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Statement by

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before the

Committee on Foreign Affairs

House of Representatives

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I am pleased to have this opportunity to review with you the international debt situation.

It is a large and complicated problem that must be effectively managed -- managed in our own immediate economic interest in maintaining the domestic and international financial stability necessary to support our own growth, and managed in our broader interest of the economic growth, the political stability and the democratic evolution of the developing world.

For reasons I will touch upon later, the solutions, in my judgment, are not likely to be found in some grand new initiative or in a single "across-the-board" approach culminating in inter-governmental negotiations among borrowing and lending countries. Rather, the effort has required, and will continue to require, cooperative and imaginative efforts by all the affected parties to deal with the particular problems and needs of particular borrowing countries.

Certainly, there are and will be important common elements in those country-by-country approaches. The policies of these countries themselves are always crucial. The major commercial banks around the world, which are the major lenders and have so much at stake, need to concert their approaches. The international financial institutions -- with the International Monetary Fund initially in the lead, but with the World Bank potentially playing an increasingly critical role -- provide a focus for leadership and coordination. And none of that will work effectively without the understanding and support of national governments -- and most of all that of the United States.

As all of that implies, we face not so much a "crisis" that can be dealt with by a single master stroke, but rather a continuing hard-slogging effort to contain the strains and to manage a return to "normalcy" over a period of time extending certainly for several more years ahead. In that context, the main danger may, in fact, be a human tendency to procrastinate, to relax the necessary effort, and to fail to maintain the high level of cooperation among parties with disparate particular interests, despite the overwhelming common interest in an orderly resolution. That danger can be avoided. I believe the problem is manageable. And I also believe that your interest and your inquiries can help assure that result.

I will not burden you with reviewing the origins of the debt problem which by now I believe are well known -- the successive oil price disturbances, overly enthusiastic borrowing and lending policies fostered in substantial part by an inflationary environment and inflationary expectations, failure to encourage and attract more direct investment from abroad in developing countries, and the related undermining of the confidence of those with capital within the borrowing countries. World recession and higher interest rates helped account for the timing and extent of the difficulties, but, with the benefit of hindsight, unsustainable trends had emerged well before that time.

Suffice it to say there are lessons here for all of us for the future. But I want to concentrate today on assessing the nature and dimensions of the problem and the more immediate approaches for dealing with it.

The Extent of the Debt-Servicing Problems

In assessing the debt problems, I would first point out they do not uniformly impact developing countries as a whole. Many of the larger developing countries in Asia -- including those that are major borrowers from banks (for instance, South Korea and Taiwan) -- have continued to meet fully and on schedule their debt-servicing obligations; financial markets remain open to them, and growth has continued at a rapid rate. Their ability to achieve and maintain high rates of export sales has been a major factor of strength.

At the other end of the spectrum, most of the poorest of the developing countries, concentrated on the African continent, have been less affected by the slowing in international bank lending for the simple reason that these countries had never been able to borrow sizable amounts and had not become dependent on external private sources of credit. They do have severe development problems, and a few of them had failed to maintain debt service years before the more general problem arose. But the financial exposure of private lenders is limited.

The debt-servicing problems of more general import have been mainly concentrated in Latin America, among several East European countries, and in Nigeria and the Philippines. Among developing countries, these have generally had relatively higher incomes and they typically had experienced rapid growth during much of the 1960s and 1970s. While in varying degrees, these countries have faced -- and are continuing to face -- severe external payments difficulties, they also have diverse needs and capabilities. Some, for instance, are large oil exporters; others are heavily dependent on imports of energy. Some have a sizable manufacturing base, while others are more dependent on agriculture or mining. Their internal economic approaches and problems differ, so that even within this group of countries faced with large external debts, a pragmatic and flexible case-by-case approach has evolved toward dealing with them.

That approach has relied on several common elements:

-- Adjustment by Borrowing Countries

Over-extended developing countries have recognized the need to reduce external financing requirements and to improve economic management and incentives internally to restore a base for sustained growth.

