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AN OUTLINE OF REMARKS: "FINANCING DEVELOPMENT: THE REAL WORLD"

I. COMMERCIAL BANK LENDING IN THE 1970s/EARLY 80s: THE ENVIRONMENT

A. Governments were pressuring, or at least encouraging, banks to recycle OPEC financial surpluses.

B. There was divided responsibility: London vs. New York.

C. What else to do with OPEC deposits? Buy U.S. Treasury obligations at 2% less than LIBOR?

D. There had been little previous pain. All "foreign" debts in recent memory were serviced.

E. Herd instinct -- market share; Japanese banks were moving to London.

F. Excellent rewards. Locked in spreads.

G. Present pleasure vs. future potential pain. But at the moment excellent returns on shrinking capital bases.

H. Spin off risk. Syndicate loans to others -- compete with investment banks.

I. The dread factor -- the loss potential was so severe, (nothing could go "wrong") given the magnitude of the lending. All countries were deemed creditworthy -- whatever the exposure and irrespective of the economic plan of the borrower -- central banks would always be there as a lender of last resort.

II. WHAT NOW ARE THE PROSPECTS FOR HEAVILY INDEBTED LDCs?

A. Mostly, they will not repay principal -- and it really is of no great moment so long as all interest payments are serviced. The difference between repaying and not repaying principal over 40-50 years, assuming interest is paid, is a few basis points.

B. Virtually all principal falling due over this decade will be rescheduled or refinanced.

C. Over the next several years, the amount of increased exposure of commercial banks, official institutions, including governments will not likely exceed, at the most, the interest payments due to those institutions;

D. There will be, at times, selective rescheduling of interest, a reduction of interest rates, while at the same time there will be pressures to reduce the lending of export credit agencies -- particularly to countries in default.

E. Securitization is not likely to be a meaningful solution. It is a <u>technique</u> used to implement a solution -- not a solution itself.

III. WHAT DO THE COMMERCIAL BANKS WANT?

A. They want out. To keep as low an exposure as possible; to get paid, to have someone else take over their loans. They look at least to a nod to some creative accounting and a relaxation of regulatory pressures. Basically, they want leverage but they do not yet have it. They may, however, get it from the recent rapid reduction of the LDC exposure to their capital -- as yet a mostly unpublicized development -- or from the fact that some have already provisioned against the loans. They cannot get leverage from the World Bank because we do not have it to give away even if we wanted to -- which we do not.

B. At an earlier stage, as recently as several months ago, banks expected the World Bank to join with them in what they described as a partnership -- a partnership which would guarantee their new loans, reschedule our loans, cross default link our new lending to the maintenance of debt servicing on theirs, share pro rata all payments received by us, subordinate our claims and disburse -- quickly. In classic example of denial, they preferred to view our rather negative reaction to such proposals as the result of bureaucratic red tape and managerial ineffectiveness.

IV. WHAT WILL THE WORLD BANK DO AND WHAT WON'T THEY DO?

A. Our guarantees will be quite limited and, even then, made only on a selective basis. We will, in short, not take out the Banks or broadly guarantee their increased exposure. We are not like the

IMF. We don't make BOP loans. We are not likely, consciously, to jeopardize our preferred creditor status.

B. WHAT WILL WE DO? Mostly give good economic development advice.

C. We will also monitor performance. But the "monitoring" will be based on economic criteria which will be highly subjective. We are not likely, through a monitoring process, to call a loan in default because a failure to meet a subjective economic test -- partricularly where the "default" is fairly attributed to factors outside the control of country. And, I suspect, we are even less likely to call a default if our loans are being serviced and a failure to meet economic tests would also trigger a halt in commercial bank flows. Our intellectual integrity will be sorely tested if we get into this monitoring business.

D. With respect to our lending, it is highly unlikely that given the quality of the Bank staff, we will operate like automatic teller machines or printing presses. The Bank staff has generally insisted on market based economies, an absence of subsidies, or a plan which can support savings, investment, export and growth with meticulous attention to incentives and priorities. And those values, though not publicized, have always been what the Bank has been all about. In short, Bank staff are simply not likely to provide cash resources to LDCs so the indebted countries can service their private debt to banks.

V. WHY DO WE OPERATE THAT WAY?

A. Why don't we do even more?

B. Not because we are bureaucratic, not because we are bound in red tape, not because we have committees, clearances and reports, not because the decision making process is slow. Because development programs, let alone fundamental structural changes in the economic practices, typically involve basic political and social changes in that society. The changes are not easy to measure; they are difficult to implement, difficult to monitor -- particularly, in countries which have diverse political and social structures, inadequate controls, weak long term planning capacity, fragile democracies, even weak dictatorships. In many cases, there are core differences within the society as to the nature of the compact between government and the citizen, in the distribution of wealth and power, and all this while the country is under great pressures -- from factors outside their control. Weather; Western protectionism; recession; falling oil prices.

C. The World Bank, the rhetoric from within and outside the Bank, notwithstanding, does not have the power, wisdom or leverage to solve those problems. The developing country must have the will and the capacity. And it is a most naive understanding of the way the world works to attribute the failure to solve problems attributed to a complex set of political, social and financial relationships -- to our clearance procedures. The programs and adjustments that need to

be implemented are particularly tricky to sustain, let alone guarantee over the decade that is needed to get results. And the Bank staff will not settle for a quick fix by writing out checks which have little prospect of being used for wise and productive purposes. And which, I might note, would get lost in the magnitude of the financial flows that are needed to pay interest to the private sector, let alone sustain growth. And the fact is governments, including the U.S., know it and would not have it otherwise. Only banks, not unexpectedly, given their past experience, seem to believe they truly know how to distribute hundreds of billions without economic programs in place.

