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Statement by

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of the

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I appreciate the opportunity to review with you the debt situation of developing countries. Over the past four years, I think we can point to some substantial progress. But despite that progress, serious problems remain. The sharp decline in oil prices has brought some of them to an acute stage once again.

We have much of the essential framework in place to support growth with necessary economic adjustments among the borrowing countries. But the hard fact is that much remains to be done, in the industrialized world and in the heavily indebted countries of Latin America or elsewhere, to implement the measures necessary to that goal. That is the continuing challenge, and, I for one, believe that it will be attainable in practice with continued, and in some cases, intensified cooperation.

The fundamental causes of the international debt problem that burst forth on the front pages of newspapers four years ago are complex. They included economic policies in the borrowing countries that were premised in part upon the assumption that funds would continue to be available indefinitely from abroad at low or negative real interest rates; in some countries, the foreign borrowing increasingly financed capital outflows. In essence, the domestic policies of the borrowers did not command the confidence of their own citizens, who placed much of their domestic savings in other countries. The commercial banks and other lenders that so freely provided the funds from abroad could not or would not assure the productive use of that money. As the crisis broke, access to new loans was abruptly curtailed. At the same time, profound changes in the world economic and financial situation provided a more difficult environment for the borrowers as real interest rates rose, inflation subsided, and commodity prices declined.

There is no point at this stage in pointing fingers at one culprit or another -- although there are many lessons for the future. More important, once the crisis was upon us, it was evident that the problem threatened not only the economic fortunes of the particular borrowing countries, but also the performance of the world economy and of the world financial system as a whole. Leading banks both in the United States and abroad were heavily exposed at a time when many of them also faced the pressure of recession and financial strains at home. Exports to the borrowing countries dropped abruptly, and possibilities of political strain were aggravated.

A high degree of international cooperation involving borrowing countries, commercial banks and creditor countries has been necessary to deal with the situation, taking account, on a case-by-case basis, of differences among the borrowers. During the initial crisis stage, it was natural that the International Monetary Fund played a central, coordinating role; it could advise the borrowing countries and, in effect, certify both their economic programs and the size of their external financing needs. It could also work with both lending banks and creditor countries. That role was performed with skill, if not without controversy.

With its traditional emphasis on long-term investment planning and on project lending, the World Bank was not in a position to react as quickly as the Fund to the immediate adjustment needs of the major borrowing countries. Nor were borrowing countries -- faced with priority short-term needs to cut back on internal budget deficits, to bring monetary expansion under control, and to achieve and maintain more competitive exchange rates -- able to give the same attention to introducing necessary structural changes in their economies to enhance efficiency and competition. Indeed, sharp cutbacks in overall investment as well as consumption expenditures by the indebted countries became unavoidable.

As time passed, the Fund and the Bank have found more and more opportunities for mutually supportive approaches, and both of them have flexibly adapted earlier approaches as justified by the needs and circumstances of particular countries.

By the end of 1985, for instance, Colombia, Ecuador, Chile and Uruguay had put in place rather comprehensive programs looking toward more open and efficient economies as well as more immediate fiscal and external adjustments, working constructively, in different ways, with both the Bank and Fund.

Drawing on this kind of experience, Secretary Baker, as you know, outlined the concept of a Program for Sustained Growth in Seoul last October. He envisaged an increase in such cooperative efforts, including an enhanced role for the World Bank and the other multilateral development lending institutions. His basic premise -- that a solution must be found in a context of growth -- is of course widely shared. And I believe there is increased agreement with the proposition that success will be dependent on on-going structural changes as well as adjustments in fiscal, monetary, and exchange rate policies.

A great deal remains to be done before the international debt problem is resolved. But the very considerable accomplishments already achieved strongly suggest the problem should be manageable in ways that serve the interests of both borrowers and lenders.

Over the past three or four years, some substantial -- even dramatic -- adjustments have been made on the external side. That is most clearly evident in the fact that the fifteen major borrowing countries that have been somewhat arbitrarily identified with the Baker Initiative together achieved a current account position of essentially zero during both 1984 and 1985. In contrast, their collective deficits were about $50 billion in 1981 and 1982. The shift was not simply a consequence of import compression: the volume of their exports rose by about 15 percent during 1983-84 before levelling off last year.

While progress is uneven, the burdens of servicing the external debt of the major borrowers has also been reduced. Reschedulings of their debt to banks and official creditors have sharply limited amortization requirements. Lower world interest rates have been reflected in declines in interest payment obligations. In some cases, interest payments as a percentage of exports of goods and services this year will be as much as one-third below their peaks.