-- Continued Lending by Commercial Banks

In the process of restoring and maintaining orderly debt servicing, current maturities need to be extended and some new money -- typically in diminishing amounts -- may need to be provided as the internal adjustments are made. In disturbed circumstances, these arrangements involve negotiations affecting virtually all bank lenders.

-- Expanded Role of the International Monetary Fund

Thirty-six countries are currently operating with IMF-arranged and IMF-monitored stabilization programs. The IMF also has helped in coordinating financial resources from banks and official sources to cover financing requirements of debtor countries. The IMF's capacity to operate on this scale has been strengthened by the implementation last year of the quota increase and the enlargement of the General Arrangements to Borrow.

-- Official Bilateral and Multilateral Assistance

An expansion of official export credits and other forms of official assistance has been essential in helping cover the financial needs of a number of debtor countries. Multilateral and regional lending institutions also have redirected some of their activities to help cover the financial requirements of borrowing countries.

Before bank and IMF resources come on stream, governments and central banks (sometimes under the aegis of the Bank for International Settlements) occasionally have found it necessary to provide short-term bridge financing.

-- Sustained Non-Inflationary World Economic Recovery

Growing markets for exports are essential over time to enable borrowing countries to restore balance to their international accounts. The strong recovery of the United States has been especially helpful in this regard; recovery in some other industrial countries appears to be on the way and will broaden the markets for developing-country exports. The maintenance of a free and open trading system is essential if the borrowing countries are to expand their exports.

As these approaches imply, debtor countries, commercial banks, industrial countries, and international institutions must be willing to work closely together to deal with a problem beyond the capacity of any of those parties individually. In other words, an extraordinary continuing effort in international cooperation, among countries and official institutions, and between borrowers and private lenders, has been and will continue to be required.

The Adjustment Path of Borrowing Countries

The core of any successful effort lies in the adjustment actions of the borrowing countries themselves -- all else rests on the perception and the reality of their own efforts to rebuild a base for sustained growth with reduced reliance on external funds. In most cases, those actions have been framed in cooperation with, and have received the financial support of, the International Monetary Fund, and that has been a crucial ingredient in building further financial support.

The results thus far of the adjustment efforts by some of the most important borrowing countries have been encouraging. In

Mexico, Brazil, and Venezuela, for example, budget deficits are being sharply reduced by 4 percent or more of the GNP in a single year -- the equivalent of moving the U.S. budget deficit from its present position into balance or surplus in one fell swoop. Other measures, including restraint on money growth, have been taken to bring domestic demand more in line with domestic capacity and to reduce inflationary pressures. In order to correct external deficits and long-standing distortions in relative prices at home, borrowing countries have allowed sharp depreciation of their currencies and reduced subsidies, at the expense of higher prices of important goods and services.

In the midst of that difficult process, a number of countries have, perhaps inevitably, experienced a sharp contraction in economic activity. But those countries that responded promptly to their balance of payments and debt-servicing problems with comprehensive adjustment programs do show substantial improvement in their external positions. Now, some signs of a resumption of growth are appearing. At the same time, the challenge remains to restore growth over time in a manner consistent with a more limited availability of foreign bank financing.

The results of adjustment efforts adopted by borrowing countries in the aggregate have been impressive. The combined current account deficit of the non-OPEC developing countries was almost cut in half between 1981 and 1983. The reduction in the deficits of 10 major borrowing countries, most of whom have experienced debt-servicing difficulties, has been even larger --

from some $46 billion in 1981 to about $16 billion in 1983. (See Table 1.) Some further progress is taking place this year.

Some key debtor countries -- Mexico and Venezuela in Latin America, Yugoslavia and Hungary in Eastern Europe -- have actually moved into current account surplus, notwithstanding their heavy interest payments. In others, notably Brazil, trade surpluses are significantly exceeding expectations, and the remaining current account deficits are smaller than anticipated. Moreover, the payments performance of some of these countries has allowed them to replenish their reserves, which were depleted following the onset of the debt problem.

