A Balanced Approach to the LDC Debt Problem

Good morning ladies and gentlemen. I welcome this opportunity to address again the annual meeting of the Bankers Association for Foreign Trade. In saying that, I must confess that it does not seem possible that it was two full years ago when I last spoke to this group in Phoenix. What seems even more improbable is that we will soon enter the seventh year of efforts to cope with the debt problems in the developing world that burst upon the scene in August 1982. In the face of that, I would like to use this occasion to share with you some of my thoughts and observations regarding where we have been and where we are going in the continuing effort to manage and ultimately resolve the debt problem.

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I believe a useful starting point in that exercise would be to review briefly just what has—and has not—been accomplished over the past six years. Retrospective review is always useful, but in this case it is especially important because it reveals that far more has been achieved than is widely recognized. Accordingly, allow me to briefly highlight some of the accomplishments of the effort to date and then mention some of the areas in which progress has not been as great as we would have liked:

Debtor countries have made some very important strides in improving their economic policies and their economic performance against very strong countervailing forces. To be sure, that progress has been uneven and in some respects disappointing, but the setbacks and disappointments should not distract our attention from the gains that have been made.

First, and we should never forget this, in the early days of the debt crisis only swift, decisive, and broadly based cooperative efforts by debtors, creditors, central banks, governments and multilateral institutions allowed us to avert financial and economic calamity. Since that time, the dangers of such a systematic disruption to international trade and finance clearly have been reduced. But the overall situation is still one in which systemic risks are present. Thus, a focus on the "big picture" must remain in the forefront of constructive thinking and progressive actions regarding the debt problem.

Second, debtor countries have made some very important strides in improving their economic policies and their economic performance against very strong countervailing forces. To be sure, that progress has been uneven and in some respects disappointing, but the setbacks and disappointments should not distract our attention from the gains that have been made. Let me cite a few specifics to back up that point and in so doing

Remarks by E. Gerald Corrigan, President of the Federal Reserve Bank of New York, before the 66th Annual Meeting of the Banker's Association for Foreign Trade, April 25, 1988

I will focus mainly on a group of eight troubled debtor countries where U.S. bank exposure is the largest. Those countries are Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, the Philippines, and Venezuela

- For these countries, there has been a significant improvement in aggregate trade and current account positions despite the fact that virtually all have experienced devastating setbacks in the terms of trade during the period in question. For example, in 1982, the aggregate current account deficit of the eight countries was almost $40 billion; in 1987, it was about $5 billion. To fully appreciate the nature and scope of this adjustment, just contemplate for a minute the difficulties we in the United States are having in making external adjustments, which in relative terms are much smaller than the adjustments these developing countries have made.
- Growth in GDP and per capita GDP has reemerged even if at slow and sporadic rates. In three of the countries—Chile, Colombia, and the Philippines—recent growth patterns in the context of inflation performance are distinctly better. In addition, renewed initiatives in the area of both macro and structural policy should work in the direction of improved prospects elsewhere In another case, that of Mexico, the tremendous growth in non-oil exports and the build-up in official reserves have been particularly striking, especially in the context of continuing efforts on the policy front.
- The key ratio of external interest payments to exports is falling in virtually every country and for a majority of the eight that ratio is now below 30 percent, while for three the ratio is in the low 20 percent range.
- Important but not yet decisive steps are also being taken by the countries in the move toward more open and more competitive economies. Trade policies are becoming more liberal; some state enterprises are being divested as elements of privatization begin to take hold; the institutional environment for foreign direct investment is improving—a process that has been spurred in part by the success of debt equity swaps in countries such as Chile; and direct and indirect subsidies on a wide range of goods and services are being reduced or eliminated.
- Finally, considering the economic environment of the past six years—that is, one in which cyclical forces would be expected to swell public sector deficits—some debtor countries have made important strides in reducing public sector deficits as a percentage of GDP. Here too, progress has been uneven and, on balance, deficits are still too large, but the direction of movement over time is generally right and in some cases the amount of the adjustment is significant.

