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WITHDRAWAL SHEET

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Collection Name Robinson, Roger: Files

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SRN 2/15/2012

File Folder INTERNATIONAL FINANCIAL: 07/27/1983-08/01/1983

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GRYGOWSKI

24

ID	Doc Type	Document Description	No of Pages	Doc Date	Restrictions
131262	DRAFT OUTLINE	ROLE OF U.S. GOVERNMENT GUARANTEE AND TRADE FINANCE PROGRAMS	11	7/24/1983	B1
131263	MEMO	DONALD TEMPLEMAN TO STEVE FARRAR RE: DEBT SERVICE PAYMENTS	1	7/6/1983	B1
131264	TABLE	RE: DEBT SERVICE PAYMENTS	3	ND	B1
131265	MEMO	NORMAN BAILEY AND ROGER ROBINSON TO WILLIAM CLARK RE: INTERNATIONAL FINANCIAL CRISIS	2	ND	B1
131266	MEMO	WILLIAM CLARK TO THE VICE PRESIDENT ET AL RE: INTERNATIONAL DEBT PROBLEM	3	ND	B1

The above documents were not referred for declassification review at time of processing

Freedom of Information Act - [5 U.S.C. 552(b)]

- B-1 National security classified information [(b)(1) of the FOIA]
- B-2 Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
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131262 DRAFT OUTLINE

11 7/24/1983 B1

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131263 MEMO

1

7/6/1983

B1

DONALD TEMPLEMAN TO STEVE FARRAR RE:
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WILLIAM CLARK TO THE VICE PRESIDENT ET
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INTERNATIONAL DEBT PROBLEM: ASSESSMENT AND STRATEGY

The international debt problem has been the principal international financial issue for some time now and is likely to remain a dominant concern for years to come. It is a truly global issue that, directly or indirectly, affects almost all countries, the banks, and official insititutions. Currently, about 30 developing and Eastern-bloc countries, with total external debt of close to \$300 billion and bank debt of over \$200 billion, or roughly half the bank debt of the non-industrial countries, are in arrears or have sought debt re-negotiation. Moreover, countries that are not in arrears or have not rescheduled debts are feeling the impact of an overall slowdown in international lending and a stiffening of lending terms.

Since the debt issue surfaced last summer, there has been a gradual evolution of thinking about how to proceed. During the Mexican and Argentine crises, it was recognized that close cooperation among the industrial countries, LDCs, banks, and official institutions would be necessary to avert a collapse of confidence. By year's end, with IMF-backed adjustment programs about to be implemented in several key countries, the mood was more upbeat. The assessment, based on aggregate analysis of the 21 major LDC borrowers and which assumed a moderate OECD recovery, was that their debt-servicing capacity, as measured by external indebtedness in relation to exports of goods and services, would improve substantially within 2 or 3 years on average. The results, however, were influenced by the inclusion of several Asian countries with comparatively low debt/export ratios such as Taiwan, Malaysia, Thailand, Korea, and Indonesia, and it was recognized that it would take longer for some of the high debt LDCs. The current appraisal, based on more disaggregated and country-specific analysis, bears the latter contention out, particularly for some Latin countries and oil exporters. It suggests that LDC adjustment and OECD recovery are necessary, and sufficient, to solve the debt problem, but that it could well

take most of this decade for some of the major LDC borrowers to regain normal market access.

While the debt issue is manageable, it will require skillful and cooperative management on the part of governments, official institutions, and the banks. It will not manage itself. A first step in tackling the debt issue is to identify and begin to correct various aspects of the problem that have contributed to its severity. Second, conflicting objectives between the need for balance-of-payments adjustment and additional financing need to be reconciled. Third, new initiatives may be required to provide banks with incentives to continue lending, to assure that additional long-term development assistance is forthcoming, and to foster a climate for increased foreign direct investment and free trade.

Dimensions of the problem

The global debt problem is a highly complex issue that cannot be dealt with through a quick "push button" solution. There are at least five key aspects that will require considerable time to correct, and efforts to deal with them may conflict with one another to some extent.

1. Excessive LDC debt

First of all, the excessive buildup of LDC debt since the mid-1970s needs to be corrected. For the 21 major LDC borrowers growth of external debt averaged over 21% per annum since the mid-1970s and has slowed significantly only within the last year or so (see Chart 1). LDC exports of goods and services were able to keep pace with the debt buildup during the inflationary environment of the 1970. However, they have slowed significantly in the 1980s, and even fell slightly in nominal terms in the last two years because of world recession and depressed commodity prices. The average growth rate since the mid-1970s has fallen to 16% per annum. This has resulted in a sharp rise in the

total external debt of the major LDC borrowers in relation to their exports of goods and services, from less than 125% in 1980 to over 170% in 1982 (see Chart 2). The debt buildup has been particularly great in Latin America, where it has climbed to about 260% of exports, reflecting difficulties those countries have had in adjusting to the new global environment of disinflation.

Any estimates of the amount of excess LDC debt clearly must be imprecise, since they invariably reflect subjective judgments about debt servicing capabilities, which vary from country to country. Based on experiences of countries that relied heavily on commercial bank borrowings since the first oil shock, the incidence of debt reschedulings is found to be considerably higher for countries with debt/export ratios in excess of 160% and to rise steadily thereafter. Virtually all countries at one time or another have been forced to reschedule portions of their debt as the ratio climbed beyond 200%. Using the latter ratio as a guide, the amount of excess debt of the LDCs and Eastern bloc countries is estimated to be on the order of \$100 billion, of which about two thirds is accounted for by Latin borrowers (see Table 1).

It should be stressed that these calculations do not imply that LDC debt levels actually have to be reduced by the estimated excess debt, either through repayment or forgiveness of debt. To bring the debt export ratios to more reasonable levels and to restore creditworthiness, however, it is vital that the rate of debt accumulation slow significantly and exports accelerate. As recent experience attests, debt ratios that were maintained in the past owing to sizable infusions of new bank money may prove untenable in a noninflationary environment of high real interest rates and slower growth of international lending. Thus, the relevant threshold range indicating likely onset of debt-servicing problems may be considerably below the 160%-200% range in the inflationary environment of the 1970s. If so, the amount of excess LDC debt to be worked off would be even greater than that estimated above and more time would be required to bring debt ratios down to

more manageable levels.

2. Excessive short-term debt

A major part of the excessive debt is short term. Such debt (original maturity of one year or less) is estimated to have been \$125 billion as of end-1982 for the major LDC borrowers, or one quarter of their total external debt. In the past, there was a tendency to ignore short-term debt partly because of inadequate data, and also because it was assumed to be trade related and therefore automatically rolled over. For a number of countries, however, the level of short-term debt far exceeds any reasonable relationship to trade financing, and has been used for long-term balance of payments financing. Moreover, rollover has proved to be far from automatic. If a country uses medium-term financing to cover mainly capital goods imports and borrows for up to 90 to 120 days to finance its remaining imports, short-term debt should be equivalent, at most, to about three months of merchandise imports. This is probably a reasonably good yardstick for most LDCs that are not money centers, although allowance should be made for any reserve accumulation in excess of three months' imports. Applying this guide, the amount of excess short-term debt of the developing countries is estimated to be on the order of \$65 billion, or roughly two-thirds of the total excess LDC debt (see Table 2).

To prevent a recurrence of the present situation, information will have to be provided on a much more timely and comprehensive basis so that short-term debt accumulation can be monitored closely. Also, guidelines covering short-term debt will need to be formulated by the Fund and the banks. In addition, a number of developing countries will need to have portions of their short-term debt stretched out and converted into medium- and longer-term credits to alleviate pressing cash-flow problems. The major LDC borrowers will have to roll over about \$35 billion in term debt that matures this year, raising the total amount of debt falling due in 1983 to over \$160 billion. This represents a third of their total external debt and 80% of projected debt service payments.

3. International lending surge and concentrations of credit

As a counterpart to the LDC debt buildup, there has also been an excessive growth of bank lending to the developing countries. Such lending to all LDCs has averaged slightly over 20% per annum since 1975 and has been even higher, 25% per annum, to the major LDC borrowers. The initial surge after the first oil shock occurred during the 1974-75 recession, when private credit demand in the United States and other industrial countries and when levels of credit outstanding to developing countries were relatively low. The momentum was maintained even after private credit demand picked up in the industrial countries and credits to developing countries expanded significantly. It partly reflected increased participation by foreign banks in international lending, such as domestically-oriented European banks and new Arab institutions, as well as new U.S. entrants, particularly a growing number of smaller, regional banks. The latter group now account for about 20% of all U.S. bank credits to the LDCs.

