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Informal Remarks

Thank you very much. It is a pleasure for me to speak with you this morning. I must say that I took on this responsibility with some anxiety. You are sophisticated. You know all about LDCs and the debt crisis. It reminds me of the story of the man who died and upon request for entry to heaven, was required by Saint Peter to describe the most important event in his life to an assembled jury.

"That's no problem," said the applicant, "it is the Johnstown flood."

"That won't do -- you must have something more dramatic and more important," said Saint Peter.

"No, no, that was very important. There was a big wind storm, lots of rain, trees were felled. We huddled together in the old barn. The insurance companies were there; it took us days to clean up."

Saint Peter: "I suggest you try something else."

The applicant: "No, no, that's it."

Saint Peter: "Okay, okay, tell us about the Johnstown flood, but just remember, Noah is in the audience."

Like the applicant, though many Noahs (and some Jonahs) are in the audience, I would like to share with you some commentary and perspective about matters which are the subject of this symposium. I do not have a prepared text and ask therefore that you bear with me and excuse what will doubtless be far too many oversimplified, unqualified conclusions about the debt crisis, its causes and prospects for the future.

First, I would ask -- Why did lending to LDCs take place in the first place? I suspect the answer to another question -- what might be done now -- will probably be found in the roots of what started it all in the first place.

Second, I would like to talk about what attitudes and posture banks might take in confronting the "LDC problem."

Third, I would like to briefly comment on what might be expected from the World Bank.

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How did it all happen? My first premise is that it was inevitable. Banks were neither heroes nor villains. OPEC financial surpluses accumulated because countries had the credit standing to borrow; if they could not borrow, to finance oil imports, there would not have been the massive financial surpluses from the sale of oil in the first place to generate those deposits. In short, surpluses, by definition, accumulated because countries could borrow to finance their current account deficits which in turn permitted the recycling of those surpluses through deposits in lending banks.

It also was a time, if you recall, of increasing competition amongst banks for market share. Particularly from Japanese banks, who were just beginning to open up offices off shore in a desire for market influence and possibly even profitability. Also, in the 1970s, Regulation Q was dismantled; banks could pay market rates for funds and pass on the interest rate risk by matching those deposit liabilities with their loan charges.

Credit risk evaluation was in its infancy. Perhaps I overstate, but for the most part, financial institutions concluded that they had never had a problem with LDCs before; therefore they wouldn't have one in the future. A loan to a sovereign state, with whom banks had long standing and complex trade and export finance related business, seemed a reasonable bet. Transfer risk was not considered a risk factor.

Indeed for some, the risk of default was unthinkable. The losses from such circumstances would be so severe that it would shatter their world's financial system and was therefore beyond risk assessment.

For others, if errors were made in risk assessment, the blame could be shared. You might ask yourselves how many London offices concluded that LDC credit risk assessment was the responsibility of Chicago or New York, not the responsibility of London. It became the responsibility of the central office, credit risk officers, senior loan officers, the economists, the investment banking department. In effect, no one had the responsibility. Responsibility in the 1970s, I think we might agree, was fragmented and uncertain.

There was also some champing at the restrictions of the Glass-Stegall Act, a sense of -- "finally we can get into the business of being investment bankers." Syndicate departments and sales forces were developed; relationships with borrowers went well beyond previous activity. All perfectly understandable. Besides, what else were banks to do with ballooning deposits? As a practical matter, banks could not pay LIBOR for OPEC deposits and buy U.S. Treasury Bills. That would have generated about a 150 basis point loss on each deposit. And that, I would think, would be no way for a bright young or not so young new inves ent banker/controller of syndicated loans to make his mark and start a long standing career with his bank. Better to lend to LDCs at 1-2%+ over the marginal cost of funds.

And, given the prevailing spreads and return on capital, there was the anticipation of substantial present reward for possible (but not at all certain) future pain. Besides, most of the risks might be passed on to "regional banks." Finally, most banks were in the act. They had opened offices and were pushing for market share -- the herd instinct.

I would suggest therefore that the LDC loans of the 1970s were inevitable, for economic reasons -- wherever there is a deficit, there must be a surplus -- and for reasons dealing with the practicalities of coping , and with an eye to the level of rewards and the uncertainties of punishments.

But lending was also inevitable from the LDCs' perspective. Most of you have read Bill Cline's studies at the Institute for International Economics. Bill has observed that almost five hundred billion dollars of the increase in LDC debt in the 10 year period 1973-83 could be accounted for by relatively few exogenous factors. LDCs had to borrow.