The large trade surpluses being recorded by these countries are a partial counterpart of the enlargement of the U.S. trade deficit. The strength of the U.S. economic recovery and the appreciation of the dollar have stimulated U.S. demand for imports, and the weakness of internal demand in many of the major developing countries and the strong dollar have reduced foreign demand for U.S. exports. As a result, the U.S. trade deficit with Latin American and Asian developing countries nearly doubled between the fourth quarter of 1982 and the second quarter of 1984 (from about $21.5 billion to nearly $41 billion). Those countries that started effective adjustment programs earlier, and have thus been able to take advantage of growing markets in the United States and elsewhere, have benefitted most from the factors contributing to the widening of the U.S. trade deficit.

At the same time, I must emphasize that so far a disproportionate part of the improvement on the external side has come from sharp declines in imports. In fact, imports in a number of countries have dropped to levels inconsistent with growth and development. Over time, both imports and economic activity must expand if the adjustment programs are to be successful, and consistent with social and political stability. Moreover, there are a number of countries that, so far, have not been able to implement effective policies, and related financing and refinancing programs are in abeyance.

The difficulties in this area are apparent. Effective measures in practical terms mean strong and politically difficult actions that sometimes must be shaped in the midst of blossoming democratic movements. That implies a need for a high degree of consensus -- no simple task for those of us who have enjoyed stable democratic governments for many years.

In this situation, concern is often and understandably expressed that too much is expected of these countries by the IMF in shaping its lending programs, by creditor countries or by banks. But I question whether there can be an easy painless way to restore equilibrium, or whether failure to adjust can be in the basic interest of the borrowing countries themselves.

Economic growth in developing countries over a long period ahead, and the prospects for political stability, will be dependent on their ability to participate fully in an interdependent world. In that world, credit-worthiness and credit availability will be precious, for they are essential to support trade and investment.

Once lost, those qualities are difficult to restore -- and democracy is not likely to flourish in the midst of accelerating inflation and economic isolation.

In many of those countries, their excessive debt burdens can be traced in large part to a flight of capital by their own citizens discouraged from investing at home. To me, the ultimate test of a successful economic program will not be whether, at a moment of time, it is acceptable to the IMF or to bank lenders, but whether it, in fact, can restore and maintain the confidence of a nation's own citizens -- and whether, as a consequence, its own savings are employed productively at home.

Threats to Adjustment

At the same time, the efforts of the borrowing countries will not be successful without a reasonably favorable economic climate elsewhere. Specifically, prolonged increases in interest rates and increased protectionism in the industrialized world can undermine the best efforts of the borrowers. Higher interest costs directly add to debt service burdens. An unwillingness on the part of industrial countries to accept more imports would make it impossible for the borrowing countries to earn the foreign exchange they need to service their debts.

Recent changes in these respects are not so significant as to thwart the adjustment process. In fact, to the extent that the higher interest rates are a reflection of the stronger than anticipated U.S. economic growth, the burden is offset to a considerable degree by the higher exports to the United States. Nonetheless, anticipations of further changes have been a source of considerable uncertainty, tending to undercut the cooperative effort to manage the debt problems in an orderly way.

Given our own strong interest in achieving an orderly resolution of the debt problem, these concerns reinforce the urgency of forceful and prompt action by the Congress and the Administration to reach agreement on ways to reduce the huge budget deficits that have helped keep our interest rates high and indirectly aggravated the deficit in our own trade. Although I understand that these hearings on the international debt situation are not intended to result in legislation, I cannot resist suggesting that further efforts in resolving our budget deficit problem would be the single most important contribution the Congress could make to an easing of international debt problems.

Financing Adjustment and Growth

In the near term, the major borrowing countries must, by force of circumstances, bring their current account positions into alignment with a reduced availability of external financing. By the standards of the late 1970s, new bank lending is likely to remain restrained relative to the bank's own capital and assets; a number of banks in the United States and elsewhere will probably be looking to reduce their exposure relative to their capital. The amounts of indebtedness by major borrowing countries and the loans of commercial banks are displayed in Table 2 and 3 attached to this statement. As indicated there, growth of such lending has in fact slowed, and the exposure of banks, relative to assets or capital, has begun to decline marginally. In a context of growth, both in the industrialized and developing world, this relative exposure could decline much more significantly, even as the total loans outstanding rise moderately.