Even with these new entrants, the rate of increase of bank lending to the LDCs far outstripped the growth of bank capital, which for the major U.S. banks has been running in the vicinity of 9%-10% since the mid 1970s. This resulted in an overall deterioration in capital/loan ratios and increased concentrations of credits to a few countries in relation to capital. Credits to Mexico, Brazil, and Argentina, for example, now represent about 115% of the capital of the nine largest U.S. banks and almost 85% of that of all U.S. banks.

While there clearly is need to reduce lending concentrations in the future, it is also imperative that this is done within the context of a moderate expansion of new bank lending to the LDCs. IMF standby programs call for an overall expansion of new bank credits of 7% per annum in order to assure orderly balance of payments adjustment. Assuming that a number of the smaller, regional banks either leave exposures unchanged or reduce them, the remaining U.S. banks would have to extend new credits at a rate of

9%-10% per annum if the overall target set by the IMF were to be met. Thus, improvements in capital/loan ratios hinge on significant expansions of bank capital. A doubling of capital of the largest U.S. banks over the next five years, implying a 15% per annum increase, would eventually bring credits of these banks to the three principal LDC borrowers down to about 90% of their capital. It would also raise their overall capital/asset ratios from 4% at present to about 6%, assuming lending both domestic and international, grew at a 10% rate. //

4. Insufficient official financing and foreign direct investment

The rapid growth of bank lending to LDCs has resulted, in part, because of the inability of official financing, bonded debt, and foreign direct investment to keep pace with LDC financing requirements. The proportion of net capital flows to all developing countries, excluding short-term capital and reserve changes, provided by these sources is estimated to have declined from 60% in 1970 to 50% in 1982. If short-term capital flows are included, the share in 1982 is about 40%.

One of the principal drawbacks of substituting bank lending for official financing and bonded debt or equity is that many of the development projects undertaken by the LDCs require longer-term financing than can be extended by commercial banks. It is important in the future, therefore, to make longer-term financing more readily available to the middle-and higher-income LDCs. The proposed expansion of IMF resources will not address this aspect of the debt problem, since the Fund's role is to provide temporary balance of payments assistance to countries. Rather, the role of the World Bank and other multilateral development institutions must be strengthened to provide long-term development assistance. This will entail boosting the resources of the World Bank, as well as modifying its lending policies and the concept of "graduation".

Increased foreign direct investment is also vital as it provides a means for developing

countries to finance their current account imbalances without adding to their external debt burden. Moreover, the balance-of-payments cost incurred in the form of profit remittances is directly related to the commercial success of the venture. Developing countries increasingly seem to recognize these advantages, with net direct investment flows to them rising from about \$2.5 billion in 1970 to nearly \$16 billion in 1982. This represents an average annual increase of 17% in nominal terms and 6% in real terms. In part, the increased emphasis on foreign direct investment reflects growing disenchantment with Socialist experiments in a number of LDCs. Nonetheless, it will be difficult to sustain this real rate of increase in the future, considering the diminished growth prospects of many LDCs and the stiff competition they face from industrial countries, which account for about two-thirds of all foreign direct investment inflows.

5. Need to restore LDC growth

It is in the interest of the industrial countries to tackle the LDC debt issue in a way that will restore economic growth in these countries and improve their living standards as soon as possible. The LDCs are a significant market for industrial-country products, accounting for nearly 40% of U.S. exports (3% of GNP) and one-quarter of OECD exports (4% of GNP). Reductions in their import demand necessitated by the slowdown in international lending was a factor delaying U.S. economic recovery last year, and could dampen the upturn. A uniform 3% cutback in LDC growth, for example, is estimated to lower OECD growth by 0.8% and U.S. growth by 0.5%, and the impact on the United States would be even greater if cutbacks were concentrated in Latin America, as seems likely (see Table 3).

Beyond this, there are also important political and strategic interests at stake. With several LDCs, especially those in Latin America, now facing a third year of austerity, further cutbacks in living standards are likely to increase political and social tensions,

raising the risks of a moratorium on repayment of principal or interest, and at the extreme, outright repudiation.

To reduce these risks, it is imperative that the net flow of resources to the LDCs improve (see Chart 3). The slowdown in LDC growth in recent years has been accompanied by a sharp reduction in net financial transfers to these countries, which in many cases has turned negative. Unless additional official financing and/or foreign direct investment are forthcoming, the overall net resource transfer to the developing countries as a group could turn decidedly negative in the remainder of this decade, especially with interest payments continuing to rise.

Alternative strategies

Any plan for dealing with the international debt issue, if it is to succeed, must come to grips with the various aspects of the problem outlined above. The key objectives for the borrowers are: (i) to restore their creditworthiness by reducing relative debt burdens, (ii) to restructure their debt, especially short-term debt, and establish guidelines for subsequent accumulations, and (iii) to resume moderate economic growth in the next couple of years or so partly by improving overall resource transfers to them. For the lenders, the main goals are to raise their overall capital/loan ratios, to reduce their lending concentrations, and to avoid new surges in international lending.

To some extent, these objectives conflict with one another. Thus, there is need for the LDCs to adjust, and yet restore growth. There is need to reduce relative LDC debt burdens and credit concentrations of banks, and yet continue with new lending. The solutions, therefore, require treading a very narrow path between balance-of-payments adjustment and additional financing. Tilting too far in either direction may jeopardize the entire strategy.

The various proposals to deal with the debt problems fall into three basic classes,

each calling for different degrees of financing and adjustment. One is a relatively optimistic, laissez-faire type school that views the current debt situation as a fairly short-term liquidity issue to be solved primarily through LDC adjustment and reliance on market forces. Such adjustment together with an optimistic assessment of the prospects for a strong OECD recovery – exceeding 4% per annum – would provide a sharp boost in LDC exports and substantial current account improvement. It is felt that banks will restore new lines of financing fairly quickly even if some existing obligations are marked down. Accordingly, adherents to this school downplay the need for stepped-up official assistance, other than on a strictly temporary basis. Some even question the need for an IMF quota increase.

The principal advantage of this approach is that it properly stresses the need for LDC adjustment and recognizes what can be accomplished through sound economic policies. Experience has demonstrated that, in a favorable external context, an individual country's overall payments position can improve significantly within a couple of years following the adoption of sound adjustment programs. Such programs are essential to restore confidence and to create incentives for banks to commit new funds.

Nonetheless, it is also a high risk strategy, and there are serious flaws in using this approach to tackle a global or systemic problem. The chief shortcoming is that it considerably underestimates the time required to reduce the relative debt burdens and to restore the creditworthiness of several of the major LDC borrowers. The strategy may produce a quick current account improvement in individual-country cases, such as Turkey, which adopted an austere stabilization program in a favorable environment of rapidly expanding middle-Eastern exports. However, the same progress cannot be expected of a large group of countries in a less favorable external environment. Moreover, as Turkey's experience attests, even when there is substantial current account improvement, it still may take considerable time for countries to regain normal financial market access. By

ignoring long-term structural elements of the international debt program or overstating the prospects for global recovery, this approach risks forcing excessive costs on both borrowers and lenders. It is also overly optimistic about the willingness of financial institutions ^{To} continue lending.

At the other extreme are proposals that reflect a pessimistic view of the LDC debt situation. Their proponents see the situation essentially as a structural, rather than short-term liquidity, problem that is not solvable by LDC adjustment or OECD recovery alone. The main concern is that current reliance on IMF adjustment programs will jeopardize economic growth in the LDCs, creating political and social strains in those countries, and in turn adversely affect industrial country growth. Their proposals seek to eliminate the debt overhang through a simple magic formula and, in addition, to resume private lending thereafter as soon as possible, albeit in a more orderly way. They call for forgiveness or write-offs of substantial amounts of LDC debt, new institutions to take over bank claims on LDCs at a discount and restructure them, or repayment tied to future export growth. *why magic?*

The virtue of this approach is that it recognizes the severity and duration of the problem, as well as impediments to sustained LDC adjustment if OECD recovery is only moderate. The main shortcoming, however, is that writing off or forgiving portions of existing obligations would reduce incentives for LDCs to honor future obligations and jeopardize new flows of money to the LDCs. Choking off new loans risks precipitating crisis situations, rather than avoiding them, in effect turning good debt into bad debt. The various proposals also ignore important differences among developing countries, applying the same treatment to all borrowers, irrespective of the need for debt relief. As a result, there would be strong incentives for countries to seek debt relief even when they do not need it.