D. And the <u>financial markets</u> demand that we conduct our operations with attention to the quality of the countries' performance. We have borrowed almost $100 billion in 18 different currencies. Publicly and privately, at <u>market rates</u> from retail accounts, from huge institutional investors. We have borrowed long term, at fixed rates and variable rates, in capital, not money, markets. We do not have a natural deposit base or a lender of last resort. We borrow once every two days, every day of the year, somewhere in the world. We borrow $10-12 billion a year to finance an expanding lending program. We earn over $1 billion profit a year; we have reduced our lending charges to a few basis points over cost; and with one minor exception, borrowers are servicing their debt. We do not reschedule or restructure loans.

E. The buyers of our obligations trust us with their money; and so do the governments who own our stock and stand with the institution. In the real world, insurance companies, pension funds, holders of savings, support our lending operations. They do not look upon our mandate or capacity, with their money, to save the world's financial system. And the U.S. government also knows that if we were to loose the confidence of that market by providing transfer payments -- to pay commercial bank interest -- it would assuredly mean that we could not obtain the funds necessary to finance the lending in the first place. No goverment, particularly the U.S., given their very substantial liability in the form of callable capital -- which can only be called if we act imprudently and cannot obtain market support, wants to bail out the World Bank becuase we bailed out commercial banks. They will not do indirectly, what they are not prepared to do directly.

VI. LET ME CONCLUDE:

A. First -- the underlying premise of my remarks: Not all problems can be solved painlessly. Particularly if the definition of what is the problem is not agreed to by the parties in contention. The Parties, in this case, do not have the same interests. Not governments, not LDCs, not commercial banks, not multinational banks, not the private financial markets.

B. We all know that there will be increased poverty and political instability if countries tighten too much in order to service their debt. We also know there will be financial problems of considerable magnitude if banks are not paid interest. Governments too, will feel great pressure in industrialized countries if they have to support their financial systems and so will stockholders. PROTECTIONISM. There are significant geopolitical considerations for many countries implicit on both paying banks and not paying them. Each party is now jockeying to reduce pain. Just like politics -- but in politics often there are no evetns. There is language, posturing, warnings which admittedly on some occasions, cause events to occur -- or prevent them. In the world of finance, however, an event occurs every six months. Predictably. Interest must be paid. Money must be transferred. Politicians, indeed statesmen, typically use rhetoric because that is what they are familiar with and, often it provides a sense of comfort, of dominion, of control. It won't work here. Events are triggered by contract.

C. The better part of wisdom is, first, admit that there are inconsistent objective; next, admit that there will be pain and it will be shared in different ways in each country; third, realize that no one party can ex ante predict or control who will have to bear the most pain; fourth, understand that no one party has the power to determine who "should" bear it. Finally, governments should take care about this business of leverage and confidence. For the leverage

that is gained only will harden and weaken the other player. That is a dangerous game when interest is due every six months.

Let me summarize: LDCs are under great political pressure and will be under increasing pressure to limit their transfers of wealth from their countries to us which is now occurring. Their negotiations with Western financial institutions cannot be perceived domestically in their countries as less tough than their neighboring countries. The fact is the developing world knows that the annual increased lending from banks does not nearly approach the interest they pay out. That is not a sustainable situation for them or us. Second, our financial institutions, pressured by regulatory agencies and stockholders, and given the alternative investment opportunities and the lessons from past experience understandably, are reluctant to lend more. Third, given the interdependence of economies between the developed and underdeveloped world, a lack of new external funds means minimal or negative growth, leading in turn to a contraction of trade and an inability of indebted countries to earn the dollars needed to service debt -- a problem yet further compounded by protectionism measures which defeat their export potential and capacity to earn dollars. This is a complicated set of problems.

And, all of this in a vulnerable political environment. We know the old standby is that economic development is necessary for political stability. We also know, however, the truth that economic development can be a destabilizing phenomenon itself, that countries may go through a variety of stages in their political development as they cope with rising expectations and increased de-

mands on government. So perhaps we can be more precise. While there is no single recipe for political stability, there is, hoever, an open invitation to instability -- if we cut off hope in a lifetime, let people think their children will have no more than they have, freeze privilege and opportunity in small pockets of the society. Then, most assuredly, we will have unstable regimes and unliberal political outcomes. The Western world either must assist countries in developing their economies by providing, for the very poor, concessional aid and, for those better situated, access to our financial and trade markets -- or lose any hope of retaining influence.

There is, therefore, great vulnerability at every level but little public policy response. Little integration or recognition of links; little awareness of the implications of lack of control -- how vulnerable is the financial system, the implication of poverty for geopolitical military confrontations. Few global thinkers. And, public service and public policy have a bad name. Not fun and games. High risk; lots at stake; very difficult; we must learn about finance, political economy, social historical trends, and must know how to recommend, act, and implement.

The underlying premise of my remarks is that not all problems can be solved painlessly. Particularly if the definition of what is the problem is not agreed to by the parties in contention. The parties, in this case, do not have the same interest. Not governments, not LDCs, not commercial banks, not multinational banks, not the private financial markets. Each party is now jockeying to reduce pain.