The financial constraints for the borrowers, and the risks to lenders, would both be reduced by restoration of, and increases in, the flow of direct investment to developing countries. In the light of the financial and economic uncertainties of the past two years, the opposite has happened. This emphasizes the importance of the borrowing countries, as part of a reshaping of their economic policies, to attach priority to approaches that will strengthen confidence in their economic prospects abroad as well as at home. That process inevitably takes time, but it is urgent that it begin. The adjustment programs undertaken are broadly consistent with the need, but much more could be done to deal with specific obstacles to foreign investment.

Given smaller inflows of capital from abroad, growth in major borrowing countries of necessity will have to be financed to a greater extent than in the past by internal savings. Stabilization programs designed to curb inflation, to maintain realistic interest and exchange rates, and to eliminate or reduce price distortions are designed to be consistent with that goal. Over time, encouragement of domestic savings and economically rational investment decisions can provide a far sounder base for development than unsustainable amounts of foreign borrowing, important as capital imports may continue to be at the margin.

In the best of circumstances, these adjustments could not bear fruit in self-sustaining growth immediately. And, lenders need to appreciate that countries launching an adjustment effort will need financial support from abroad for a time that will not be forthcoming spontaneously -- that is by the uncoordinated action of individual banks and countries. Indeed, as debt problems first became apparent, the understandable reaction of individual lenders was to pull back abruptly, under the pressure of directors, accountants, and public opinion suddenly conscious of risks that had not been so apparent only a short while before. But experienced bankers quickly realized that that approach would guarantee precisely the result they feared -- that borrowers would in fact be unable to repay so suddenly, their economic futures would be jeopardized, and as a result, the basic value of existing credits would be undermined.

By cooperation, and at times with transitional support from governments, central banks and the IMF, a coordinated and constructive approach has been maintained, resting on analysis that extension of old credits -- and in a number of cases new credits -- can be justified when necessary policies are adopted and long-term debt servicing capacity maintained and enhanced.

That kind of approach is not new for bankers; a similar appraisal is necessary when difficulties arise in meeting debt service requirements of domestic business. What is new is the level of complexity when hundreds of lending institutions, various governments, and international institutions are all involved with many differing interests, different accounting and legal systems, and historical lending relationships. The one feature that tends to bind all these efforts together is a common appreciation that the success of the total effort depends on cooperation by all participants. And we can now see instances where the adjustment effort and transitional financing appears to be strengthening the basic credit-worthiness of borrowing countries.

A New Phase

Indeed, I believe the stage has been set for a new phase in financing programs tailored to the progress and circumstances of individual countries. The bulk of the financing has been, and will continue to be, provided by commercial banks, and is a matter for negotiation by borrowers and lenders. But I am glad to see that, recognizing the progress made by certain countries, the banks are now engaged in negotiations for multi-year restructuring of debts on terms that both reflect the stronger credit-worthiness of individual countries and permit planning on a more assured basis for the future. These arrangements, combined with prudent policies by the lender, can pave the way for meeting any more limited further needs for new money in the years ahead through more normal and spontaneous market processes.

All of this seems to me entirely consistent with the conclusions of the recent Economic Summit in London: "in cases where debtor countries are themselves making successful efforts to improve their position," the Summit participants attached particular importance to "encouraging more extended multi-year rescheduling of commercial debts and standing ready where appropriate to negotiate similarly in respect of debts to governments and government agencies."

The process of renegotiating the debts to banks has required the resolution of difficult and contentious issues in a financially and politically sensitive environment. In the process, considerable experience has been developed and the effort has become better organized and more orderly. Steering committees act as negotiators and perform a liaison function with the much larger group of lending banks, and better lines of communication have been established.