The third approach to the debt issue seeks to balance needs for adjustment and financing, borrowing positive elements from the two former approaches. It recognizes

that considerable time will be required to restore LDC creditworthiness and restructure bank balance sheets and calls for a sharing of adjustment/financing responsibilities among the participants. The industrial countries would strive for economic recovery, while the LDCs would pursue IMF-backed adjustment programs with the goal of restoring moderate growth after a couple of years or so. At the same time, the banks would be called on to supply additional financing and to restructure, but not reduce, existing obligations, while official institutions would provide increased long-term assistance.

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Given the time horizon involved and shocks that could occur, there are considerable risks entailed in this approach. Critical in the defense of this strategy is sustained economic growth in the industrial countries leading to a partial rebound of LDC terms of trade. Without such a recovery, LDC debt service capacity will not improve very rapidly and financing requirements to support moderate LDC per capita income growth of 1%-2% per annum or so will be excessive. There are also risks that sufficient new bank money may not be forthcoming to handle the new financing needs of some of the very high-debt countries or the oil exporters. Moreover, with the industrial countries facing severe budgetary problems, official lending may not be able to fill the financing gap. In that event, even more of an adjustment burden will fall on the LDCs, with attendant political and social risks.

11

Among the alternative strategies, however, this approach is the most attractive in terms of being the least disruptive both to lenders and borrowers. It enables banks to build up their capital and to reduce lending concentrations gradually. It also allows for gradual reductions of LDC debt/export ratios, while requiring prompt adjustments on their part in reducing current account imbalances. Provided all elements hold together, this approach offers a means of resolving the debt problems of most developing countries within about 3-5 years, although it will take longer for some of the very high debt countries. This is borne out in the scenarios elaborated below, which are based on balance of payments

11

models for ten key individual LDC borrowers and for a composite of the 21 principal LDC borrowers.

Medium term scenarios

The base case assumptions about world economic conditions shown in Table 4 reflect current economic policies in the key OECD countries, which aim for a return to noninflationary growth. They envision a moderate OECD recovery beginning in 1983 that gathers strength in 1984-85, averaging 3 1/2% per annum, with 3% per annum growth sustained thereafter. Industrial-country inflation is assumed to rise gradually, from an average of 4% in 1983 to 6% per annum in 1985 on, as measured by wholesale manufactures' prices in local currency terms. Some softening of the dollar is assumed later this year and continuing into 1984-85, but which would still leave it on a real effective basis about 10% above its 1975-79 average. Interest rates as represented by LIBOR for 6-month Eurodollars are posited to decline to an average of 8 1/2% next year and to average roughly 3% in real terms in the second half of the 1980s. Oil prices, as measured by the effective average OPEC price, are assumed to average \$28/barrel in 1983 and to rise to \$32 by 1985, remaining constant in real terms thereafter, which would bring them to nearly \$43 by 1990. Prices of non-oil commodities, as measured by a composite dollar index, are assumed to increase by about 25% between 1982 and 1985, which would reverse more than two-thirds of their nominal decline between 1980 and 1982. In real terms, they would recover only one-quarter of their 1980-82 decline of 21% by 1985 and about two-thirds by the end of this decade.

Under these conditions, it is estimated that exports of goods and services of the 21 major LDC borrowers would grow at an average rate of 13 1/2% per annum in the rest of this decade, while their imports would rise at a 12 1/2% rate. With imports declining again in 1983 and increasing only 10% next year, their aggregate current account

deficit is projected to drop by about \$33 billion, from \$62 billion in 1982 to \$29 billion in 1984. In relation to exports of goods and services, the current account deficit would fall sharply, from 23% in 1982 to 9% in 1984, and continue declining to about 5%-6% in the latter part of this decade (see Table 5). Even with such adjustment, however, total external debt in relation to exports would fall very slowly from nearly 175% in 1982 to about 160% in 1985 and about 120% by 1990.

The overall results for major LDC borrowers are quite sensitive to changes in key assumptions about world economic conditions from those used on the base case. As shown in Table 6, the greatest sensitivity is to the OECD growth rate, where a 1% change from the base case beginning in 1984 can affect the current account balance by about \$12 billion (or 2% of exports) in 1985 and approximately \$90 billion (14% of exports) by 1990. The debt/export ratio would not improve during the remainder of the decade if the OECD growth rate were 1% lower than in the base case. The results are also very sensitive to a 1% per annum change in the terms of trade after 1983, particularly as the effects accumulate through the remainder of the decade. A 20% change in oil prices from those assumed in the base case likewise has significant effects. For the 21 major borrowers as a group, the net effect higher oil prices is favorable, reflecting the fact that the benefits are heavily concentrated among the principal net oil exporters, whereas the unfavorable consequences for net oil importers are more widely disbursed. A two percentage point change in interest rate levels after 1983 has a strong immediate impact on current account performance, although over time the effects are less pronounced than the 1% change OECD growth rate, the 1% per annum change in terms of trade, and a 20% change in oil price levels.

While the baseline results for the major LDC borrowers in the aggregate indicate an overall improving trend in both current account and debt ratios, there are important differences among individual borrowers. The current account performances of most of

the ten individual borrowing countries shown in Table 5 improve substantially by 1985.

The deficits of Argentina, Mexico, and Korea narrow to 5% or less of exports, and Chile moves into equilibrium. Although diminished, Brazil and Indonesia continue to have the largest deficits in absolute terms and relative to exports in 1985, and in 1990 the two are joined by Venezuela.

Current account improvements notwithstanding, debt/export ratios for many of the ten countries shown in the table exhibit only limited declines between 1982 and 1985, indicating that considerable time is required, even under relatively favorable conditions, to reduce relative debt burdens. Brazil's ratio in 1985 is unchanged from last year's level, while those of oil-exporters Venezuela and Indonesia increase, albeit from much lower initial levels. However, Mexico, by virtue of more rigorous adjustment, succeeds in reducing its ratio. By 1985 debt/export ratios of all six Latin borrowers as well as Turkey and the Philippines remain above 160%, the initial threshold based on past experience with debt servicing problems; the ratios for Brazil and Argentina are still above 300%. Even through 1990, Brazil and Argentina remain heavily indebted in relation to exports, while Venezuela's ratio rises above 200%. Korea stands out with its comparatively moderate relative debt level throughout, although by 1990 Chile, Colombia, Mexico, the Philippines, and Turkey bring their debt ratios down to 110%-130%.

As regards financing needs, the additional external debt buildup of the 21 major LDC borrowers is estimated to approach \$350 billion in the remainder of the 1980s, or nearly \$45 billion per annum. This compares with debt buildup of \$375 billion from 1975 to 1982, or almost \$55 billion per annum. The projections imply a growth of LDC external debt of about 7% per annum (less than 1% per annum in real terms), or about one-quarter of the annual rate of increase since the mid-1970s.

In the event that bank lending grew roughly in line, the bank debt of the major borrowing countries would rise by about \$210 billion over the rest of this decade, or by

over \$25 billion per annum. It would mean that banks would continue to supply roughly two-thirds of these countries' external financing requirements in the aggregate. This would leave the remaining \$130 billion of funds to be supplied by nonbank sources, mainly official creditors and suppliers.

The projections raise two sets of questions: (1) Are the baseline assumptions unduly optimistic or pessimistic? (2) Will the amount of new financing envisioned be forthcoming? As regards the first question, the baseline scenario presented must be considered relatively optimistic, for it assumes that the remaining impediments to economic recovery are overcome and are followed by a period of steady economic growth, relatively low inflation, no rise in interest rates, and no shocks or setbacks. Undoubtedly, there could be favorable surprise developments such as a return of private capital inflows in some countries or greater upturns in individual commodity prices than those envisioned. Nevertheless, to base policy on an even more optimistic appraisal risks falling into the trap of assuming the international debt problem away.

As regards the question of financing, there are two issues: Will the banks, which are already overextended to a number of developing countries, extend new credits at a 7% per annum rate, implying 9%-10% annual expansions on the part of the major money-center banks? Will additional official assistance be forthcoming to reduce the burden on the banks and to substitute more long-term development assistance for short-term trade credits?

