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Remarks by

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Permit me to summarize where I think we are at this juncture on the implementation of the recent initiatives announced by U.S. Secretary of Treasury Brady:

I think the sooner a transaction is executed, the better. Expectations are quite high. Frankly, it doesn't really matter whether the transaction results in reduced cash outflows from the debtor countries. Indeed, most debt relief and debt reduction proposals will not significantly affect how much debtors will actually pay, over and above the funds lent to them. The fact is, in recent years, many are meeting only about half of their debt service obligations -- the balance coming from the banks themselves. The great advantage, however, of Secretary Brady's initiative is that it is politically attractive in debtor countries. If executed, the initiative could forestall calls for

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moratoria or cessation of payments; it could diffuse radicalized movements in countries with fragile political systems; it could even contribute to the repatriation of flight capital because it could remove the uncertainty of protracted, contentious negotiations for new money packages. The new initiative certainly will be described in a manner which makes it seem as if the burdens on the debtors are lessened. That, too, is a reality which may be just as important as the real effect on the borrowers' actual external payments.

The dangerous scenario is not to execute any meaningful transaction, or to create exaggerated expectations that, by magic, debtors will be supplied with cost-free funds to buy back enough debt so that what remains will result in a meaningfully lower burden than what they are now paying. That will not happen -- given the magnitude and sources of the funding.

I cannot emphasize that point too much. Most commentators on Secretary Brady's initiative confuse two separate aspects: the actual cash flow burden on the debtors versus the accounting effect of the transaction on the creditors. They are <u>not</u> reciprocals of each other. In part, the confusion occurs because the terms "debt relief," "debt forgiveness" and "debt reduction" are typically used to describe the effect on the creditors' books and records after the transaction is executed, and do not describe the before and after actual cash flows of the debtor net of new lending.

But the way that debt reduction is recorded on creditors' books has little to do with the actual cash savings of the debtor, that is, the net interest paid by debtors to creditor banks. For example, if a debtor owes, say, $4 billion in interest in a given year on $40 billion of debt outstanding, and the banks, as part of a "new money" package or otherwise, increase their exposure during the year by lending, say, $2 billion, which is then "round-tripped" back to them, then the net burden on the debtor's economy in that year is $2 billion, not the $4 billion interest "paid." Therefore, if subsequently, a debt reduction or debt relief scheme were implemented (even assuming it costs the debtor nothing) which enables the debtor to buy back half of its debt or reduce its interest payment obligations by half, the debtor, still required to pay interest on the remaining half, would have the same <u>net cash outflow burden</u> as before the transaction were executed. It is only under conditions when the debt reduction or debt relief transaction is (a) cost free, (b) in substantial magnitudes, or (c) accompanied by new lending, that debt reduction schemes will, in fact, result in a lesser burden than before. This is not to say that the initiative is insignificant, for there are great political and image advantages to debtors, and it is in the interest of creditors to accurately reflect the real world. But let us not pretend that when we finally accurately reflect reality, that we are changing it.

One of the reasons why the proposals now being considered are not

likely to have a substantial cash flow impact is because international institutions have constrained resources and competing demands for money or guarantees from other developing countries who are not part of the debt crisis and who have performed well. They cannot overcommit limited resources to a few countries in Latin America. IFI's also have to satisfy constituencies in the credit markets who look carefully at their policies and programs in deciding whether to provide finance.

I, therefore, have urged, in other writings, the establishment of an affiliate which would take guarantees and much new lending to the heavily indebted debtors off the books of the development banks. But I do not want to get technical here. We should be aware, however, of what the World Bank can do, by way of additionality, in implementing the Brady initiative within its current financial and capital structure. Indeed, I suspect that whatever the World Bank makes available by way of permitting buy-backs of debt, the debtor country will receive that much less from the Bank, almost dollar for dollar, for imports of goods and services needed to maintain their exports.

I would urge also that we understand that whatever the transaction under the new initiative, it will not remove the need for debtors to take painful adjustment measures in their own economies; indeed, it will likely increase those pressures as credit enhancement or guarantees from international financial

institutions will assuredly be accompanied by considerable conditionality. Indeed, whatever the financial engineering, it should be tranched in a manner in which the economic reforms can be monitored over the medium and long term. In short, the international institutions must retain the continuing leverage to insist on structural economic reform in debtor countries.

Despite what I think will be a rather modest role as compared to the magnitude of the problem in the very heavily indebted countries, there remains the risk that in some countries official guarantees or credit enhancement could be quite significant. Then, there might be little alternative in the debtor country but to default to official institutions during periods of stress if they have assumed a substantial portion of the debtors' remaining external indebtedness. In short, therefore, there always should be substantial risk left with the commercial banks in all countries so that during periods of stress -- high interest rates, recession, deterioration of terms of trade, falling (or rising) prices for oil -- there remains a cushion, i.e., commercial bank lending which can be still called upon. Otherwise, all the risk will be on the IFI's, with the potential to do great damage to them.

It obviously is not possible here to describe what specific measures the World Bank might take to maintain its deservedly high credit standing because that would very much depend on the

magnitude of what is guaranteed, how it is guaranteed, and whether the World Bank's risk is increased or stays the same, i.e., is there additional risk or is the form of risk merely changed? But, there are ways to both lay to rest any question about the Bank's credit standing in the markets and, at the same time, increase the penalty to commercial banks so that Secretary Brady's initiative would not be considered a "bailout." For example, if there were guarantees which were exercised and "put" to the World Bank upon receipt of payment from the World Bank, those funds might be relent immediately back to the World Bank at three-month U.S. Treasury bill rates for, say, 20 years. For want of a better term, since the World Bank has been put in play, as the saying goes, we might call that a "poison put." It seems fair enough and, in any event, an opportunity loss is a concept which, as we all know, is not recognized as a standard acceptable accounting principle and, therefore, would not show up as a loss on commercial banks' books.

I have one final point -- perhaps the most important which I would raise here. There is a lot of talk about issuing bonds -- bearer bonds -- in connection with debt reduction or debt relief schemes. If these were issued in large amounts, I would send up a red flag, because those bonds would be traded outside the banking system. If defaulted on, as they well might be if the amounts were significant, the pension fund, insurance companies and private individuals are not likely to be nearly so malleable as

commercial banks in working out the problem. Instead, they will go to court and will attach the assets of the debtor or insist on being bought out by the banks. I am surprised the Federal Reserve has not commented on this aspect. For my own part, I simply am not comfortable with a lot of LDC bearer bonds floating around outside the banking system in a litigious society like the United States.

Thank you.

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