The role of the International Monetary Fund in the loan renegotiation process has been expanded and also has been defined more clearly. The IMF also has improved the flow of its technical information about borrowing countries to lending banks in a manner that does not appear to have compromised its ongoing relationship with its members. But, as time has passed, shortcomings in the process are also apparent. The new arrangements in a situation in which there could be no "track record" of adjustment, have typically been for relatively short periods, and rates and terms reflected the appreciation of extra risk. One of the dangers has been that, as the sense of emergency passed, the effort would flag and a sense of frustration about continuing negotiations would impair the effectiveness of the effort.

Now, however, the opportunity has arisen, within the general framework of a case-by-case approach, to take a longer perspective. Growth in the industrialized countries has resumed. Some important borrowing countries have demonstrated their ability to adjust their external positions and to encourage export-led growth. Lenders can recognize that progress in extending maturities and in providing more favorable terms in other respects.

As a result, there is an opportunity to move progressively from a "crisis" stage of debt management to longer-term arrangements on reasonable terms. I believe it is critically important that that opportunity be seized.

I am aware of the difficulty of conducting negotiations with so many borrowers and many lenders, and so many individual and syndicated loan agreements involved. There are concerns that each renegotiated loan may be interpreted as a precedent for future agreements where circumstances may not be similar. Lenders or borrowers have particular negotiating objectives that may be difficult to reconcile. But both have clear and overriding incentives to build on the constructive attitudes and the efforts by important borrowing countries to restore domestic and external stability. Relevant negotiations are underway now with Mexico and Venezuela. I hope they can be concluded shortly.

<u>Concluding Observations</u>

In sum, there are grounds for encouragement in the progress that has been made over the past two years in dealing with the international debt problem. The record and the prospects do not justify a sense of despair. But neither do they suggest grounds for complacency -- the threat to international financial stability remains real, and will need the continuing attention of governments as well as private lenders if it is to be successfully resolved.

In the light of all the difficulties and strains, proposals have been made that the slogging, difficult, continuing process of adjustment, negotiation, and refinancing country by country be essentially abandoned and replaced by some sweeping new initiative to settle the problem decisively and "across the board." These proposals seem to me based on unrealistic assumptions -- typically on an expectation that someone else is prepared to assume large new burdens.

I do not sense, in that connection, any willingness on the part of the U.S. Congress, or other parliaments, to provide massive new financial assistance for countries that, in the economic hierarchy of developing countries, are among the most advanced. Lending banks understandably do not volunteer to provide large interest subsidies for, or to write down, loans that can, after all, be serviced; nor is that necessarily in the interest of countries that will be looking to international markets for credit to support growth in the years ahead. Those countries are not in the same position, in terms of their own resources and in terms of the efforts they have made to place their own economies on a sounder footing, and it would be difficult -- even perverse -- to provide the same terms and conditions for all.

I do not minimize the real strains or, almost as important, the sense of fatigue that can set in when a large and complicated effort needs to be sustained. Results take time. That is one reason why, as I noted above, that as progress and performance justify it, it does seem to me critically important to move to a new phase in which individual borrowers be able to refinance maturing debt for some period ahead at reasonable terms, permitting both borrowers and lenders to have a more certain and stable base for planning.

As the initial adjustments under the aegis of the IMF are made, the role for the World Bank and the regional development banks should become relatively more important, both in helping borrowers develop appropriate investment strategies and seeing to it that they can be appropriately financed. There are promising initiatives underway in the World Bank, for instance, that could importantly supplement the efforts of the IMF, the borrowing countries and the banks as the total effort is viewed in a longer-term perspective. I am thinking in part of the possibilities of encouraging so-called "co-financing" techniques, combining the strengths and resources of private lenders with those of international institutions. These initiatives, it seems to me, deserve our sympathic attention, and the institutions themselves our continuing financial support as required by prudent and effective policies. All of this would represent a natural evolution, providing both a transition to "normalcy" and a basis for constructive new patterns of international lending.

With this continuing effort, successful management of the debt problem can continue so long as certain fundamentals are respected -- persistent and effective adjustment efforts by the borrowers, continuing growth among the industrial countries as a whole, maintenance of open markets for the products of developing countries ready to compete fairly in world markets, and reasonable stability in financial markets (or better yet, declining interest rates) which in turn rests on keeping inflation and budgetary deficits under control. None of that requires perfection in every respect, and none of it will produce sudden and complete success in every case across the board. The process will take time. But it can work, and I believe it is working.