Assuring new financing

To assure that banks continue to provide the major portion of funds to the developing countries, they must first have confidence that the adjustment efforts and

financing requirements suggested in the baseline scenario are feasible. Above all, they must be convinced that noninflationary OECD growth of at least 3%-3 1/2% is attainable over the rest of this decade, given the sensitivity of the results to the growth rate assumption. Even though U.S. recovery appears on track and monetary policy has been highly accommodative, there is considerable doubt about recovery in Japan and Europe.

Beyond this, lenders must have confidence that adjustment efforts in the developing countries will be sustained and will be particularly strong in the next couple of years. Efforts being undertaken in Mexico are a definite plus, and will help set the stage for an eventual return of private capital. In contrast, the adjustment program in Brazil, which was quickly conceived and had difficulty gaining acceptance from the start, has hampered efforts to rebuild confidence, particularly with slippages in some of the Fund's targets. In the future, it is essential that slippages in stabilization programs are kept to a minimum. In this connection, the Fund and World Bank could play a pivotal, leadership role in overseeing LDC adjustment efforts, coordinating with central banks and other institutions in monitoring debt buildups in these countries, and assuring that cooperative recycling is maintained.

For their part, the banks will have to make adequate reserves provision and to expand capital so they will be in better position to extend new credits to the developing countries. As indicated earlier, if 7%-10% expansion in lending to LDCs is to be maintained, banks will have to augment capital substantially in order to reduce lending concentrations. The recent efforts by U.S. and foreign banks in this direction are a ^{positive} position development. U.S. banks have accelerated capital expansion lately and have also increased allowances for possible loan losses. The regulatory changes proposed by the Federal Reserve, OCC, and FDIC, are helpful by establishing

clearer and more systematic guidelines for the supervision and regulation of international lending. In Japan, banks have been encouraged to set aside reserves of 1% to 5% for credits to troubled countries, and in Europe, there are reports of some banks making provisions for up to 20% of credits to problem countries. In all this, it is important to increase prudence in international lending in such a way as to provide for orderly balance-of-payments adjustment through continued steady flows of bank credits.

As regards official financing, the IMF will serve as the principal source of new funds in the next few years. With the Fund's holdings of usable currencies likely to be virtually committed by year's end, the proposed 47% increase in quotas and enlarged GAB are absolutely essential. Together, they will add some \$25-\$30 billion in usable currencies and enable the Fund to maintain its higher profile. A number of key developing countries already are committed to borrow the maximum allowable over the next three years. In view of the magnitude and duration of adjustments required of some countries and the large financing requirements entailed, the option of permitting them to return to the Fund a second time should be left open. Therefore, rather than to scale back IMF lending limits from ^{450%}~~45%~~ of quota, as some officials have suggested, these limits may have to be liberalized in the future.

It is particularly important that lending by the IMF be supplemented by increased long-term development assistance from the World Bank. In all the recent calls for a new Bretton Woods system, too much emphasis has been placed on the need to reform the exchange rate system and not enough attention has been devoted to the critical issue of development finance and the need to expand the activity of the World Bank. Whereas over the past decade the IMF has undergone a

number of fundamental changes such as the creation of new Fund facilities and the addition of the Article IV provisions covering the exchange rate regime and Fund surveillance, the World Bank's charter and lending policies, for the most part, have remained pretty much intact. Thus, the World Bank's aggregate lending limit is still determined by a strict one-to-one relationship to its capital and reserves, and disbursements of funds are closely tied to the gradual execution of projects, such that they cannot be increased very rapidly. Expansion of World Bank activity is also constrained by a number of self-imposed guidelines.

The World Bank's lending to individual countries is guided, in part, by the principle of graduation, which has been strongly endorsed by the U.S. government. The concept evolved out of a belief that developing countries would be able to obtain ready access to long-term funds for economic development. Many of the World Bank's LDC clients, however, now find themselves heavily loaded with medium-and short-term obligations to commercial banks. And, as a result of recent events, it may be many years before some LDCs regain even limited access to international bond markets. With a number of countries approaching graduation (e.g., Argentina, Brazil, Chile, Mexico, Portugal, and Yugoslavia), current conditions clearly necessitate delay in implementing the graduation process.

In the case of both the IMF and World Bank, ways must be found to increase their leverage in inducing new flows of bank credits to the LDCs without tapping the budgets of the member countries. Current reliance on moral suasion and arm-twisting may work in an emergency for a limited period, but will not be sufficient to ensure adequate bank financing over the long haul. Both institutions, therefore, should be encouraged to consider innovative methods to improve the overall net resource transfer (both private and official) to the developing countries. Whereas

In the past some of the resources of the Fund and World Bank were set aside to assist the poorest countries, thought should now be given to aiding the hard-hit higher- and middle-income LDCs. Conceivably, a portion of the IMF's assets, including \$45 billion in gold holdings, could be set aside for the purpose of insuring or guaranteeing new private credits to developing countries. Just as the Trust Fund, which provides assistance on highly concessional terms to eligible members, was financed from profits derived from the sale of some of the Fund's gold, the proceeds from additional sales of IMF gold or other assets could be provided to developing countries to defray insurance costs.

As regards the World Bank, the main factor limiting its overall activity is the strict one-to-one gearing ratio. Barring a change in the gearing ratio or expansion of the Bank's capital, which is not planned until 1986, the main avenue for expanding World Bank activity would entail creation of a subsidiary that could participate with banks in Eurocurrency syndications. Whereas IDA was established to assist the poorest LDCs, providing long-term assistance at highly concessionary rates, credits extended by the affiliate would be at commercial rates and tied to IBRD project loans. In the event a country failed to meet regular payments on such credits, disbursement of ongoing World Bank project loans to the country would be halted, creating strong incentives for these credits to be serviced. By providing a form of "protective cover" for bank credits, it would help to unleash more commercial bank money.

*Incentives
are not
the problem*

Steps also need to be taken to ensure that additional foreign direct investment is forthcoming. The baseline scenario projects such flows to the major LDCs borrowers to double, from over \$5 1/2 billion in 1982 to \$11-\$12 billion at the end of the decade. This would represent an average annual increase of about 10% in nominal terms and 3%-4% in

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real terms, or about half the real rate of increase as in the past decade. While it will be highly desirable to maintain the trend rate in the 1970s, it will be difficult without a marked improvement in the LDCs' overall external financial position and economic growth prospects. A recent OECD study concludes that, while fiscal incentives or guarantees can help private capital flows to developing countries, the principal determinant is the overall investment climate and economic policies of the host countries. In this regard, the World Bank could play a useful role in advising LDCs on appropriate tax, pricing, and exchange rate policies to attract foreign capital. Beyond this, there is need to clarify and strengthen rules and institutional arrangements to protect foreign investment from government intervention, possibly within a GATT-type framework.

Finally, it is imperative that an open trading system be maintained in order to enhance the LDCs' capacity to service external debt and to reduce their reliance on external borrowing. Current adjustment efforts fall heavily on import reduction, given the weak global environment. Over the longer run, however, efforts need to be directed at export and trade-expansion so that LDC economic growth can be restored. The industrial countries clearly must resist pressures to limit low-cost imports of manufactures from developing countries. But, the LDCs also have an obligation to liberalize their trading regimes and bring them more in line with the standards of the industrial countries.

tlements and pre-printed constituent letters. The issue this time: whether Congress should mandate equal treatment of men and women through the use of "unisex" pricing (BW—Apr. 18) for insurance policies and pensions.

A change in the practice of charging women less, because they live longer and have better driving records than men, would cost insurers \$1 billion or more, they claim. But the lobbying is making the \$525 billion insurance industry itself the issue, and a possible target for retaliation.

"I'm not saying there will be a cause and effect relationship" between the lobbying campaign and a possible congressional crackdown on the industry, says Representative James J. Florio (D-N.J.), chairman of the House Energy & Commerce subcommittee that drafted the unisex legislation. "But to the degree the industry has demonstrated a lack of sensitivity, they are going to have some attention on them, I suspect."

Florio has told the Senate Commerce Committee that, as a result of the campaign, "some members are talking about the continued validity" of the 35-year-old federal policy of leaving insurance regulation to states. And, he added, "we have members of the House Ways & Means Committee feeling there is a need to look into the system of taxation on insurance companies." Florio's subcommittee already has voted to ask the Federal Trade Commission to examine three areas in which, he suggests, uneven state-by-state regulation may be leading to unnecessarily high rates and fewer available policies. Staff members of the Senate Finance Committee and Ways & Means acknowledge that special tax treatment enjoyed by the industry is a likely target if Congress decides to seek new revenues.

