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The Baker Plan: A New Initiative

On October 8, at the joint annual meeting of the International Monetary Fund (IMF) and the World Bank in Seoul, Korea, Secretary of the Treasury James Baker unveiled a U.S. plan entitled "Program for Sustained Growth" for dealing with the thorny debt problem of less developed countries (LDCs). Current strategy centers on debtor nations' balance-of-payments adjustments under IMF surveillance. The U.S. plan — now commonly called the "Baker Plan" — adds macroeconomic and market-oriented structural adjustment policies to be implemented with assistance from multilateral lending agencies and commercial banks. It calls for new funding of $29 billion over the next three years. Baker stressed that the plan was not meant to replace the international strategy currently in place, but to expand on the short-run successes of the last three years in keeping the world debt problem under control.

This *Letter* analyzes the problems in the current LDC situation that have given rise to the plan. It also discusses the plan's prospects for acceptance by debtor nations, the adequacy of the new loans, and the likelihood of securing the additional funds without government guarantees or a relaxation of international lending regulations. The conclusion is cautiously optimistic in all three respects.

Features of the plan

In Baker's words, the plan consists of three "essential and mutually reinforcing" elements:

1. The adoption by principal debtor nations of comprehensive macroeconomic and market-oriented structural adjustment policies to promote growth, reduce inflation, increase domestic savings and investment, induce repatriation of domestic flight capital, and attract foreign capital inflow.

2. A 50 percent increase ($9 billion) over the next three years in World Bank and Inter-American Development Bank lendings to 15 key debtor countries in support of the countries' structural adjustment programs.

3. Increased new lending ($20 billion over the next three years) by the international banking community to those key debtor countries that commit themselves to policies consistent with the plan.

The structural adjustment policies include a) market-oriented exchange rate, interest rate, wage and price policies to promote greater economic efficiency and responsiveness to growth and employment opportunities; b) sound monetary and fiscal policies for reducing domestic imbalances and inflation; c) greater reliance on the private sector to help increase employment, production and efficiency; d) supply-side actions to mobilize domestic savings and facilitate efficient investment by tax reform, labor market reform, and financial reform; and e) market-opening measures to encourage direct foreign investment and capital inflows, as well as to liberalize trade (e.g., by reducing export subsidies).

To help debtor nations carry out these fundamental policy reforms, the IMF is expected to continue to play a pivotal role in the balance-of-payments adjustment and medium-term financing area. The Baker Plan adds the World Bank to the center stage to promote long-run market- and growth-oriented structural reforms. Overall, the plan aims to help debtor nations *grow* out of their debt problems through economic reforms that would lay the groundwork for vigorous output expansion. Such expansion would presumably enable the countries to service better their external debts and, at the same time, improve their standards of living.

Wherefore the plan?

In the last three years, the strategy to solve the world debt problem has aimed to forestall debt crises. First, the debtor nations have been helped to adopt adjustment programs for slowing import growth and expanding exports, and thereby to reduce their payment imbalances. Second, commercial banks have rolled over loans to debtor nations and extended new loans to help them meet interest payments and other pressing needs. Third, the IMF has played a pivotal role in this strategy by providing balance-of-payment assistance to debtor nations conditional on their adop-

tion of adjustment programs. In addition, IMF credits have also served as a pre-condition for banks and official creditors to agree to reschedule maturing claims and to extend new loans.

The strategy is essentially short-run in nature. It has bought time pending a vigorous world economic recovery and substantial declines in real interest rates, which are expected to help improve debtor nations' payment prospects and restore voluntary private international lending.

Thus far, the strategy has achieved considerable success in containing numerous potentially disastrous situations. A large element of the success can be attributed to the very substantial adjustments that have been made by debtor nations to reduce their payments deficits. During the three years 1983-85, the combined cumulative current account deficit of ten major debtor nations fell to an estimated $10 billion from $110 billion during the preceding three years, 1980-82.

But despite improvements, the debtor nations have continued to incur substantial current account deficits because of the huge interest payments they have had to make. Data on interest payments by the ten major debtor nations are not available. For the non-OPEC LDCs as a whole, total gross interest payments this year are estimated to be about $72 billion, of which only $43 billion will be paid by these nations' combined trade-and-service surplus ($31 billion) and bilateral official grants ($12 billion); the rest ($29 billion), i.e., their combined current account deficit, must be financed through increased foreign indebtedness.

Thus, total LDC debt has continued to mount. For the ten major debtor nations, the combined debt-to-export ratio actually increased from 257 percent in 1982 to an estimated 308 percent in 1985. This means that the actual debt burden has increased, not decreased, over the last three years.

Debtor nations' conditions did improve considerably in 1983-84 when their exports grew vigorously, especially their exports to the United States. Since mid-1984, however, the export boom has waned as U.S. output growth slowed and growth in other industrial countries failed to pick up the slack. Although nominal interest rates have declined sharply since mid-1984, world commodity-export prices have also fallen such that real interest rates for the LDC-debtor nations have hardly declined. Moreover, increasing protectionism in major industrial countries poses a serious threat to the debtor nations' ability to service their external debts through export expansion.

To further aggravate the situation, net capital flows to the debtor nations appear to have declined sharply. According to available statistics, net lending by commercial banks to all developing countries declined from $21 billion in 1983 to $8 billion in 1984 and a *negative* $2 billion in the first quarter of 1985.

