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THE WORLD DEBT CRISIS AFTER FIVE YEARS
- WHERE DO WE STAND?
- WHERE DO WE GO?

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Ever since Mexico declared its inability to service its external debt five years ago, the world debt crisis has been with us. Some observers have argued for the entire five years that the debt bomb is about to explode and to destroy the world financial system with it.

But while the problem is still with us, I would like to suggest to you that we have made significant progress over the last five years in defusing the potential threat. We have developed a broad set of principles to guide the overall approach to the problem, and in those instances where these principles have been effectively implemented, considerable progress has been made in overcoming the crisis.

From Emergency Assistance to Containment and Diffusion

Three distinct stages in coping with the debt crisis can be distinguished: there was first of all the immediate <u>emergency assistance</u> program. As part of this effort, official funds were made available through international institutions, such as the Bank for International Settlements and the

International Monetary Fund. Countries adopted foreign exchange and import controls as an emergency measure to reduce the financial hemorrhages.

The second stage emphasized containment of the problem. Comprehensive financial adjustment programs were implemented in many countries that tried to come to grips with the immediate causes of the financial problems, such as large governmental deficits, inappropriate interest rates, and misaligned exchange rates. In many cases, the International Monetary Fund helped in the implementation and design of appropriate policy measures.

As part of this containment effort, commercial banks restructured their claims and made collective commitments for further lending, thereby preventing the problem from getting worse. The banks also increased their own capital, thereby strengthening their balance sheets and enhancing their capacity to deal with the problem. Major banks have now established substantial loan-loss reserves against their exposure to heavily indebted countries, thereby erecting a strong containment barrier to any potential future calamity.

As a result of all these containment actions, the risk of a systemic failure that might endanger the global financial network is now substantially reduced.

I would argue that we have now entered a third phase in the process of coping with the debt problem. We have begun to diffuse the problem, so that it can be managed successfully. It is about that diffusion process that I want to talk with you today.

No Global Solutions

Over the past five years it has become clear that there is no single global solution to overcoming the debt crisis. If there were such a comprehensive solution that is preferable to the case-by-case approach, someone would probably have found it by now.

While many global solutions were proffered, they did not survive careful scrutiny as to their total costs and the distribution of these costs among the various participants.

Many proposed solutions rest on a need to appropriate public funds to make them work. This has proved to be unrealistic in times of budgetary stringency in most creditor countries and due to political resistance to using taxpayer funds for international activities.

Other generalized proposals would impose large losses upon the lending institutions. Some of these proposals would force American banks to forgive a certain portion of the outstanding debt. As a result, foreign banks might find that the likelihood of repayment on their still outstanding loans would be increased. We would encounter the classical "free rider" problem.

But the central flaw of these schemes is that they have not adequately considered the potential for damage to the ultimate objective of reestablishing access to world financial markets on behalf of the debtor nations. It stands to reason that if lenders were to suffer significant losses, they would think twice before committing new funds to the debtor countries. Yet, the restoration of private financial flows to these nations is the very objective of the exercise.

Furthermore, the global solutions discussed do not offer sufficient flexibility in dealing with the unique circumstances pertaining to individual countries. As a result, such schemes may well impose unnecessary costs upon the countries as well.

Restoring Economic Growth

The keystone of the Baker initiative promulgated two years ago is the enhancement of economic growth. Economic growth will directly benefit the residents of the debtor countries by enlarging the economic pie that is available to them.

In addition, growth will also shrink the debt service burden of these countries relative to their economic capacity. While we often focus on the absolute size of the debt, the truly relevant magnitude is the size of the debt service burden relative to the earnings of the economy. Clearly, it will be much easier to service the existing debt within a context of economic growth because the relative debt service burden shrinks.

This realization became increasingly apparent after the initial austerity programs had resulted in a 10 percent reduction in per capita income levels in the heavily indebted countries. It became clear that countries could not shrink themselves back to financial health. While additional interest payments obligations continued to mount, the economic base to service the debts was eroding.

Since the Baker initiative, growth has returned to the debtor countries and at the present time we see growth rates of 5 to 6 percent in some of the most heavily indebted nations. This is the best growth performance since the onset of the debt service difficulties.

Key to the improvement in growth has been the economic restructuring and increased export orientation of many developing countries.

The case-by-case approach was also very instructive as it permitted a certain degree of experimentation and learning by doing. Even in the difficult external economic and financial environment of the early eighties, some countries performed spectacularly well. I need not remind you of the showcases of Taiwan and Korea. But also relatively poor and large countries that adopted an increasingly flexible approach, such as India and China, did rather well. Their performance serves as an example that can be emulated by others and thereby helps to shape the evolving strategy.