'BLINDSIDED.' Two factors particularly infuriate Florio and Senate Commerce Chairman Bob Packwood (R-Ore.), author of legislation identical to Florio's Fair Insurance Practices Act: The timing of the \$900,000 lobbying effort by the 14-company Committee for Fair Insurance Rates and the campaign's reliance on facts disputed by congressional staffs. Both legislators negotiated with the industry for two months to soften the impact of the bill on insurers; the deal that evolved eliminates the original bill's retroactivity provisions that would have required equalizing premiums and benefits for all policies currently in effect and delays implementation of the law.

But the industry broke off the talks and began its campaign to kill the legislation outright, including mailings to 500,000 constituents of 31 congressmen who serve on panels considering the bill—a move that both Florio and Packwood feel is evidence of bad-faith bar-

gaining. Packwood, for example, says he was "blindsided" by the industry.

The industry's lobbying group, the American Council of Life Insurance, however, was torn by dissension that caused it to change strategy. The ACLI board—led by Robert A. Beck, chairman of Prudential Insurance Co., the nation's largest insurer, opened talks with Florio and Packwood in mid-March because the board wanted to soften legislation it thought was sure to pass. But on May 12, a special meeting of ACLI's members voted 382-102 to reverse the board and oppose the bill. "We thought we had a gun to our heads before," says Robert N. Houser, chairman of Bankers Life Co. and a board member of the ACLI.

Spearheading the bitter industry campaign are 14 ACLI members including Allstate Insurance, Nationwide Life Insurance, and Travelers. They contend that even without retroactivity, eliminating differences based on gender would cost women \$360 million a year more for life

insurance and \$700 million for auto insurance to offset current differentials in their favor. "The irony is that this is being passed off as something that will help women," says George Bernstein, an attorney representing two of the 14 ACLI member companies.

T. Lawrence Jones, president of the American Insurance Assn., which represents property and casualty companies, worries that the acrimony will outlive the legislation. "It's a darn shame that it's gotten down to personalities and not substance," he says. Florio agrees, although he pledges that compromises already worked out on retroactivity and implementation will be honored. He has attracted 125 cosponsors to his legislation, including at least three targeted by the lobbying blitz. "What they are doing is probably foolish," he says. "After what we went through with withholding, there are a lot of people who see this as their opportunity to get their backs up and fight back." □

WORLD TRADE

THE HIGH COST OF KEEPING BRAZIL AFLOAT

The multibillion-dollar financial bailouts hastily stitched together just a few months ago for Latin American debtors are already unraveling. The Brazilian government has announced that the International Monetary Fund is withholding \$411 million it was scheduled to pay Brazil on May 31 as the

World debt crisis. The fund's delay will hold back Brazil's receipt of a \$634 million installment on a \$4.4 billion "jumbo" credit from commercial banks that is tied to the IMF loan. That will prevent Brazil from meeting more than \$700 million in payments to commercial banks and the Bank for International Settlements that are falling due—added to \$800 million in Brazilian debt payments that are already in arrears.

But if the IMF disburses the money to Brazil despite its failure to fulfill its promises, Mexico, Argentina, Peru, and other debtors in equally desperate straits will demand that the fund ease austerity measures imposed on them as a condition for getting similar bailouts.

LITTLE CHOICE. The inability of Latin American debtors to meet their financial targets means that they will need an additional infusion of \$20 billion to \$30 billion in 1983 and up to \$30 billion in 1984 to keep them afloat, experts predict. Otherwise, they will almost certainly default.

The crisis leaves the biggest U.S. banks, which hold \$16.4 billion of Brazil's debt (table), with little choice but to pump even more money into Brazil. U.S., European, and Japanese commercial banks rolled over \$4 billion of maturing Brazilian debt last February, besides lending \$4.4 billion of new money.

But now, regional U.S. banks and European banks are refusing to renew in-

WHAT BRAZIL OWES U.S. BANKS

ESTIMATED GOVERNMENT AND PRIVATE LOANS OUTSTANDING

	Billions of dollars
Citibank	\$4.6
Chase Manhattan	2.4
BankAmerica	2.3
Manufacturers Hanover	2.0
Morgan Guaranty	1.7
Chemical Bank	1.3
Bankers Trust	0.9
First Chicago	0.7
Continental Illinois	0.5

SOURCE: KEefe BRUYETTE & WOODS, BW

second installment on a \$4.9 billion rescue loan granted last February. The IMF is concerned about Brazil's failure to live up to its pledges to curb inflation, cut deficit spending, and carry out other belt-tightening measures.

Eventually, to avoid pushing Brazil into default, the IMF will probably have to part with the money anyway. But its reluctance signals the onset of a new and more dangerous stage in the Third

terbank credits to Brazilian commercial banks. Interbank credits—very short-term loans from one bank to another—have already dropped to around \$5.7 billion, which is \$1.8 billion below the amount called for in the February package, and the big U.S. money center banks will have to put up more funds to avoid further shrinkage. Since U.S. banks have the largest exposure in Brazil, "it will be up to the large American banks to buy out the smaller banks," says Chusuke Takahashi, deputy president of Japan's Sumitomo Bank Ltd.

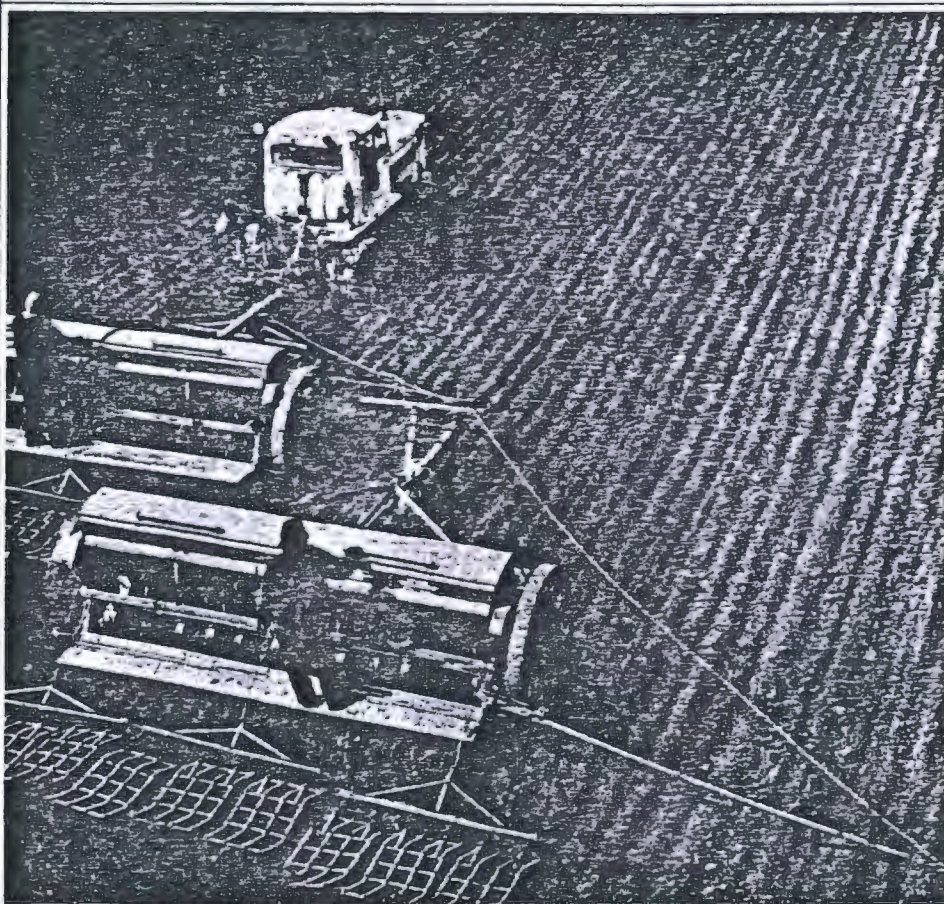
So far \$600 million in interbank credits have been dropped by 40 to 50 U.S. regional banks, led by Dallas' Interfirst Corp., the 14th-largest U.S. bank. The prospect of Brazilian requests for still more cash "is a subject we are not anxious to consider," says William E. Gibson, senior vice-president at Dallas' RepublicBank Corp. European banks—mostly Swiss, French, and German—are also putting pressure on the major U.S. banks by withholding more than \$1 billion in interbank credits to Brazil.

