For release on delivery
10:00 a.m., E.S.T.
March 9, 1988

Testimony by

Manuel H. Johnson

Vice Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on International Development
Institutions and Finance
and the
Subcommittee on International Finance,
Trade and Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

March 9, 1988

I am pleased to have this opportunity to appear before these two subcommittees and to assess the international debt situation in light of recent developments.

At the outset, let me state that despite occasional setbacks I see no workable alternative to the case-by-case approach of dealing with international debt problems in the framework that Secretary Baker put forward in Seoul. This approach has achieved considerable progress, more than many observers have given it credit. That basic framework has involved a cooperative enterprise by the borrowing countries, the industrial countries, the international lending institutions, and the commercial banks.

The ongoing efforts to deal with the international debt problem have been far from static. Over time, the various aspects of these efforts have been modified. The approach to the debt problem has been adaptive and has allowed for differences in individual countries' circumstances. Above all, it has laid the foundation for borrowing countries to resume sustainable economic growth while maintaining orderly debt servicing.

Role of Borrowing Countries

Many of the borrowing countries have shown constructive responses in the face of adversity. They have demonstrated the political capacity and will to pursue sound economic policies, despite at times facing adverse external developments. In contrast to the "inward" looking policies followed by many of these countries in the fiscal, monetary, exchange rate, and structural areas for a number of years prior to the onset of the debt crisis, many of these countries have adopted stabilization programs in recent years that represent a distinct change with the past.

Moreover, many leaders of borrowing countries have recognized the need to restructure their economies, by correcting economic and financial distortions. They also have acknowledged the benefit of greater emphasis on the private sector in development. In a number of borrowing countries, incentives to private industry have been strengthened by the removal of price controls, reduction of trade barriers, and the simplification of regulations and licensing requirements. Similarly, some public enterprises have been privatized or the scope and operation of state-owned enterprises have been rationalized.

Some positive results of this shift in policy emphasis are already evident in many of the borrowing countries -- a resumption of economic growth, a dramatic improvement in external accounts, and lower public sector deficits. Changes in the economic policy environment also have led to more efficient utilization of domestic resources and have improved the incentives to save domestically. The establishment of confidence among local citizens has led to a halt and even a reversal of capital flight and should lead to increased confidence by non-resident investors.

Not all of the borrowing countries have participated evenly in this policy reorientation. Those countries that have been in the forefront in pursuing sounder macroeconomic stabilization policies and adopted structural adjustment policies have shown better results than others that have been reluctant to embrace change. For example, a number of borrowing countries that have adopted realistic exchange rates have recorded impressive gains in their exports in recent years, particularly of non-traditional exports, while those countries that have maintained overvalued exchange rates have experienced stagnant export growth.

The maintenance of orderly debt servicing has been a challenge for many of the borrowing countries. Despite political pressures to take unilateral actions regarding debt-servicing obligations, responsible leaders of these countries have recognized the benefits to be derived from being a functioning participant in the international financial system. Trying to withdraw from the system could be costly. Brazilian leaders have recently acknowledged that Brazil's interests were not served or attained by last year's debt-servicing moratorium. The normalization of Brazil's relations with its creditors, which appears to be proceeding in a constructive manner, not only promises to restore orderly debt-servicing arrangements for Brazil and access to international credit markets, but also can facilitate Brazil's achievement of its immense potential.

Role of Industrial Countries

A favorable economic, financial, and trade environment in industrial countries is essential for the borrowing countries to continue their progress. Economic policies in industrial countries need to continue to be directed at achieving sustainable economic growth, while at the same time seeking to correct large global payments imbalances. The need for adjustment and sound economic management is not only a prescription for developing countries, but applies equally to industrial countries.

The slow growth and high levels of unemployment in a number of Western European countries and persistent large external imbalances in the United States have generated political pressures for trade protection as an expedient way to resolve these problems. Besides being an inefficient policy tool to deal with the problems facing these countries, protectionist policies hit the developing countries particularly hard. In order to allow these countries to grow out of debt, it is essential that their access to the markets of industrial countries remain open and is allowed to expand. In this connection, it is noteworthy that imports by Japan and by Western European countries from the main borrowing countries are relatively small and have shown little or no growth in recent years.

Role of International Lending Institutions

The third component in the cooperative effort to deal with the international debt problem involves the international lending institutions. The IMF and the World Bank have played constructive roles in assisting the borrowing countries. In the period ahead, these institutions will continue to be relied upon to act as catalysts in mobilizing financial support by other creditors and to help guide the adjustment and structural reform policies of the borrowing countries.

The IMF has played a major role in arranging financing arrangements for the borrowing countries. The recent approval of the Enhanced Structural Adjustment Facility and current efforts to modify the Fund's lending programs illustrate a willingness to strengthen the capacity of this important institution to adapt to changing circumstances.

The financial assistance of the World Bank and that institution's role in contributing to structural adjustment programs being introduced in a number of borrowing countries have taken on greater importance in recent years. The recent agreement in the World Bank Executive Board to recommend a sizable General Capital Increase, if approved by national authorities, should assist the World Bank to play a key role in continuing to assist the developing countries in the future. Prompt Congressional approval of legislation for this capital increase when it is submitted to Congress will provide assurance that the World Bank will be able to fulfill its role in this area.