The pace of bank lending has slowed substantially as the borrowing countries have acted to bring their external debts into better alignment with their productive capacities. Meanwhile, bank capital positions have been strengthened. As a result, U.S. banks' exposure to non-OPEC developing countries in relation to their capital dropped by about one-third between mid-1982 and the end of last year; those ratios have declined even further over the first half of 1986. No doubt there have been comparable declines in relative exposure by foreign banks.

Indeed, one can question whether, in the past year or so, net bank lending has not been below levels that will be necessary to complement effective economic programs of some borrowers, particularly in the light of the sharp decline in oil prices. In any event, the relative reduction in overall exposure should continue even as the banks are called upon, consistent with the Baker Initiative, to provide the moderate amounts of net new private lending over the next several years needed to support borrowers' plans for structural adjustment and growth. And, as those relative exposures decline, one of the preconditions for returning to more normal, fully voluntary, debtor-creditor relationships can be achieved. In relatively benign circumstances for the world economy, steps in that direction by one or more countries well advanced in the adjustment process could possibly appear this year or next.

Economic growth has rebounded smartly in a few countries even as they have reduced or eliminated their external deficits. The biggest economy and largest borrower among the middle-income developing countries -- Brazil -- is a leading case in point. The economies of Argentina, Chile and Colombia are expanding as well.

But the pattern has been uneven and disappointing in some cases. Looked at as a group, the value of exports by the major borrowers, upon which so much depends, declined during 1985. That was in large part a reflection of lower commodity prices and the slower expansion of the industrial countries that must provide their principal markets.

Since last fall, the sharp decline in world oil prices has added a new and disconcerting dimension to the problems of Mexico, Nigeria, Venezuela and Ecuador. Each of those countries has lost both real income and budgetary revenues in amounts that are critically large in relation to their resources. Adjustment to that loss of resources is inevitable. What is at issue is the speed and effectiveness of that adjustment.

One clear implication is that most of them will need to cover larger external needs than anticipted earlier, although not nearly as much as the decline in oil prices taken alone might imply. Lower world interest rates and their own efforts, will balance part of the losses, and potentially more rapid growth in the industrial countries will increase export opportunities.

After four years, a sense of fatigue among borrowing countries coping with continuing economic and debt problems is hardly surprising. For some, the reduction in oil prices has added a sharper edge of concern, if not despair. At the same time, commercial banks are naturally impatient and seemingly more reluctant to step forward with new money pending concrete evidence countries are successfully undertaking extraordinary stabilization efforts. Negotiation and implementation of new financing packages or restructurings linger on, sometimes entangled in particular grievances over particular past loans. In the process, there is some danger of losing sight of the larger issues surrounding the fundamentals of economic policies on which the soundness of the loans ultimately depends.

But far too much is at stake -- and far too much has been accomplished -- to make it sensible to give way to any sense of frustration. The mutuality of interest of borrowers and lenders in constructive approaches is as strong as ever.

It is difficult -- I think impossible -- to deny the simple proposition that the debt problem, as so many others, must be resolved in a framework of growth. The corollary is that sustainable growth requires both financial discipline and structural changes. And none of that is likely to proceed for long unless developing countries are able to defend and maintain their credit-worthiness and access to the markets of world finance as well as goods.

The question is whether we can find the will and the means to act upon those propositions with the necessary sense of conviction and urgency. That is why we stand at a kind of watershed. Business as usual clearly will not be good enough. And the whole structure of economic and financial relationships between the United States and other industrialized countries and Latin America will be affected, for better or worse.

Crisis serves a constructive purpose when it galvanizes constructive responses. I believe the so-called Baker Initiative can and does provide a kind of rallying point for that effort, not because it is a precise plan "made in the USA" but because it captures the essence of much of the thinking emerging in many parts of the world -- developed and developing -- over recent years.

The approach recognizes that success can only lie in a mutual, cooperative effort to achieve growth. The borrowing countries must indeed "adjust" -- adjust not just in the sense of effective fiscal, monetary, and exchange rate policies, but "adjust" in the sense of encouraging more competitive, investment-oriented, and open economies. Their industry must be capable of attracting domestic and foreign savings, penetrating export markets and meeting the needs of growing populations at home. All of that depends on productivity growth.