Third, on the financial side, the scope of the overall debt restructuring effort has been remarkable. Just think of it more than $200 billion of existing debt has been restructured to the *mutual benefit* of debtor and creditor alike, and in the process countless innovations have been introduced into the terms and conditions of the restructured debt. These developments suggest to me that there is still ample room for further innovation that is consistent with the time honored precept of debtors and creditors working together to forge voluntary and mutually beneficial solutions to their problems.

Fourth, the commercial bank new money process has also worked reasonably well in that over the 1983-87 period the international community of banks has committed to lend almost $45 billion in fresh money to the Baker 15. The new money process has also been enhanced by its own adaptations and innovations, but there is a question in my mind—to which I will return later—as to whether we can be satisfied with the status quo as it applies to the new money financing process by the commercial banks—a process that remains a central and indispensable element to ultimate success in this overall effort.

On the financial side, the scope of overall debt restructuring effort has been remarkable. Just think of it: more than $200 billion of existing debt has been restructured to the *mutual benefit* of debtor and creditor alike, and in the process countless innovations have been introduced into the terms and conditions of the restructured debt.

Finally, and certainly not inconsequentially, the past six years have witnessed a dramatic reduction in bank exposure to the troubled LDCs. For example, for any cross section of the very largest U.S. banks, exposure to the Baker 15 relative to primary capital in 1982 was in the range of 225 to 250 percent. Reflecting primarily the enormous growth in primary capital at these banks in recent years, these ratios at year-end 1987 were in the range of 80 to 90 percent, despite the fact that the major U.S. banks have been, and should be, among the leaders in providing new money to the debtor countries. The current exposure ratios, however, are still too high but also are still declining as capital grows and as individual banks utilize various bilateral and voluntary techniques to reduce exposure. It should also be stressed that reductions in bank exposures have been aided by limited but not unimportant amounts of outright debt repayments as, for example, in the case of Colombia and Venezuela and on the part of private debtors in many countries.

In the interests of time, I don't want to belabor the point, but I do want to emphasize that a great deal has been achieved on many fronts over the past six years Some would suggest that this period has simply been an interval of "muddling through" and little more has been done other than to buy time. I simply don't see it that way. To be sure, time has been bought, but it has not been wasted in that clearly we are closer to lasting solutions now than we were a year, two years, or six years ago, even if it remains true that the process will still take time—a lot of time

In pointing to the progress that has been made, we must also be realistic in recognizing that from the perspective of the debtor countries that progress has been exacted at a high cost in both political and economic terms. Let us also not lose sight of the fact that clear problems remain: inflation performance, especially in the largest debtors, has been a major disappointment; the levels of debt relative to GDP or to exports have not come down and in most cases have actually increased, major structural impediments to more open and more efficient economies remain, frustration and fatigue are at high levels; the need for greater adaptability in the approaches of the multinational institutions is apparent; and, in an ironic and worrisome way, the new money commercial bank financing process has been weakened in part because bank exposures have been reduced so dramatically.

In looking at the overall [debt] situation, it is clear that we are at something of a crossroad in that we face the crucial question of how best to sustain the progress of the past while dealing with the shortcomings that have emerged over the past several years.

Indeed, if we needed a reminder of the remaining problems, the Brazilian moratorium provided evidence of the vulnerabilities. Fortunately, Brazil has concluded that the moratorium was not in its interests and is now in the process of seeking to normalize relationships with all of its creditors, a process that hopefully can be completed in the weeks immediately ahead. Regrettably, we have also seen a case or two in which a country has chosen to attempt to "go it alone." However, when I look at the results of those experiments, they seem to me to provide striking support for the wisdom of the more conventional and cooperative approach.

In looking at the overall situation, it is clear that we are at something of a crossroad in that we face the crucial question of how best to sustain the progress of the past while dealing with the shortcomings that have emerged over the past several years. Some have suggested that the way for the future lies in some sweeping and generalized approach that would incorporate—one way or another—a program of debt relief, debt forgiveness and/or the shifting of commercial bank debt to the official sector. I do not share that view and I say that for a number of reasons.