I am particularly impressed by the speed with which the situation in a country can change. One recent case in point is Mexico. Only a year ago there was much public concern about Mexico's economic and financial prospects. Now there is renewed confidence by both foreign and domestic investors in the country.

How was this turnaround achieved? It was due in large part to a more realistic exchange rate, a tighter monetary policy, a reduction in the fiscal deficit, tariff decreases, a restructuring of the economy that emphasized private sector investments, as well as a fortuitous increase in the price of oil. Now, non-petroleum exports are expanding rapidly and capital flight is being reversed. Mexico's international reserves are now at a record level and residents of the border states are again allowed to hold dollar accounts. This shows the renewed confidence by Mexicans in the future of their own country.

Investors willing to take risks have already profited handsomely from Mexico's recovery. The Mexican stock market has boomed and the value of shares of the Mexico Fund, which is traded on the New York Stock Exchange, have appreciated from about $3 to well over $12 during the course of the last year. By this reckoning investments in Mexico have been one of the most profitable investment opportunities in recent years.

If Mexico's successful policies are sustained, the country which first encountered debt service problems may well be among the first nations to regain access to private financial markets as well.

Restoring Financial Stability

There is a need for innovative policies not only on behalf of the debtor nations, but also on behalf of private and official creditors. Here, too, much progress has been made, but there are still plenty of challenges ahead of us. Also here the key is to reduce the size of the problem through a diffusion strategy.

During the last two years, commercial banks have rescheduled approximately $110 billion in outstanding debt and committed about $10 billion in new loans. These are substantial magnitudes in anybody's book.

Banks showed great understanding and solidarity during the years that they participated in what constituted essentially involuntary lending. They did so because they recognized that this was the most effective way to assure the continued viability of the outstanding loans and in an effort to help restore the creditworthiness of the debtor countries through a cooperative effort.

But as time passed, it became increasingly clear that the interests of all of the banks did not necessarily coincide. Hence, the inflexible across-the-board rescheduling approach was abandoned in favor of the menu approach, which allowed individual banks to select various options best suited for their own needs.

Recent rescheduling agreements with several countries have offered various options that will allow banks to further diffuse their exposure and to diversify the risk that the banks face in the debtor countries. Central to some of these options is that they offer either an upside potential to the bank participating in the new loan or in that they limit the future downside potential.

For instance, debt to equity swaps help the country to reduce the debt and debt service burden, while offering the bank the opportunity to participate in a potential increase in the value of the new equity investment.

Additional opportunities for diffusion are being created through the establishment of mutual funds that will permit smaller banks to participate in debt to equity conversion opportunities while relieving them of the burden of day-to-day management of their equity investments.

The Federal Reserve has recently liberalized its regulations pertaining to direct investments in commercial enterprises, thereby facilitating debt to equity swaps. From now on, bank holding companies may under certain conditions acquire 100 percent of the equity in enterprises that are being privatized by heavily indebted developing countries. This constitutes a sharp improvement from the old 20 percent investment limit in such enterprises.

I am proud of the role I was able to play in placing this important issue on the Board's agenda. Further liberalizations in the rules and regulations may well be forthcoming if they should prove to be helpful and not endanger the safety and soundness of the banks.

Exit bonds now offered by some countries make it possible for small banks to reduce or eliminate their exposure and to avoid future new money obligations. This is another example of an innovative diffusion strategy.

Some countries have experimented with interest capitalization schemes or offered the opportunity to convert debt into local currency for use by charitable organizations. In one recent instance, a charitable organization bought a large section of Bolivian jungle as a nature preserve at a highly advantageous price.

These are all examples of the various ways in which an excessively heavy debt service burden is being cut into more manageable pieces and the danger of collapse for both lenders and borrowers is considerably reduced. It is true that not one of these schemes offers an all-encompassing solution to relieving the debt burden, but in the aggregate they certainly make it more bearable by distributing it more broadly.

Developing Sources of Future Finance

The economic future of the developing countries rests in no small measure upon their success in developing new sources of finance. Without this, growth will be stunted, and the growing populations will have less and less capital resources to complement their work effort. Developing new sources of future finance is therefore essential to assure future growth.

Let me outline five features of a realistic program to restore access to financial resources.

Of primary importance is the establishment of confidence in a stable and secure economic and financial environment. This is absolutely essential if savers and investors are to commit their financial resources to the developing countries. As long as there is uncertainty regarding the future financial stability and the security of property rights, no domestic or foreign investor will be willing to commit new financial resources.