TREMENDOUS ERROR: There is increasing disagreement even among central banks about how the Brazilian crisis should be managed. The Bank of England—concerned about the \$2 trillion Euromarket, based mostly in London—is backing U.S. efforts to keep Latin American debtors afloat. But Continental European central bankers are standing behind the technical arguments against including interbank credits in any rescheduling package and are instructing their major banks to hold out against pleas for help from the U.S. Treasury, the Federal Reserve Board, and the IMF.

Brazil's latest crisis is caused in part by unrealistic trade and financial projections used by banks, the IMF, and the Brazilian government as the basis for the initial, hasty bailout. The rescue package was based on an estimated \$6 billion Brazilian trade surplus in 1983 that is more likely to be around \$4 billion, many observers believe. Concedes a Belgian banker: "There was a tremendous error in calculating how much financing was needed."

As a result, Brazil will need an estimated \$3 billion of new cash to get through the rest of this year and an additional \$5 billion next year. But there is growing talk in Brazil—most recently from several business associations—of calling a moratorium on debt payments rather than sinking deeper into debt. Whatever the outcome, the main impact will be on the U.S. "The European central banks believe, in the end, that Brazil and other Latin countries will become wards of the U.S.," says a Reagan Administration official. "And if there is a default, they expect the Fed to step in and save the U.S. banks." □

MOSCOW WILL HAVE THE EDGE IN NEW GRAIN TALKS



PLANTING IN RUSSIA: THIS COULD WELL BE THE BIGGEST HARVEST IN FIVE YEARS

After more than two-years of indecision, the Reagan Administration is about to begin talks with the Soviet Union on a new multiyear grain agreement. But bumper crops worldwide and the bickering among U.S. farm interests and federal agencies have so weakened the Administration's position that the Russians will arrive at the table in London on June 1 holding nearly every strong card.

Because the U.S. is now considered to have vast overcapacity to produce grain (BW—Mar. 21), the Administration's foremost goal is to get a new pact requiring significantly larger annual orders by Russia. Thus, U.S. negotiators will probably propose nearly doubling the current minimum required level—6 million metric tons of corn and wheat. Knowing the Administration is under pressure to increase exports, the Soviets will take an extremely hard line in response, suggesting that the minimum order level be lowered or even eliminated.

Moreover, unless Russia suffers a crop catastrophe this summer, Soviet negotiators will have every incentive to delay the talks. "No American farm organization is going to be completely

satisfied with whatever the Administration brings home," says Michael L. Hall, Washington representative of the National Corn Growers Assn. "But if the talks stall, that would be an even bigger political setback."

TURNING THE TABLES. Ironically, the situation is nearly opposite that of 1976, when the U.S. entered the agreement mainly to limit Soviet orders after a secret Russian buying binge in 1973 sent U.S. food prices skyrocketing. In addition to the 6 million-ton minimum, the agreement—which has been extended twice beyond its scheduled expiration in 1981—prohibits sales above 8 million tons without prior approval from Washington. It is now due to expire on Sept. 30. But until recently, hardliners in the Reagan Administration successfully blocked negotiation of a new pact on the ground that the U.S. needed to retaliate for Soviet actions toward Poland.

In the meantime, the Soviets effectively diversified their sources of grain. In the marketing year ending June 30, for example, 80% of projected Russian imports—which could total 34 million tons—will come from Canada, Argentina, Brazil, and other exporters. In con-

END THE GAMES THAT THE IRS PLAYS

When Congress enacted President Reagan's three-year tax cut, it thought, among other things, that the resulting gain in disposable income would give a needed boost to the economy. But Congress reckoned without the Internal Revenue Service, which used the power vested in the Treasury to manipulate tax-withholding rates to play its usual games with the taxpayer. The IRS, which seems to believe that most taxpayers are (or long to be) tax cheats, assumed that everyone would leap to cut their withheld taxes by abusing the system of withholding allowances. To make sure that this would not happen, the service, by fiddling with maximum tax rates, in essence countered by overwithholding upper-income taxpayers.

The IRS was wrong. Everyone did not underwithhold, and the result has been a bulge in the money supply in May. That in turn so unnerved the money markets that interest rates started rising again, threatening the health of the baby recovery. What is so irritating is that the culprit is the IRS rather than the Federal Reserve Board, which is supposed to control these things.

Because the IRS overwithheld, the mails have been full of tax-refund checks recently. In addition, the IRS delayed refunds to early filers, dumping those refunds into May. Meanwhile the Fed, which seasonally adjusts the money supply figures, continued to use its usual modifiers, further distorting its numbers.

The lesson is clear. When making fiscal policy, the Congress should be concerned about the economic impact of what it is doing. It should also take care that the IRS not frustrate that aim.

THE REAL VIRTUE OF THATCHERISM

Contrary to the popular impression, the principal achievement of Prime Minister Margaret Thatcher's first four years at the head of the British government may not be her record in reducing inflation from more than 20% to 4% in April. After all, Thatcher did not exactly accomplish that with finesse, since it was the result of a particularly nasty recession during which unemployment exceeded 13%. In retrospect, the real accomplishment of Thatcherism may prove to be a singular change in the atmosphere of British labor relations (page 50).

What seems to be happening is astonishing, even if one discounts the chastening effect of recession on what workers demand. In a society in which labor militancy and confrontation have been constants through good times as well as bad since the 1920s, employees have in some cases refused to back strikes called by their leaders. In even more cases, workers are listening with interest to arguments that productivity and competitiveness in international markets are intimately connected. Thatcher has managed to marshal some popular support for new laws that restrict organizing ability and make unions legally liable for damages caused by some of their actions. And she has steadfastly tried to keep the government out of the collective bargaining business. In several instances, potentially damaging strikes have simply collapsed.

It is, of course, not easy to overstate the case for a

permanent shift in economic power in Britain. So far, the climactic change in labor relations has taken place in part because jobs are scarce and workers are frightened and demoralized. It is unclear whether the Prime Minister's ability to reduce the power of the trade unions will survive, say, the serious shortage of skilled workers that could develop during a sustained recovery. One of the most positive signs that the change will be lasting, however, is that few strikes or disputes have occurred throughout most of private industry, including such key sectors as computers.

The next task is to work on Britain's managers. Although they have had some unaccustomed successes in wage negotiations recently, the managers must do several things if all the gains are not to be thrown away. First, they must resist the temptation to confront labor at any cost. They must also abandon their traditional contempt for the people who work for them. And last of all, they must not subside into that lethargy in the face of union power that characterized British management for years.

What may save the situation is that Thatcher, whatever her limitations, has brought more excitement and resolve to the job of running Britain and motivating its people than anyone has in decades. In fact, she is the nation's first real leader since the end of World War II. And while it is fashionable to deprecate the critical role of a leader in changing people's minds, Margaret Thatcher may succeed in changing the mind of Britain.

SHARING THE RISKS OF THIRD WORLD DEBT

Here comes round two of a worsening Third World debt crisis. Brazil has failed to live up to the conditions of a bailout hastily cobbled together a few months ago, and other Latin debtors face similar problems. Yet they will still want disbursements of credits from the International Monetary Fund. And soon they will ask for more money from international agencies, from Western governments, from private banks.

The industrial nations have little choice but to try to keep Brazil, Mexico, and the others afloat until, one hopes, economic recovery in the industrial world boosts their export earnings enough to cover their debt service. These nations cannot tighten their belts much further without risking serious domestic political upheavals. And if a major country is forced into default, the international financial system risks severe contraction that would plunge the world back into deep recession.

In financial rescue efforts to head off something that unthinkable, the immediate beneficiaries are the banks, most of them U.S. institutions, that have lent \$115 billion to Latin America and still reap big profits from those loans. But no one else will do very well out of it. Ultimately, the cost of bailout funds supplied by the IMF or by governments will be borne by Western taxpayers. If it is to give more credits, either direct or through such agencies as the IMF, the U.S. government must require at least that American banks limit their interest rates and fees from these loans, and deposit the income in loan-loss reserves rather than pay it out in dividends. Nor should the banks receive interest or principal payments before the Treasury, the Federal Reserve, or any agency financed by the taxpayers.

The banks and their shareholders must accept real risks as the counterpart to their profits from foreign lending. Otherwise, even the specter of an international financial crisis will not persuade U.S. taxpayers to help keep either foreign debtors or their U.S. bank creditors afloat.