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For one thing, the outright shifting of even a part of the commercial bank debt to the official sector is—among other things—plainly a political nonstarter. That, of course, is not to say that the multilateral institutions should not play an enlarged role as, for example, is contemplated by the broad thrust of the Baker Plan. Nor is it to suggest that the creditor governments do not have a role to play in helping things along. But there clearly are limits as to how much the official sector can and should do, and any realistic assessment of those limits implies that the commercial banks must remain an essential part of the solution.

It is also true that anything approaching a "forced" write-down of even a part of the debt—no matter how well dressed up—seems to me to run clear risks of inevitably and fatally crushing the prospects for fresh money financing that is so central to growth prospects of the troubled LDCs and to the ultimate restoration of their credit standing. But that risk is one that applies not only to current troubled debtors but to others as well. For example, what entity—private or public—would be willing to risk its capital in lending to any country if the lending entity concluded there were risks that political forces might, at some later date, require the creditor to accept losses to its shareholders or to those for whom it has fiduciary responsibilities? You may answer that question in your own way, but I, for one, am hard pressed to imagine how such an approach could work in a constructive fashion. Indeed, I find it wholly unrealistic to assume that creditors would take forced losses and then turn around and extend new credits, even if such new credits were senior to the old credits.

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I find it equally unappealing to run the risk that the process of attempting such an approach might trigger a wholly unacceptable series of actions on the part of creditors or debtors or both that could be highly destabilizing. Even now, many bank creditors are unwilling to extend new money in a setting in which the bulk of existing debt has been and is being serviced at positive interest rate spreads.

Finally, and perhaps most importantly, generalized approaches to debt relief or forgiveness seem to me to also work the wrong way in terms of incentives in the debtor countries. That is, even the specter of some generalized form of debt relief can carry with it the illusion that the burden of policy adjustment and adaptation is lessened or removed. To the extent that occurs, conditions could actually worsen and the slippery slope of debt relief will become very slippery indeed In other words, once the process starts, what is to stop it?

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In the final analysis, the task before us is one that requires that we carefully weigh and balance the risks and rewards of alternative courses of action. In turn, that seems to me to require that we have some criteria against which we can systematically look at the advantages and disadvantages of alternative courses of action.

I have previously suggested a general framework that I believe has value in this regard. Specifically, as I see it, today, as a year ago or five years ago, or for that matter a year or several years into the future, there are certain fundamental prerequisites that must be a part of any constructive effort to forge a permanent solution to the LDC debt problem. Those prerequisites include the following:

First, growth in the debtor countries in the 5 percent range that they have all experienced in the past must be sustained over a period of time.

Needless to say, achieving that result presupposes appropriate macro and micro policies on the part of the debtor countries. It also requires an international environment conducive to LDC export growth, which means policies for noninflationary growth in the creditor nations and a strong and continuing commitment to free and open trade on the part of all

Second, the maintenance by the LDCs of businesslike relationships with their creditors, which means the timely servicing of financial obligations. In that regard, in a context in which a country has an established track record of servicing its obligations, innovative steps such as the *voluntary* Mexican debt repurchase plan can play a constructive role, especially if such efforts are viewed essentially as exit-type vehicles. But here too we must be realistic. Such efforts can be a constructive step in appropriate circumstances, but no more than that. They are not, nor will they ever be, either a substitute for the willingness and ability of debtor countries to service their debts or a sustainable channel for needed financing.

Third, a reasonably stable and predictable flow of appropriate amounts of official and commercial bank credit to the LDCs must be maintained. Approaches to the LDC problem that fail to take explicit account of the need to provide new financing—including private financing—to the LDCs over time should be viewed with skepticism. At the extreme, a debt strategy that cannot hold out the hope of renewed debtor access to market sources of external finance is no strategy at all. The object of the exercise is to restore creditworthiness and confidence, not to further impair them

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Fourth, strong and well-funded multilateral official institutions are central to the process not only because they can provide the added financing needed to close external financing gaps in the LDCs but also because they and they alone can be the locus of policy coordination and conditionality—a process that should become more flexible but that remains a crucial ingredient for success.

Fifth, an appropriate degree of solidarity and commonality of purpose among private bank creditors, and especially major bank creditors, must be maintained.