The returns available in growing, productive economies can in turn justify raising abroad some margin of the credit and capital needed to support growth. Reasonable needs can be met through a combination of official and private resources, drawing on the World Bank and other development institutions and the commercial banks around the world with so much at stake. Moreover, in reasonably favorable world economic circumstances, those additional credits can be consistent with falling debt service ratios and declines in bank exposure relative to capital, just as in the past four years.

None of that provides a fixed formula or standard cookbook for dealing with the specific problems of individual borrowing countries, each with its unique history and economic situation. But it does provide a broad framework within which individual cases can be discussed, detailed approaches developed, financing negotiated, and plans implemented.

The approach won't work unless it is convincing to the leaders of the borrowing countries themselves, consistent with the way they come to assess their own priorities, and capable of commanding the support of their people. Those countries must be willing to work toward more efficient, competitive and open economies. They can improve the climate for investment, whether by their own citizens or from abroad. Pricing policies of state enterprises can be made more economic, and those enterprises can be sold, reduced in scope, or shut down when the job can be better done in the private sector. Barriers to trade, including imports, can be reduced and rationalized, in part to support the competitiveness of exports. And inefficiencies in financial systems can be attacked.

The needed measures sometimes go against the grain of much of post-war history in certain countries, and against the grain of established political systems. Suspicions abound -- fear of invasion of domestic markets by international companies, concern about foreign or private domination of key national industries, a breaking down of bureaucratic control. Long cherished concepts about the proper role of the state are challenged.

But the basic ideas and motivations are, of course, quite different -- to promote the efficiency, the capital formation, and the use of technology upon which competitiveness and growth rest. What is encouraging is how widely these ideas are recognized among leaders in Latin America and elsewhere. Inevitably, the pace of change is conditioned by their own experience and realities. Vested interests are tempted to respond with nationalistic rhetoric. But one simple truth has been increasingly widely recognized: in today's world, no single country is likely to prosper and grow without being an effective part of the larger world community, with good credit standing, access to world capital markets, the capacity and incentive to export, and financial stability.

Success will remain dependent on a cooperative approach, with necessary external financing available to support growth and adjustment. The Bank and the Fund will remain focal points in that process.

For its part, the World Bank has moved quickly since last fall to play an increased role. A number of important negotiations are in various stages with Mexico, Argentina, Ecuador, Colombia, the Ivory Coast and others -- more than I might have thought likely six months ago. The Bank's ability to respond effectively reflects both already established criteria for supporting the structural adjustment process and its considerable experience in such areas as trade, energy, financial institutions, and rural development. The negotiations for structural reform in these and other areas have also had the benefit of consultation with the Fund, helping ensure that Bank-supported sectoral programs are consistent with the country's overall macro-economic requirements and priorities. Moreover, some of the World Bank programs and loans should provide opportunities for parallel or co-financing by others, including commercial banks.

Amidst all the difficulties, there is some danger of losing sight of how much the approach of individual countries, their stated policies, and public attitudes, has changed. Mexico is only one example of a country undertaking some important reforms of trade policies -- a process reflected in its long-debated decision to join GATT. We have seen sales or closings of some state enterprises. Rationalization of price and regulatory systems in the agricultural and financial sectors is proceeding.

More immediately, most of the major borrowers have encouraged the development of more realistic exchange rates, providing a competitive base for future export-led growth. Notably, Argentina, Bolivia and Brazil have embarked since mid-1985 upon bold domestic programs to disinflate and de-index their economies.

Commercial banks have made clear their broad support for the broad concepts of the Baker Initiative. But their willingness and ability to mobilize additional financing quickly once a borrower has developed a policy program and received general international endorsement has not been tested. Within the general framework of market criteria and covering costs, there may also be room for exploring innovative techniques in new borrowing arrangements to take more account of the uncertainties of oil prices or interest rates.

All of these considerations and propositions are, and will be, tested in the case of Mexico. Its problems are unique and severe; the decline in oil prices and production has reduced its national income significantly, reduced government revenues by as much as 4 percent of its GNP, and cut exports by about a third of last year's total. Obviously, strong and effective internal measures to deal with those losses are required, but in the best of circumstances the necessary adjustments will take time.

Some delay in response was perhaps inevitable, given the abruptness and nature of the changed circumstances. But I remain hopeful that efforts both in Mexico and elsewhere to develop a coherent, effective response, with adequate external financing, will soon bear fruit.

A lot is at stake, not just because Mexico is a large country immediately on our border, with very large debts. Success in providing a base for new hope among the Mexican people, in laying the groundwork for renewed growth next year, and in maintaining credit-worthiness and access to world financial markets will encourage other countries in their efforts. If, in contrast, we collectively falter in that effort, the progress of others will be undermined.

