# BLESSINGS, SALVATION AND FORGIVENESS: A SOLUTION TO THE DEBT CRISIS?

This paper argues that proposals which involve ways to "forgive" or guarantee existing developing country debt in a manner acceptable to banks, or to the debtors, without providing for new lending, are of doubtful significance. Indeed, I believe they are basically counterproductive and prevent a meaningful increase in the new flows that are necessary to encourage domestic macroeconomic reform in debtor countries.

The main points made here are: (a) banks are not likely to lend voluntarily or if they are mandated to formally "forgive" debt; (b) they are likely to lend if provided with credit enhancement or guarantees; (c) an acceptable credit enhancement program should not involve a call on U.S. taxpayer or the callable capital of the World Bank; and (d) such a program can be developed using a World Bank affiliate to encourage new commercial bank lending. This new lending, backed by credit enhancement, would provide maximum leverage for structural economic reform; debt forgiveness does not.

## LDC PROSPECTS FOR SERVICING DEBT

While it is a truism bordering on a cliche that solutions to the

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international debt crisis must be tailored to the demands and requirements of each country, I would hope there is room for some straight talk. Most heavily-indebted LDCs are not likely to repay principal in the foreseeable future. Virtually all principal falling due in the next ten years, and probably longer, will be rescheduled -- the pattern of recent years. The difference, however, between repaying and not repaying principal over a long period -- assuming interest is paid -- is but a few basis points. The issue is perhaps better put:
Can LDCs service their debt, maintain modest growth and some semblance of political stability -- without new loans equal to a substantial fraction of their debt service obligations? I think not. Based on recent experience, however, the amount of lending from commercial banks is not likely to come close to the interest payments due to those institutions. The key, I would suggest, is to provide credit enhancement to encourage commercial bank lending <u>without</u> a liability on the taxpayer. To fashion such a vehicle, however, requires a balancing of the positions and concerns of the various parties in interest.

COMMERCIAL BANKS: A CONSTITUENCY

I assume that banks will continue to set interest rates for LDC debt below the market; industrialized countries will offer direct bilateral assistance during periods of stress, and debtors and

creditors will agree to convert loans to bonds at discounts from par with selective credit enhancement by borrowers. But, as banks begin to sense leverage, they will tend to reduce their lending for round trip interest payments back to themselves. Their leverage comes from the threatened withdrawal of short-term export financing and trade credits unless interest payments are made, without help from the banks themselves, on the diminishing stock of debt on their books.

Banks want out, and as close to par as possible. They do not want to increase their exposure, even if by so doing the loans are deemed "current." Banks would like others to assume or purchase existing loans at as high a price as possible. They seek guarantees that interest payments on the debt remaining on their books will be credit risk free.

They look for a nod to some creative accounting, a relaxation of regulatory pressures and for ways to "spread out" their losses over a period of time should they sell their debt in the secondary market or back to the debtor. Further, banks may be well on the way to achieving the upper hand in their negotiations with debtors because of the substantial reduction of their LDC exposure to their capital, from the fact that some have already provisioned against the loans, from sales of loans, and from financial engineering which permits them to delay, mask or amortize their losses over time. These developments, as a

practical matter, remove the pressure to lend -- even to pay themselves interest. However, from the debtors' perspective, it also reduces the pressure to make painful macroeconomic changes as the debtor comes to realize that "new" money is not likely to be forthcoming.

## THE DEBTORS: A CONSTITUENCY

There are political pressures to service debt and pressures not to. Factions both in and out of power in developing countries find the high nominal and real costs unacceptable. Those costs are borne by poor people often living at the margins of existence in countries with fragile political systems. That produces domestic political pressure for debt forgiveness, debt reduction or moratoria. And as new lending declines, the attractiveness of moratoria on debt service increases.

There are, nonetheless, also significant pressures to service debt in order to maintain some economic stability. Exports must be financed, industries retooled, infrastructure put in place and short-term export credit financing maintained. If borrowers do not service debt, those short-term credits are at risk. If these are not maintained, the country shuts down. LDCs, in short, are under considerable pressure, facing basic choices that affect their viability as sovereign nation states.