These prerequisites are a package deal. Success in any one or two or four is not good enough; true and lasting success will be found only if we have progress on all five fronts. Indeed, the great problem with many of the alternative schemes that one can conceive is that they can be quite responsive to one or even several of these prerequisites but miss the mark rather badly on others, that's not good enough. We need to make simultaneous progress on all.

Having stated these prerequisites, and having earlier pointed to what has and has not been achieved over the past several years, let me now conclude with a few comments on some steps that I believe can help to ensure continuing progress in the period immediately ahead.

Turning first to the LDCs, there is no question in my mind that the only real solution to the debt problem is for the countries to grow out of the problem over time. There is also no question in my mind that such a solution can work—even though it cannot be expected to be a straight line—but it can work only in the context of sound policies. There is no magic to it; good economic performance rests on good macroeconomic policy. In the case of the LDCs, however, it is more and more clear that macro policy must be complemented by even greater emphasis on the structural side. And, within that broad area, I believe that there is much to be said for efforts aimed at greater strides in the direction of privatization and—consistent with national interests—reductions in the size and role of state-owned enterprises. I sense that greater efforts in that direction may be especially valuable for several reasons: it can aid the financing process; it can surely aid the cause of greater efficiency and competitiveness; and it may also be true that it can help reduce budget deficits and minimize some of the structural pressures on domestic price inflation.

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In other words, I'm suggesting that there may be potentially large paybacks to the debtor countries stemming from greater effort to reduce the size and scope of state-owned enterprises, even though I am obviously sensitive to the political problems that can be encountered in such an effort. I am even more sensitive to the fact that there is a point beyond which that process cannot go. But, within those constraints, I would hope more can be done in this area for the reasons I have cited but also because greater progress in this area can help ease the burden on macro policies. Finally, I have to wonder whether it is possible that such efforts might not help stimulate capital repartition—the ultimate pot of gold at the end of the rainbow!

With regard to the multilateral official institutions, there are several near-term priorities. The first is seeking to put in place the much needed general capital increase for the World Bank. That will not be easy, but if the World Bank is to play an enlarged role in helping to manage the debt problem, as all observers seem to agree it must, the general capital increase is a must.

In the case of the IMF, the areas of greatest priority—greater flexibility and a longer perspective—are currently being addressed in that a variety of important adaptations in the financing programs and monitoring techniques of the Fund are under active consideration. Indeed, the prospect of multiyear financing facilities, financing facilities to help guard against certain external contingencies such as rising interest rates, and greater flexibility in the use of performance indicators seem to me to be important steps in the direction of a stronger and more flexible role for the Fund that should be welcomed by both the debtor countries and the private creditors.

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The commercial bank financing aspect of the debt problem must also be strengthened. The menu of options has already been broadened, but what we need is not a menu but a smorgasbord that can appeal to the increasingly diverse needs and desires of individual banks and individual countries. But—and I want to emphasize this point strongly—even the most imaginative steps in that direction will not be enough, given the prerequisites I cited earlier and given the increasingly divergent attitudes and behavior among segments of the commercial bank creditors. In that regard, the one thing we do not need is to have the debt problem again take on the characteristics of a debt crisis because of a crisis among the creditors.

To avoid that, we need a strong reaffirmation of the commitment of the creditor banks to the bigger picture; we also need to see decision making at the Advisory Committee level expedited and driven more by policy consideration and less by legalities and technicalities. Finally, we must find a solution to the so-called free rider problem in which an increasingly large number of banks refuse to participate in the new money lending but get the benefit of the process in the form of interest payments on existing loans. If nothing else, equity considerations point to the need for a solution to this problem. But far more is involved than equity considerations. Thus, I believe the time has come for the direct parties to the process to get serious about workable and effective approaches to exit-type vehicles, which of necessity will have to entail some cost to those who choose to exit. While it is not my role to suggest what form such vehicles should or might take, I do want to stress that they should emerge as a part of the continuing process of cooperation between the debtors and the private creditors.

I apologize for starting off your meeting with such a long and complex speech, but as I said at the outset, much is at issue here. How we respond to the next phases of efforts to manage and ultimately resolve the debt problem remains one of the great issues of the day in the arena of international trade and finance. I remain confident that we can see it through successfully, but that will take vision and, as symbolized by this speech, it will take time.