In Mexico, as elsewhere, success in making effective use of its own savings and capital will be crucial. The massive capital flight from a number of Latin American countries during the late 1970s and early 1980s greatly added to their needs for external borrowing.

While the data have to be interpreted with great caution, the evidence suggests that capital flight has receded somewhat in more recent years. Indeed, in several countries, indirect evidence suggests rather dramatic improvement. Even in Mexico, where credit policies have been very restrictive, there are signs of some reversal this year.

I don't refer to this evidence with any sense of complacency. Extremely tight money is not a long-term answer, and we are a considerable way from a point where we can say, with confidence, that a constructive, self-sustaining process of growth and development is underway among most or all of the borrowers, that their access to external credit is restored, or that fully effective use is being made of domestic savings.

Behind all those particulars about where we stand with respect to the international debt problem, a still larger question remains: Will the global environment be conducive to favorable conditions, to strong markets and to sustained growth for the developing world?

One critical variable has been going right: The level of world interest rates has receded markedly, taking at least part of the sting out of the collapse in oil prices. The LIBOR rate to which most loan agreements are keyed is more than 5-1/2 percent below its mid-1984 level, and 1-1/4 percent below the level as recently as December. Most loans are denominated in dollars, so the decline in the dollar exchange rate is also helpful to most borrowers.

The major countries meeting in Tokyo last month stated the importance they attach to a capital increase for the World Bank when appropriate. To facilitate private capital movements toward the major borrowing countries, the new Multilateral Investment Guarantee Agency, or MIGA, should in time facilitate increased flows of direct investment. It is regrettable that Congressional support for that concept has lagged.

More particular actions can also help. For example, export credit agencies of the OECD countries, especially the

U.S. Export-Import Bank, have been an important source of support for the financing of trade flows to the developing countries during this period of financial uncertainty. The interruption to debt service by the borrowers has, in some cases, caused official agencies to go "off cover" and cease new lending to the country in question. While in some cases such action may be justified, it will also have perverse incentive effects in the context of efforts to achieve constructive debt restructuring. I hope there is now more general recognition of that fact.

Another obligation we in the United States, as well as other countries, must accept is to restrain the forces of protectionism that hamper exports from developing countries to our markets. With developing countries eager to import what their resources can support, rising exports to the industrialized countries also mean more buying <u>from</u> us.

Building the competitive ability of borrowers to export, while reducing unfair subsidies, is not a matter of stealing jobs from our workers. It is a matter of participating in, and sharing in the fruits of, growing two-way trade.

But none of those areas is so fundamentally important to developing countries over the next several years as the prospects for sustained growth of world markets. And that unavoidably raises a question of adjustment not just by the borrowers but by the industrialized world.

The United States is in an expansion period that has already been sustained longer than most during the post-war era. The evidence is clear that during most of this period it is our economy that has been the principal motor for world expansion. But in that process, serious international imbalances have developed. And, partly as a consequence, our own growth has slowed

In effect, over the past four years, the United States, directly and indirectly, has provided a disproportionate share of the incremental demand to the world economy. We have made room for most of the external adjustments of the debtor countries as well. In fact, Japan and Western Europe essentially have had no increase in imports from Latin America since 1982, while the United States has shared disproportionately in reduced exports of manufactured goods to that area.

The resultant strains are showing. I for one do not believe that relying upon exchange rate changes alone promises a simple and easy solution to the imbalances, however important it is that we have now achieved a more competitive exchange rate structure. Among other things, we had better not forget that we are today the world's largest debtor, dependent on a continuing large inflow of capital to finance our own budget deficit, and that capital will not flow freely without continuing confidence in our own stability.

The implication is not, of course, that we should stop growing, but that other strong countries, with little or no inflation, with excess capacity and historically high unemployment, and with very strong external positions, should assume more of the leadership in providing the impetus for world growth. Such adjustments do not come easily -- our long struggle with our budget deficit is the most obvious case in point. But that is the kind of mutually complementary action that is required. And difficult as they may be, we might keep in mind the adjustments involved for us in the industrialized world do not approach in relative magnitude those we expect by the debtor countries.

We can ill afford to be cynical or defeatist about all these efforts, difficult as they may be. Too much hinges on our success, and I know of no other approach that promises so much in terms not just of economic success but harmonious political relationships with Latin America and the developing world.

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