The large trade balance improvements in the last three years have been achieved at great sacrifice to the debtor nations' populations. For the ten major debtor nations, per capita real output declined by 10 percent from its average in 1980-81 to 1985. The decline amounted to 17 percent for Argentina, 6 percent for Brazil, 9 percent for Mexico, and 14 percent for Peru. With these figures, which reflect steep declines in personal income and standard of living, one can understand better the popular grumbling and political unrest in these hard-strapped nations.

The debtor nations' lot can be improved only by vigorous and stable economic growth which now appears out of reach because of continued high inflation, low investment incentives, large capital flight, and structural rigidity in the countries.

Is the plan feasible?

As Secretary Baker stated, all three elements of the U.S. plan are essential to its success; failure in any one would jeopardize the entire plan.

The foremost question then is, to what extent would debtor nations be willing and able to carry out the proposed structural reforms. Judging from the protests over the hardships they have had to undergo in making balance-of-payment adjustments, it might seem unlikely that many of them would want to undertake fundamental structural adjustments that are seemingly at odds with their economic and social philosophies.

However, the severity of potential resistance should not be exaggerated. It would be wrong to attribute — or give credit — to the United States alone for a market-oriented approach to economic growth. Modern history is replete with success sto-

ries for this approach — witness the Newly Industrialized Countries: Korea, Taiwan, Hong Kong, and Singapore. Even socialist countries such as China, Hungary, and Yugoslavia have increased their use of a market approach. Brazil and Mexico have already started on this path.

The second question has to do with the adequacy of the Baker Plan. Skeptics have called the total of $29 billion additional funds over the next three years "too little and too late." They cite the huge annual interest payments ($71 billion) for non-OPEC LDCs in 1985 and dismiss the less than $10 billion a year of new money as "pale in comparison."

This comparison, however, is inappropriate because it fails to take into account the progress debtor nations have already made in generating large trade surpluses, the availability of other existing public and private channels of financing, and the fact that the new funds are aimed at helping not all the debtor nations but only the "major" ones. As stated, an estimated combined cumulative current account deficit of the 10 largest debtor nations in 1983-85 is about $10 billion. It appears, therefore, that the projected amount of new funds, if attainable, should be adequate.

Finally, to determine the availability of the funds, it is useful to separate the public sources of funds from the private. The plan calls for the World Bank and the Inter-American Development Bank to increase their total lending by $9 billion over the next three years. During the fiscal year that ended June 30, 1985, the World Bank approved $11 billion in new loans and disbursed $9 billion. According to a U.S. Treasury estimate, the Bank has an annual lending capacity of about $14 billion. Apparently, the existing World Bank resources have been underutilized, and a substantial expansion of its lending should be feasible.

A more questionable source, however, is the commercial banks. Under the plan, they are expected to provide $20 billion in new loans over the next three years. Bankers' reactions have varied. According to press reports, large international banks have been cautiously supportive, but regional and small banks have been cool. Banks were said to have asked for guarantees against increased risk exposures and relaxation of loan-loss reserve requirements as conditions for additional new lendings. It is understandable that bankers would try to set conditions for new loans to LDC debtor nations. However, government guarantees and other measures for reducing bank lending risks would render the "moral hazard" problem in international lending unmanageable; they would severely weaken restraints on imprudent lending. The dilemma lies in expecting private enterprises to help resolve the "public good" problem; it is a classic "externality" problem.

Nevertheless, the experience of the last three years has been reassuring. Thus far, in spite of the fall in net lending, the banking community by and large has been sensitive to its collective responsibility to help maintain the stability of the world banking system. It has rolled over maturing loans and extended new loans as part of an international strategy.

Despite its cool initial response to the proposed plan, there is ground to believe that the banking community can be won over. Continued dialogue with bankers will be needed to convince them that a collective increase in new lendings to LDC debtor nations would better serve their long-run interests.

The persistent LDC-debt problem has been a drag on world economic growth and a threat to the world's financial stability. The Baker Plan could be a major step towards a long-run solution. The plan, however, addresses only one part of the problem — the debtor nations. The other part rests with the industrial nations: sustained, stable economic growth and a refraining from trade protectionism are called for to provide an expanding market for the debtor nations' exports, and thus to enable them to service their debts. Both parts of the debt problem must be addressed in an effective long-run solution.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/30/85	Change from 10/23/85	Change from 10/31/84 Dollar	Percent[7]
Loans, Leases and Investments[1] [2]	196,755	793	11,010	5.9
Loans and Leases[1] [6]	177,901	832	10,722	6.4
Commercial and Industrial	50,640	− 282	− 859	− 1.6
Real estate	65,353	153	3,970	6.4
Loans to Individuals	37,876	109	7,324	23.9
Leases	5,406	0	346	6.8
U.S. Treasury and Agency Securities[2]	11,670	23	85	0.7
Other Securities[2]	7,184	− 62	204	2.9
Total Deposits	199,260	953	7,705	4.0
Demand Deposits	47,545	1,261	2,173	4.7
Demand Deposits Adjusted[3]	32,563	388	3,878	13.5
Other Transaction Balances[4]	13,835	− 56	1,532	12.4
Total Non-Transaction Balances[6]	137,880	− 252	3,999	2.9
Money Market Deposit Accounts—Total	44,904	− 602	6,324	16.3
Time Deposits in Amounts of $100,000 or more	38,475	− 21	− 2,730	− 6.6
Other Liabilities for Borrowed Money[5]	23,421	− 1,143	902	4.0

Two Week Averages of Daily Figures	Period ended 10/21/85	Period ended 10/7/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	52	− 62
Borrowings	54	82
Net free reserves (+)/Net borrowed(−)	− 2	− 144

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change