In assisting the borrowing countries, the international lending institutions must be sensitive to the circumstances of these countries. As we have learned from experience in recent years, the stabilization and structural adjustment programs arranged under the auspices of the IMF and the World Bank will be more effective if they are "home grown" and have domestic support.

Role of Commercial Banks

Commercial banks have a substantial stake in the success of adjustment by the debtor countries. For the largest international banks, their stake derives from their long-term business strategy as world-wide multinational banks. Multinational banks have an interest in finding ways to reward and reinforce good policies in debtor countries, since it is ultimately through sound economic policies that the adjustment will occur.

A return to sound policies should be accompanied by continued availability of new external financing. Commercial banks, to whom the borrowing countries owe a major portion of their external debt, continue to have a self interest in helping the borrowing countries restore an orderly debt-servicing capability. Over the past few years, banks have provided new funds, generally through so-called concerted lending in connection with stabilization efforts by the debtor countries that have been endorsed by the IMF. However, the amount of net external financing provided by banks in recent years is considerably less than the gross figures indicate, because some outstanding debts to banks have been repaid.

Debt retirement -- either outright via amortization or through conversion into alternative financial instruments -- is in general not a substitute for new money. But some elements of the "menu" approach (proposed by Secretary Baker last year) can be useful in reducing the outstanding debts of borrowing countries, thereby improving their financial position. The innovative talents of bankers have not yet been tapped fully, and I expect that we shall see additional techniques developed in the period ahead.

Reserving by banks. I believe that actions by certain U.S. banks to increase their reserves against loans to developing countries has been over-interpreted by the market, and perhaps by some officials of debtor countries. A decision by a bank to establish a reserve may reflect the judgment of that bank's management on the ultimate collectability of some part of its loan portfolio. However, that decision may also reflect a bank's plans for adjusting its loan portfolio by disposing of certain loans, perhaps over a considerable period. Under generally accepted accounting principles, once a decision is made to dispose of loans the net carrying value of those loans must be adjusted to fair market value. Because reserving is an individual decision, made in light of the bank's own circumstances and its overall business strategy, differences among banks regarding reserving are to be expected.

That is particularly true for international credits because there are greater differences between banks' judgments and strategies on these credits than on problem domestic credits. It is generally easier to assess the financial prospects of a commercial concern than of a sovereign country where the outcome will depend importantly on the policies of the country concerned. Judgments on present and future policies are likely to differ widely, especially when banks have limited international experience. Similarly, strategies vary among banks, depending on their overall commitments to international lending and the time frames in which they envision working out their positions.

The significance of bank decisions to set up reserves depends on the actions that are associated with reserving. Some U.S. regional banks coupled reserving actions in late 1987 with sales of loans in the secondary market. In total, sales announced by regional banks amounted to a few hundred million dollars of market value.

U.S. international banks that have established reserves have engaged in debt-for-equity swaps as well as other loan swaps and exchanges, including the recent Mexican exchange offer. These transactions have been relatively small in comparison with the exposure of the major banks. Moreover, these banks have not withdrawn from participating in the overall adjustment process through new money packages.

The Federal Reserve and other federal bank supervisors have strongly encouraged banks in recent years to strengthen their capital positions. This can occur in the form of retained earnings, including net additions to reserves, or from the proceeds of security issues. Within broad limits, decisions on how best to add to capital and strengthen the financial resources of banks are appropriately left to the individual banks. However, because of the great attention that has been focused on reserving actions, we must recognize that there is a systemic risk if officials of debtor countries interpret additions to bank reserves as presaging a withdrawal by these banks from the adjustment process.

As part of the menu approach banks can withdraw from new money packages via exit instruments, and this may be particularly appropriate for those smaller banks that have no real long-term interest or expertise to be part of the international lending market. Some banks have taken advantage of the opportunity to do so through the Mexican exchange offer. Slimming down the number of banks involved in new money packages in ways such as this offers promise of simplifying the process, with advantages for all parties. Thus, the Mexican exchange offer appears to have been a useful effort to reduce marginally the outstanding stock of Mexican debt, and to permit banks to adjust their portfolios.

Another technique that has contributed to ameliorating debt problems has been debt-for-equity swaps. As you are aware, the Federal Reserve recently further liberalized its regulations to enable bank holding companies to make investments in up to 40 percent of the shares of any private sector company in a heavily indebted country, and also substantially lengthened the permissible holding period for investments made through debt-for-equity swaps. In a number of countries, debt conversions have resulted in reductions in outstanding debts of the countries concerned. But the contribution that these swaps can make to helping investment in the debtor countries may be as important as the impact on the level of outstanding debt, since it is ultimately through investment and reallocation of resources in the debtor countries that the adjustment process must take place.

Conclusion

Despite the considerable progress achieved over the past six years in dealing with debt problems, we have a way to go before being able to declare that these problems are behind us. The dimensions are complex and of a long-term nature.

The current approach, which allows for differences in particular countries' circumstances, offers the best prospects for continued adjustment and resumed access to external finance by the borrowing countries. The search for a universal solution to the international debt problem that will be demonstrably preferable to the flexible case-by-case approach currently being followed appears to be elusive. At the same time, we need to continue to be ready to adapt the current approach in light of changing circumstances and new opportunities. An open mind should be kept for all options that may prove applicable to specific situations.