First, the oil price increase. That burden -- to the extent accounted for by oil price increases greater than the wholesale price index alone -- amounted to something on the order of two hundred sixty billion dollars. Second, the rise of interest rates. The increase in interest rates over the CPI accounted for another forty to fifty billion dollar burden. Third, you are aware of the thirty-year low in commodity prices, which dried up export markets during what was one of the worst recessions in thirty or thirty-five years. Finally, LDC terms of trade deteriorated in response to the inflationary pressures which increased the cost of their imports, lowered discretionary income and therefore the demand for LDC exports. In short, for the most part, the money wasn't wasted. It was inevitable that the LDCs would borrow for their economic and political survival.

It may also be useful to inquire why LDC lending took place through the form of syndicated loans from banks rather than through the institutional (non-bank) bond market or from OPEC. Why banks? Why not OPEC? Why not the fixed rate bond market? Indeed, we all know that in the 1920s that is exactly the way international current account deficits were financed. That is how every industrialized country, up until quite recently in the last decade or two, financed its deficits. Whether it was China, Russia, Venezuela, Argentina, Bolivia, Brazil or Mexico, they sold bonds -- and institutions bought them. Why did that stop? What were the dynamics?

First, obviously, there was credit risk. OPEC did not want to take the credit risk. As you ~~we~~ know, they preferred to be a depositor in a financial intermediary ~~way~~ rather than to take the direct credit risk. They thought, quite correctly, that deposits gave them more liquidity, anonymity and control. From OPEC's point of view, it was also politically easier. There was no easy way that they would be able to distinguish between India, Pakistan, Brazil, the Sudan, and Mexico. They did not want to make those kinds of decisions. A deposit taking bank would make those decisions and at their risk.

The bond market was beset with a continuing fear of inflation; it was shrinking even in nominal terms. There was a reluctance on the part of insurance companies and pension funds to make fixed rate loans to anyone, let alone to LDCs. They remembered what happened in the 1920s when pension funds, insurance companies and trusts bought the bonds of sovereign credits. They remain in default. They walked away. They were (and are) not available for fixed rate lending to LDCS.

We also witnessed an unprecedented intermediation of savings, particularly in the United States. Individuals found it easier and safer to take their savings and put them into a proliferation of short term depositary instruments -- banks. That circumstance directly affected the size of the fixed rate bond markets -- particularly as compared to the explosive growth of savings in depositary based institutions.

We also witnessed the development of laws and regulations applicable to traditional providers of a fixed term debt. These regulations typically directly restricted the amount of foreign debt in their portfolios.

From the borrowers' point of view, too, the Securities and Exchange Commission created constraints. Disclosure created problems. It was time consuming. It was contentious. There was great concern about "ratings."

Sovereign credits, understandably, therefore, went to their reliable banker who had but recently opened up its office in London -- flush with deposits.

Thus, institutional investors, borrowers and banks had a convergence of interest. The conclusion was inevitable -- an abundance of funds at banks; a shrinking fixed rate bond market. Borrowers were delighted -- particularly during periods of positive yield curves and negative real rates of interest, when lower costs from banks, though variable, were deemed more attractive than scarce, higher-cost funds in fixed capital markets. Banks could recycle deposits and employ those deposits on assets whose returns were linked to their highest marginal cost of funds. The major holders of financial surpluses, having made a conscious decision for both political and safety reasons, were pleased.

Now, however, there is not much convergence of interest. We see differences of positions and attitude between regional banks and money center banks and differences of views about what might "be done" amongst the money center banks. We have observed differences of views between banks with centralized control versus banks where decision are delegated to profit centers with little central monitoring. We see differences in attitude between banks which frankly would rather not now be in the business of LDC lending, and can afford not to be or can cut their losses, versus those banks which do not have any interest ~~or expertise~~ to do very much else -- or at least can't get out. We have seen, not surprisingly, a proliferation of proposals to protect the system, to protect each banking constituency, to protect the world's trading system, to facilitate political stability, ward off regulators, politicians, stockholders, and to meet just about every other objective, inconsistent as they may be to each other. Each of these proposals have different accounting, legal, public policy, political, practical and utility components. Time will not permit me to set them out here. Fred Bergsten, Bill Cline and John Williamson will shortly do that far better.

Instead, what I would like to do is share with you from one person's perspective some basic principles, and then conclude these remarks about what the World Bank might and cannot do.

Two years ago, I understand I caused some stress by commenting on the prospects for LDC repayment of their debt. I think the subject bears clarification and repeating. The principal of most LDC debt will not be repaid in the foreseeable or far off future. No more than the United States government can pay ~~down~~ off its debt. By repaid, I mean paid off. When money is due and it is refinanced, it is not repaid. Stated another way, I mean to say that the principal outstanding will be higher next year and the year after that. The close question is whether or not the amount of the increase will be 5% or 100% -- or more -- of the interest due -- i.e., how much the outstanding indebtedness will increase. It will vary for each country.