Fact Sheet

International Monetary Fund

The International Monetary Fund was established by the Bretton Woods Conference to promote a cooperative, stable monetary framework for the world economy. The IMF Articles of Agreement provide the rules for the international monetary system and the IMF is responsible for guiding the operation and evolution of the system. One of its major functions is to provide temporary balance of payments financing in support of countries' efforts to deal with their external financial difficulties. IMF financing is conditioned on the borrower adopting internationally responsible economic adjustment policies designed to correct its balance of payments problems and ensure repayment to the IMF over the medium-term.

The IMF has two departments: a "General Department" and a "Special Drawing Rights (SDR) Department." All IMF transactions are denominated in the SDR which is valued on the basis of market exchange rates for the major currencies. The General Department provides financing based on members' quota subscriptions; the SDR Department conducts transactions in SDR and upon decisions by the membership, can create international reserves through allocation of SDRs.

General Department - The resources of the IMF are largely derived from members quota subscriptions, paid in local currency and reserve assets, and can be supplemented by borrowing. Quotas also determine a members access to IMF financing and voting power and provide the basis for SDR allocations. Quotas currently total SDR 61 billion (equivalent to 67 billion dollars assuming a \$/SDR rate of about \$1.10). The U.S. quota is SDR 12.6 billion (\$13.9), roughly 20% of the total, and represents a U.S. voting power of 19.5%. The IMF is essentially a revolving fund of currencies, and financing operations take the form of foreign exchange transactions with members.

Congress is currently considering legislation providing an \$8.4 billion increase in U.S. participation in the IMF. This is part of an overall increase in IMF quotas.

The quota subscriptions of members in strong balance of payments positions at any given time are used by the IMF to finance drawings by other countries facing balance of payments difficulties. As repayments are made to the IMF, the quota subscriptions of earlier creditors are restored. Financing thus flows back and forth through the IMF, depending on balance of payments patterns and financing requirements at any given time. Although the U.S. quota subscription has been drawn upon many times over the years, U.S. drawings on the IMF are the second largest of the entire membership.

Special Drawing Rights Department - The SDR facility was created in 1969 to supplement existing reserve assets. SDR operations differ from other IMF operations in that SDR allocations represent the creation of an international monetary reserve asset, rather than an extension of temporary financing by the IMF. SDRs are allocated to member countries in proportion to their quotas, and are available to members to meet balance of payments financing needs.

Fact Sheet

The World Bank Group

The World Bank Group consists of three principle institutions: the International Bank for Reconstruction and Development (or the "World Bank") the International Finance Corporation and the International Development Association.

International Bank for Reconstruction and Development (IBRD)

Following up on a U.S. proposal to the Bretton Woods Conference, the IBRD was formally established in 1945. It is owned by 144 countries which are the member countries of the IBRD. The Bank's capital is subscribed by these member countries and it finances its lending operations primarily from its own borrowings in the world capital markets. Retained earnings and flow of repayments on its loans also contribute to the IBRD lending resources. IBRD loans generally have a "grace period" of 5 years and are repayable over 20 years or less. They are directed toward developing countries at more advanced stages of economic and social growth. The interest rate the IBRD charges on its loans is calculated in accordance with guidelines related to the Bank's cost of borrowing.

The Charter establishing the Bank outlines certain rules which govern bank operations. Among these, the Bank must lend only for productive purposes and must stimulate economic growth in the borrowing country.

International Finance Corporation (IFC)

The IFC was established in 1956 to assist the economic development of less developed countries by promoting growth in the private sector of their economies and by helping to mobilize domestic and foreign capital for this purpose. Membership in the IBRD is a prerequisite for membership in the IFC (which totals 124 countries). The IFC is legally and financially distinct from the IBRD but draws upon it for administrative and other services.

The IFC's portfolio investment contains loans and equity investment in 485 companies located in 81 developing countries.

At the end of the Bank's Fiscal Year 1983, the IFC's investment portfolio held for its own account was \$1.88 billion. In addition, \$1.12 billion was being held and administered for participants in IFC financing.

International Development Association (IDA)

The IDA was established in 1960 to provide assistance for the same basic purposes as the IBRD, but targeted primarily in very poor developing countries. There were more than 50 eligible recipients of IDA funds as of June 30, 1983. Membership in the IDA is open to all members of IBRD and 131 have joined to date. The funds used by IDA are called "credits" in order to distinguish them from IBRD "loans." IDA's funds come mainly from government contributions and are extended on concessional terms. IDA credits have a 10 year grace period, 50 year maturities and no interest. A service charge is payable at the rate of 0.75 percent on disbursed balances, and a commitment charge of 0.5 percent is payable on undisbursed balances. The Association is legally and financially distinct from the IBRD but has the same staff.

LONG TERM PLAN FOR RESCHEDULING DEVELOPING COUNTRY DEBT

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Introduction

It has been one year since the debt crisis erupted in the financial markets and some observations can now be made concerning the events of the last 12 months.

On the positive side is the fact that, so far, the crisis has been contained. This is principally due to a perception by all parties of the strong commonality of interests that exists to avoid a default, which in turn has brought unprecedented co-operation between Governments, International Official Financial Agencies and the Private Banking sector.

However, at this point, strains are starting to appear as the realisation of the magnitude of the problem starts to sink in. Indeed, questions are being asked on matters such as :

- a) The ability of borrowers to service their debt despite the measures already taken and the need to reschedule further large amounts of debts now becoming due.
- b) The adequacy of the resources of the Official International Agencies despite the agreed upon increases under way.
- c) The possible contradictions implied by the need to implement austerity programmes in many countries at a time when the economic recovery is still fragile limiting export markets and putting in jeopardy the possibility of new job creation.

Within this framework the decision to maintain, let alone to increase, loan exposure to troubled borrowers is becoming increasingly difficult. Official institutions and Governments are forced to husband their resources and the

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Private sector is unwilling to provide the additional resources because it cannot rationalise the cost of a workable solution.

So far it is the "deterrent" value of the consequences of a financial crisis that has held the system together, but as in the case of armaments, if the deterrent loses its credibility then its value disappears also.

The World is presently in a very fragile equilibrium and even a small incident could have vastly disproportionate consequences affecting not only the financial and economic scene, but leading to the possibility - if not probability - of social and political upheaval.

It is against this background that the need to concentrate on a long term solution to the international debt crisis is becoming a top priority.

The objectives pursued are several and include :

- 1) Rescheduling developing country debt on a long term basis on terms that are perceived as being realistic.
- 2) Restoring the perception of solvency to the banking system independently of the ability of sovereign borrowers to meet their commitments.
- 3) Reinforcing the resources of International Financial Agencies so as to ensure their ability to perform their function within the rescheduling process.

The plan outlined hereunder does not underestimate the difficulties to be overcome to implement the proposed ideas. It attempts, nevertheless, to provide a coherent framework within which to reach the stated objectives and also pays due consideration to political and economic realities.

Description of the Plan

The plan centers around the partial transformation of the role of the three International Financial Agencies : the IMF, the World Bank and the I.D.A.

As a first step, member countries of these institutions would be asked to agree to underwrite increases in the resources of all three agencies covering a period of 15 years with funds being provided in instalments between the 5th and 15th year. For purposes of this discussion we assume that commitments totalling the equivalent of U.S.\$ 400 to 500 billion can be obtained.

Strengthened by the commitments of their members, the three institutions, working through the IMF acting as their agent, would purchase at par value up to U.S.\$ 500 billion of loans subject to rescheduling, from the banking sector. Payment would be in the form of 15 year IMF bonds amortising on a schedule corresponding to the commitments of capital contributions subscribed by the member Governments. The interest rate would be set at say 5% p.a. In order to enhance the attractiveness of the bonds, Governments would be able to satisfy their capital contributions by tendering these IMF bonds at par value.

As a third step the IMF would renegotiate the acquired debt with the borrowers on a long term fixed rate basis, tailoring each package to the specific circumstances.

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Discussion

Taking the objectives mentioned hereabove in order, such a plan would :

1. Reschedule the developing country debt on a realistic basis : Agreement would be facilitated by having bilateral rather than multilateral negotiations allowing for much more flexibility in the restructuring packages. By lessening the current burden of debt servicing, the borrowers would release new borrowing capacity (carefully controlled) which would contribute to the fuelling of an economic upturn.
2. Restore the perception of solvency to the Banking system : By substituting claims on the three World Agencies, underwritten by their members for, at best, doubtful claims on troubled borrowers, the banks would instantly remove the difficult question of providing loan loss reserves against those assets and thereby restore adequate capital solvency. This would put the banks in a position to raise additional equity capital more easily from the market and help further expansion, including a resumption (carefully controlled) of lending to the developing world. This capacity would match the Borrowers ability to take on such new commitments as described hereabove.

