. Only by accepting error -- your Yen borrowings, for example -- will you learn about risk. And only by admitting to risk can you learn to protect yourselves and evaluate the cost of protection.

15. The best, or lowest, terms negotiated in a particular transaction may not be in the best interest of the borrower.

- It is sometimes unwise to achieve terms which are too favorable and which result in immediate losses to underwriters or investors.

- Future lenders will be more careful. They do not want to lose money.

- It is not sustainable. It may provide low cost, but in small volume, with a poor public image.

- It reduces the comfort of investors.

- You will soon owe them something.

- You will not see their newest or best ideas.

- When markets are difficult or investors reluctant, they will be unwilling to support your issues because of their previous losses.

- They will consider you as an adversary and, having more information than you, in the future they will deal with you to their advantage.

- You will discourage firms from competing for your business, for fear that if they do business with you, they will lose a great deal of money. Investors are not in business to lose money. The test should be <u>fairness</u> to all parties -- bankers, investors, borrowers. If borrowers treat bankers as adversaries, they soon will have few choices.

16. Assume China will face difficulties. China should have a plan to fall back on to service its debt. Provincial or non-PRC entities should plan ahead as if there were no central government to help them or allocate foreign exchange in the event of difficulties. But China, the central government, must act and plan as if the Provinces or other non-PRC borrowers will fall on difficult times and China will, in fact, be responsible to service that debt -- whether or not they are legally obligated to do so.

The external world can be expected to create pressures which will make it difficult at times to borrow and to sustain economic growth. Often, these pressures will involve matters outside of China's control.

A borrowing plan to finance growth will have to cope with unpredictable, yet certain, occurrences on the way. Many will be costly. Not everyone will wish you well. Your physical surroundings sometimes will create great stress and untrack careful plans: earthquakes, the need for rebuilding roads and dams; weather wreaking havoc on a proposed agricultural expansion; high interest rates in another country's currency or a revaluing currency outside of your control; falling oil prices, rising oil prices, recession in the West. Your exports will be constrained because of protectionism or international politics. All of this will occur, and in an unpredictable fashion.

All plans will need to be revised: borrowing plans, growth plans, export plans -- not only because you will make mistakes, but because the outside world will be demanding and unpredictable. A financial plan also is a political plan which should assume difficult times. If expectations of open foreign financial markets are the underpinning of economic growth and a raised standard of living, then a financial plan must cope with the unexpected and the adverse -- just like foreign affairs, and just as complex, if a continuing flow of resources from other countries is to be relied on.

Although China's reforms contemplate decentralization and further responsibility given to local sectors, where an obligation is assumed in a foreign currency, it must be monitored by the PRC. The PRC should set limits because the PRC is responsible for economic planning, the distribution of wealth, the burdens placed on future generations and the allocation, overall, of all resources or deficits from all sectors of the economy. A province or non-PRC borrower may retain administrative decentralization for purposes of execution, timing, staffing, the generation of foreign exchange or profit, but CHINA must set, overall, some national limits, publicize them, and create a sense of comfort that the nation can service debt irrespective of the identity of the borrower, and that the PRC will not need to block the conversion of local currency into "hard currencies" for external debt service.