Bankers, nonetheless, should pretend that the principal will be repaid and lower the level of rhetoric. They might start to talk that the crisis is past; "things are much better now" -- after all, after debt rescheduling, the money is no longer "due." And if the money isn't due, the money isn't owed, and if money isn't owed, no one need take write-offs. And if long term debt restructuring is considered a "solution" to the problem, so be it. I suspect that may be a wise proscription. Otherwise there is likely to be increasing trouble from stockholders -- or regulators. Further, insisting on payment -- and not getting it -- will direct attention to the strength of our financial institutions. Their cost of funds will go up. They will have increasing liquidity problems.

Some of you may have analyzed the historic spreads between LIBOR and U.S. Treasury Bills. The idea that even the strongest banks in the world should have to pay on occasion two, three or four hundred basis points over U.S. three-month Treasury Bills is ridiculous. Moreover, the increased cost cannot, as a political matter, be passed on through periodic adjustment of a syndicated loan. I assume therefore it is unwise for banks to be subject to escalating costs of funds related to adverse publicity. I would think that it would be wise for banks to have escalating costs of funds -- the more so if the result of adverse publicity. I would think that, it would be wise therefore to lower the level of rhetoric, simply because all it will do, inexorably, is put pressure on regulatory authorities and on rates. If banks complain of their increased risk and exposure, regulatory authorities will slowly back off (as they have already done) from their previous accommodating posture of, let's say, two years ago, with respect to concentration of exposure and the need for write offs. Understandably, they will take a harder, tougher position in response to your views on the seriousness of the problem. In that environment, it is very difficult, I would think, to want to lend more. Few on the regulatory side will conclude under such circumstances that this is a propitious time for increased lending. Instead, banks are likely to be encouraged to lend less. Although I think those who ~~I think~~ are committed to a political stability in the world will understand the importance of lending more. I think the job, therefore, is relatively straightforward -- to increase the "comfort" level.

I would suggest that to increase the comfort level, one should, as indicated above, (a) lower the level of rhetoric about the problems LDCs face, (b) recognize that few financial institutions have "leverage" or control, and (c) they need increased leverage as a condition to additional lending. I would assume that an increased sense of leverage, a sense of control, a sense of dominion that would permit you to make choices with respect to your largest borrowers are basic to increased lending. The other stuff -- financial engineering -- I suspect, ~~are~~ is of marginal importance. Interest rate caps are not the kind of material which future additional lending is going to be made of.

Specifically, I would suggest that a promising way to increase leverage is to convert LDC syndicated loans to floating rate notes. Create liquidity and put the paper in the hands of investors who cannot be put into a room for debt restructuring negotiations. That, of course, poses risks. It takes the debt out of banks -- not much, just some of it -- and puts it in the hands of "strangers." The "financial system" is hostage to the latter. Nonetheless, those obligations, even if 80% remain held by banks, would be virtually immune from future rescheduling. That is what I mean by increasing leverage -- having the power because of the nature of the instrument to prevent the borrower from being able to insist on restructuring. FRNs cannot be restructured. They can only be defaulted on. The question is whether that risk is worth taking. The quid pro quo would be additional resources from bank lenders.

Second, I think it may be wise for banks to increase control of the liability side of their balance sheets. I would suggest that one of the more fruitful ways of increasing banks' leverage is for banks to issue FRNs rather than rely primarily on short term deposits. Banks need not fund themselves almost exclusively with paper maturing in thirty, sixty or ninety days. They, too, might get their liabilities out of the the newspapers. Lengthen maturities. New instruments are proliferating where funds are obtained not just for three months but for ninety-nine years to perpetuity. Those instruments provide leverage because banks -- albeit to a limited extent -- would not have to constantly be in the market, Euro or domestic, particularly during times of stress and publicized pressure. That in turn creates freedom and therefore leverage, power and increased comfort..

The third suggestion is to liquify assets. I know it is easier said than done. But LDCs' debts sold in the market can increase leverage and power. Do we want to know the value of country X, Y, or Z in the marketplace? Yes. Because it reduces the competitive pressure from a few banks to make loans which others have rejected. The market pricing of LDC paper day after day, year after year will, among other things, protect senior loan officers who have declined an invitation to participate. There are few better ways to assure the integrity of creditworthiness procedures before making loans than to provide some way -- albeit indirect -- for establishing a market value for those decisions.

Further thought might also be given to the idea of shifting the currency of loans. Approximately 95% of LDC lending is in U.S. dollars. I won't go into details of the Mexican arrangement, with respect to Deutsche mark, yen and Swiss francs, etc. Suffice to note here, it is safer for a German bank to lend Deutsche mark because it has a natural constituency in Deutsche mark.