The proposed 5% rate on the IMF bonds would be "penal" to the banks making them absorb a significant but manageable share of the rescheduling burden without impairing their solvency. The ability of the member Governments to tender the bonds in lieu of contributions would give the monetary authorities in each country the necessary flexibility to support their own banking

system, if necessary, through negotiated repurchases of IMF bonds. In addition, value could be also given to these bonds by the creation of an active secondary market.

3. Reinforce the Resources of the International Agencies :

The negotiation of long term capital contributions to the three agencies would permit each of them to continue to carry out even more effectively their existing mandates without the vexed question of periodic reviews rearing its head and thereby permitting long term planning. This would be particularly useful for the I.D.A. and would have the advantage of providing out of this whole plan some tangible benefit for the poorest countries in the World who did not have the "ability" to get into debt problems in the first place.

It would, therefore, appear that the suggested plan could find support from a broad base of interested parties as it provides tangible benefits for the Borrowers, Lenders, Governments and International Agencies not to mention the overwhelming benefit to the free world of avoiding a financial crisis.

As stated in the introduction this crisis has so far been avoided mainly by "fear" of its consequences. The time has now come to replace fear by a constructive approach to the problem supported by the political will to succeed.

P.N. Goldschmidt

27 June 1983

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THE LDC DEBT PROBLEM: CURRENT OPTIONS

Introduction

This memo reviews the framework for deciding on the external financing needs of the LDC debtor nations. The example of Brazil is discussed in detail. There are two key questions to be decided at the present time: (1) What level of imports should Brazil be allowed to finance in 1984 and the remainder of 1983? (2) How shall the proposed lending to Brazil be kept flexible so that it can respond to changing conditions that are beyond Brazil's control, especially changes in the interest rate on its debt?

Background

Since the onset of LDC liquidity problems in the summer of 1982 the U.S. has supported the IMF in a strategy which balances strong adjustment measures by debtor nations with a continuing flow of finance. This overall strategy has not changed. It was recognized from the beginning, however, that details of the strategy would have to be adjusted over time. In particular, the Administration foresaw the likelihood of a "second round" of liquidity problems requiring revision of IMF programs and their associated financial packages. Brazil has now initiated this second round. Other debtors will follow.

The broad outlines of a solution to the current liquidity problems have begun to appear. Commercial banks will continue to be major providers of finance, through new syndicated loans. IMF and private lending will, however, be supplemented by additional official loans and guarantees, largely in the form of export credits. The details of this second round refinancing, however, remain uncertain. There is also an opportunity now to remove some of the inflexibilities of the original package.

Current Account Targets

The key issue at this point is the size and rigidity of current account targets. Note that the current account deficit equals imports plus interest payments paid to creditors abroad minus export earnings. A debtor country must finance its current account deficit by borrowing from the IMF, from commercial banks and from governments.

The IMF programs of 1982 and 1983 were different from the usual IMF procedure in the way that the current account targets were set. Under normal circumstances the IMF tries to ascertain a sustainable current account balance based on a country's future ability to service its debt. It then agrees with the country on an adjustment plan to move the country to that balance. In the most recent wave of debt refinancings, however, long run considerations did not play the usual primary role in the setting of current account targets. Instead, the

current account targets were determined by the IMF's estimate of the likely available supply of finance. The IMF made a judgement of the maximum rate of increase of exposure that banks would be willing to accept, and this determined the overall level of capital inflows and thus the current account. (Of course, even if the commercial banks had been willing to lend more, the IMF would not have wanted to see substantial increases in the debt in excess of what was actually available). To achieve these current account targets required abrupt, drastic reductions in imports by the debtor nations. These reductions in imports forced the debtor nations to reduce their domestic levels of economic activity and income, thereby causing severe austerity conditions.

Additional Resources

With additional official finance to be provided in 1983-84 (by Ex-Im and other U.S. and foreign sources) the current account targets should be reexamined. Although the additional financial resources could simply be used to substitute for private capital flows (i.e., reducing the rate at which bank exposure grows over the next eighteen months), it would be preferable to reduce the risks of the current programs by revising the financial plans to loosen somewhat the import constraints on debtors and to increase the flexibility of financial flows.

The case for looser constraints rests on the fact that the remarkable improvement in the 1983 trade balances of the debtor nations has been achieved almost entirely through drastic cuts in imports. The import reductions have gone beyond discretionary items and now cut into basic inputs for the domestic industries of the debtor nations. These import reductions are therefore provoking severe recessions. The social and political risks are obvious. At the same time, relatively small amounts of additional finance could ease the situation considerably. For example, a billion dollars in additional capital inflow could raise Brazil's GNP growth in 1984 by about \$5 billion, a rise of about 2 percentage points in Brazil's GNP.

Interest Rate Uncertainty

A problem that is as serious as the tightness of the import targets is the fact that rigid current account targets lead to great uncertainty about the quantity of imports a debtor country will be able to afford. For the debtor countries, both export receipts and interest payments are hard to forecast. If countries are required to stay within rigid current account targets, a shortfall in exports or a rise in interest rates forces an immediate offsetting reduction in imports. This can have major destabilizing effects on domestic growth. For example, a two percentage point rise in LIBOR -- by no means out of the question -- would raise Brazil's debt

service by more than a billion dollars and could cut GNP growth by as much as 3 percent.

What I propose is that we take advantage of the current reconsideration of the debt situation to revise our financing approach in a way which reduces the downside risks. The main point would be to enable debtor countries to sustain slightly higher and more stable levels of imports.

A Two-Part Suggestion

There are two ingredients to this approach. First to reduce the expected austerity, the Ex-Im funds and any other official financing should not be used just as a replacement for commercial bank lending. Most of the extra official financing should be aimed at increasing the import targets for the debtor nations. Second, to reduce the uncertainty about import levels, the rate of financial inflow promised by the commercial banks, IMF and other government lenders should be explicitly contingent on the level of interest rates. Thus the danger that a rise in interest rates might set off a new crisis would be reduced.

An Example: Brazil's Financing and Imports in 1983 and 1984

In the IMF's original Brazilian adjustment plan it was assumed that banks would only be willing to increase their total lending to Brazil by 7 percent in 1983, representing net lending of \$4.4 billion. By comparison net lending was \$8

billion in 1982. Together with IMF funds and other smaller sources, this was estimated to be enough to finance a 1983 current account deficit in Brazil of \$7 billion. The projected sources and uses of international finance for Brazil in 1983 were as follows:

Brazil: Projected Sources and Uses of Foreign Exchange in 1983

(\$ billion)

Sources of foreign exchange:

Exports	22.0
Net bank lending	4.4
IMF and other net credit	<u>2.6</u>
	28.0

Uses of foreign exchange:

Interest on	
international debt	9.0
Insurance,	
transport, etc.	4.0
Imports	<u>16.0</u>
	28.0

Since this plan was set out, a number of difficulties have arisen. Although Brazil's export performance appears to be on track, interest payments will be slightly higher than anticipated. More important, financial flows have been less than anticipated primarily because of a failure of smaller

banks to maintain their short-term credit line but also because of shortfalls in direct foreign investment and supplier's credits. It is generally believed that \$3-1/2 to 4 billion will be needed to sustain the originally planned level of imports.

Looking ahead to 1984, current estimates suggest that net bank lending of about \$4-1/2 billion would be necessary even to sustain the 1983 level of Brazilian imports, which was itself more than twenty-five percent below the 1981 level. In fact given the difficulties which have been encountered in getting banks to lend so far, it has been suggested that banks might not lend more than \$3 billion. In the absence of additional official resources, this would force a further ten percent cut in imports.

In providing additional official finance, there is both a question of the amount of resources provided and the way those resources are used. At one end of the spectrum, the resources could be used principally to relieve the burden on the banks. At the other end, the resources could be used principally to permit expanded Brazilian imports.

The following table illustrates five hypothetical scenarios for Brazilian financing in 1984, and their consequences. I think we should discuss these alternatives as soon as possible.

In addition to discussing where on this spectrum we should attempt to go, we should also discuss two other issues. First,

we should discuss the possibility of additional financing in 1983. Second, we should examine ways to make 1984 financial flows contingent on interest rates, so that a rise in interest rates, should it occur, will not provide a new crisis.