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Table 1
Current Account Balances of the
Ten Largest Borrowers among Developing and Eastern European Countries
($ billions)

	Average 1971-73	Average 1974-75	Average 1976-78	1980	1981	1982	1983
Brazil 1/	-1.8	-7.3	-6.2	-12.8	-11.8	-16.3	-6.9
Mexico	-3.9	-4.2	-3.0	-8.0	-13.9	-5.1	5.2
Argentina	0.0	-0.6	1.2	-4.8	-4.7	-2.5	-2.4
Korea	-0.5	-2.0	-0.5	-5.3	-4.6	-2.7	-1.6
Venezuela	0.3	4.0	-2.9	4.7	4.0	-4.2	3.7
Indonesia	-0.4	0.3	-0.8	2.9	-0.6	-6.0	-5.8
Philippines	0.2	-0.6	-1.0	-1.9	-2.1	-3.2	-2.8
Yugoslavia	0.2	-1.2	-0.9	-2.2	-1.8	-1.6	0.3
Chile	-0.3	-0.5	-0.6	-2.0	-4.7	-2.3	-1.1
Nigeria	-2.5	2.5	-1.7	4.2	-5.8	-7.3	-5.0
Total of Above	-8.7	-9.6	-16.4	-25.2	-46.0	-51.2	-16.4
MEMORANDUM ITEM:							
All non-Opec LDCs 2/	n.a.	-35	-28	-62	-81	-65	-46

1/ Includes reinvested profits.
2/ From IMF World Economic Outlook (April 1984).

SOURCE: International Financial Statistics and national sources.

Table 2
External Indebtedness of the Ten Largest Borrowers among Developing and Eastern European Countries, 1979-83
($ billions; end-of-year)

	1979	1980	1981	1982	1983
Total gross external debt	234.8	289.4	342.6	391.7	421-1/4
% change from previous year	27.7	23.2	18.4	14.3	7.5
debt to BIS-reporting banks	145.5	186.9	225.1	244.2	256.5
% change from previous year	36.1	28.5	20.4	8.5	5.0
debt to U.S. banks	56.4	67.7	83.5	94.6	98.7
% change from previous year	20.0	20.0	23.3	13.3	4.3

— Total gross external debt is all public and private debt; Federal Reserve staff estimates based on national sources.
— Debt to BIS-reporting banks is from Maturity Distribution of International Bank Lending, published by the BIS.
— Debt to U.S. banks is from Country Exposure Lending Survey, published by the Federal Financial Institutions Examination Council.

Table 3

Claims of U.S. Banks on Non-OPEC Developing Countries

Date	Amount (billions of dollars)				As Percent of Capital			
	All U.S. Banks	Top Nine	Next 15	Other Banks	All U.S. Banks	Top Nine	Next 15	Other Banks
December 1977	46.9	30.0	8.8	8.1	115	163	106	57
June 1978	48.7	31.0	9.3	8.4	115	163	107	57
December 1978	52.2	33.4	9.9	8.9	114	167	110	54
June 1979	54.4	35.0	10.3	9.1	115	166	108	55
December 1979	61.8	39.9	11.3	10.6	124	182	112	60
June 1980	66.2	41.9	12.5	11.8	123	183	113	60
December 1980	75.4	47.9	14.2	13.4	132	200	125	62
June 1981	82.3	51.6	15.4	15.3	137	207	134	65
December 1981	92.8	57.6	17.4	17.8	148	230	151	76
June 1982	98.0	60.0	19.0	19.0	148	223	150	73
December 1982	103.2	64.2	20.2	18.9	146	221	150	67
June 1983	103.7	64.1	20.5	19.1	139	212	148	63
December 1983	106.8	65.8	21.6	19.4	135	209	145	59
March 1984	107.1	66.6	21.9	18.7	133	209	144	56

Source: Country Exposure Lending Survey published by Federal Financial Institutions Examination Council.