Second, it follows that any official action that underlines the commitments made and that restores confidence should be helpful. The announcement of formal financial stabilization programs that carry the endorsement of the International Monetary Fund should be most helpful in that regard. I continue to be amazed by the argument that it is not in the national interest to come to a formal commitment to restore financial stability in cooperation with international organizations, such as the IMF. It is difficult to comprehend that the <u>absence</u> of the financial undertakings that are needed to restore stability should be seen as a sign of national independence and bring about a vote of confidence by domestic savers and investors in the future of the country.

Third, because the heavily indebted countries are already carrying an excessive external debt burden, it is essential that all potential domestic sources of finance are utilized to the fullest extent possible. Realistic interest rates that yield a positive rate of return after adjustment for inflation will help to encourage domestic saving. Residents of high inflation countries have become extremely sophisticated in financial matters and will respond quickly to the reestablishment of appropriate incentives. It has been my observation that many people in the developing countries search diligently for an opportunity to invest their savings in a secure financial instrument. Let us give them that opportunity!

Fourth, capital flight from the developing countries must be reversed. If the citizens of a country do not have enough confidence to invest their funds at home, there will not be any amount of foreign capital that will be large enough to replenish the funds that are flowing out of the country. On the contrary, it would be foolish for foreign investors to presume that they have superior knowledge about local economic conditions. Countries that have undertaken appropriate adjustment, liberalization, and stabilization programs have already experienced a substantial return of funds held by their own residents abroad. It stands to reason that the further restoration of confidence and economic stability will bring about a quick return of flight capital.

Fifth, financial liberalization,including the granting of banking licenses to foreign institutions on a non-discriminatory basis, will enhance the strategic interests of foreign financial institutions in the prosperity of the developing countries. By permitting foreign financial institutions to increase their stake in the local economy, new financial resources can be attracted. Furthermore, increased competition in previously segmented and narrow financial markets will benefit domestic savers and borrowers in the form of more attractive rates and improved service.

Reestablishing creditworthiness in private financial markets is not a singular event that can be celebrated by an announcement. Instead, access to credit markets is gained in progressive stages. We as individuals graduated from a government secured student loan to gas station cards to national credit cards. A succession of car loans and maybe a mortgage followed before we were offered an unsecured line of credit or a start-up business loan from our bank.

Similarly, the first step for international borrowers consists often of government-guaranteed trade credit. As borrowers establish their track records, they progress from private trade credit through interbank credits, project finance, club deals involving small groups of banks, and syndicated credits to full access to international bond and security market financing.

The sacrifices and policy reforms undertaken by many indebted countries have moved them upward along this continuum. It would be regrettable indeed if this progress were to be negated by unilateral confrontational policies.

The Low-Income Countries

While the newly industrializing countries have the economic and natural resources to regain their financial footings, there are certain low income countries whose capacity to service external debt is severely limited. Many of these countries have per capita incomes of $200 or $300 per year. Many of them are located in Africa, but there are also a few in Asia. High birth rates continue to exacerbate the economic pressures in these countries.

Given the limited resources of these countries it is all the more important for them to use the available scarce resources to the best possible advantage and to enhance the productivity of the population.

Private bank exposures in these countries is minimal, and much of the official debt has been restructured or converted into grants. The World Bank supports these countries through IDA grants, and the IMF has established a special Structural Adjustment Facility to assist with the needed policy reforms. Additional funding for the SAF is now needed and it seems appropriate that the countries that are in strong external surplus positions take the lead in providing the necessary funding because they have the financial capacity to do so.

We should all recognize that these low income countries represent rather special cases that call for the compassion of the world community and justify concessional assistance. But as I said before, this makes it all the more imperative that the scarce resources available are not squandered but used effectively.

Improving the Environment for the Debtor Countries

While there will be no resolution of the international debt problem without appropriate policies by the developing countries, it goes without saying that they will need open and accessible markets for their products in the industrialized world. It is here that the surplus countries of Europe and Japan can and must do more by lending a helping hand. Unless there are open export markets for the products of the debtor nations, they simply will not have the earnings to service their debt.

Furthermore, the multilateral financial organizations, like the IMF and the World Bank, must have the financial resources to support the often costly adjustment efforts. The Administration has called for the establishment of a new External Contingency Facility in the IMF which would help to cushion the impact of adverse external events. Furthermore, Secretary Baker has indicated that he believes that the time is now right for a substantial capital increase for the World Bank. Both of these proposals should be implemented quickly.

Together, these measures should move us further along the difficult path of restoring the creditworthiness of the developing countries and the sacrifices of the last five years will not have been for naught.