Second, it has a lender of last resort -- the Bundesbank -- in its own currency. Third, it is more profitable to lend in a domestic currency (rather than in dollars) because throughout Japan and Switzerland and Germany, for any yen, Swiss franc or Deutsche mark lent, the cost of those funds is lower than the marginal cost of borrowing dollars. They do not have a natural deposit base at lower costs in dollars; the cost for their dollar liabilities is their <u>highest</u> cost debt -- while their own currency is generally available at much lower costs, representing as it does the place for relatively low cost depositary individual savings in their own currencies throughout their branch office network.

You might be interested in the results of the World Bank's experience of lending to developing countries in Deutsche mark, yen and Swiss francs. In the last seven years we have borrowed ~~twenty-eight~~ 32 billion dollars equivalent of Deutsche mark, yen and Swiss francs. On the dates we borrowed those funds for on-lending to LDCs, it cost us, on average, 7.50% -- a blended mix of Deutsche mark, yen and Swiss franc borrowings. If we had borrowed dollars on those same days and on the same terms, it would have cost us 11.80% -- on 340 bond issues or note placements. We passed on that 430 basis point saving in nominal interest cost to our borrowers. The LDCs of course took the exchange rate risk. The $32 billion in debt can now be repaid by our borrowers with $26 billion -- a $6 billion exchange rate gain ~~in addition to the~~ plus a low nominal cost -- plus a realized gain on debt service as the dollar ~~continued to~~ has revalue against the Deutsche mark, yen and Swiss franc. It all works out to an effective cost of borrowing of about 4.7% at current exchange rate levels and for older loans to an effective cost of 1-2% if the loans were repaid now.

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Permit me to make some final and brief comments about the World Bank. First, I suggest that it is not inappropriate to link additional private flows to agreement and assessment by the Bank (and Fund) to the nature and quality of the country's economic performance. But there must be a delicate mix of workable controls by the Bank and the Fund in return for additionality. LDCs are sophisticated. They are not about to take additional monitoring, targeting, or conditionality unless they are assured that there will be additional resources flowing to them either from the Bank or from the commercial banking system if they perform well.

Second, I might note that it is fruitless to talk about looking for someone to take LDC paper off your hands. No one is going to "take" the paper off your hands. On our part, we have constraints on how much we can lend or guarantee. We are limited under our Articles, unlike a commercial bank, to only having outstanding loans and guarantees equal to our capital. One to one. Not twenty to one or thirty to one. And, our member governments decide how much the World Bank can lend or guarantee by how much callable capital they wish to put at risk. I do not think it likely that their capital will be utilized to take existing loans off the books of commercial banks.

We also have limits on what we can lend based on our capacity to borrow. The World Bank has $50 billion of outstanding debt -- all but $5 billion is in the fixed rate bond markets. The Bank borrows $10 billion a year in fixed rate bond markets for on-lending to LDCs. Shareholder governments are reluctant for the World Bank to finance development in the same way as commercial banks, i.e., through rate sensitive liabilities. Thus they are reluctant for the Bank to finance development in any substantial way with floating rate notes or short term funds. They would prefer our funding to be limited to the fixed rate bond market. That immediately places a practical ceiling quite apart from our capital base (which is a legal restriction on how much we are permitted to lend), on our ~~practical~~ lending capacity.

Third, the World Bank is not about to participate in debt rescheduling. We cannot. All of you have a lender of last resort. We do not. We have to convince insurance companies and pension funds, private and public, to buy our fixed rate bonds. You do not. If we were to reschedule, it is not likely we could borrow in size from them -- just as you cannot. We are a fixed rate bond-market based institution -- not a depositary based one.

Fourth, we are not likely to supply significant amounts of untargeted balance of payments support. We are not in that business.

Finally, it is not likely that the World Bank will use it guarantee power, immediately callable, as support for straight balance of payments loans from a commercial bank. The Bank believes a loan which takes two years to appraise, many years to supervise and to disburse -- all after determining whether the loan is of high quality and high priority in the context of a meaningful development policy dialogue -- is the kind of lending we do best. We are just not likely to be there solely as a financial guarantor, putting little gold stars -- guarantees -- on commercial bank balance of payment lending. There are some kinds of guarantees, however, particularly those which enhance leverage or produce better terms which might draw considerable support. But, nonetheless, every effective guarantee that the World Bank makes will count against its capital, as if it made a loan to that country.

Let me conclude by saying that the Bank's strength is in the mix of constituencies which make it up, i.e., the LDCs, the major industrialized countries, the private market place which supplies us the funds, and the staff who simply want to make quality loans in connection with a meaningful development dialogue. That's what can be expected of us. We think it is a valuable product.