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Observations on the Less Developed Nation Debt Crisis

Statement of
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Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss our observations on the exposure of the U.S. banking system to less developed country (LDC) debt, why a solution to the problems caused by that exposure is important, and how the different approaches to resolve the problem should be assessed. Our statement is based on our past work assessing federal regulators' supervision of bank overseas lending and on our on-going work assessing the various debt relief proposals.

The evolution of the debt crisis and responses

While the nature of the LDC debt problem has changed over time, the need for a solution remains. When the debt crisis began in 1982, the immediate issue was ensuring that the U.S. banking system did not crash. At the same time that many banks had problem loans to the domestic energy, agricultural, and real estate sectors of the U.S. economy, LDCs interrupted the servicing of their international debt. Exposure to these loans was large relative to bank capital, and especially so for the major money center banks. For example, in June 1982, total U.S. bank exposure to LDC loans was more than 200 percent of their capital, as defined by bank regulators. For the nine largest U.S. banks, the exposure was over 300 percent of capital.

Since then, banks have responded by curtailing new loans to LDCs, with some banks substantially eliminating these loans from their portfolios, and, with encouragement from federal bank regulators, increasing their capital. Between June 1982 and June 1988, for example, the book value of all U.S. bank loans to LDCs decreased from $139.7 billion to $97.7 billion. At the same time, U.S. banks increased their regulatory capital from $66.2 billion to $132.3 billion. Although some improvements similar to those that characterized the U.S. banking system as a whole also occurred among the nine largest money center banks, their LDC exposure remains a serious problem.

A major component of the increase in regulatory capital was increased reserves against the potential losses on these loans.[1] Bank regulators have required about $2.3 billion in special reserves for LDC debt, and in the last year and a half banks have voluntarily set aside over $20 billion in reserves.[2]

In our testimony before the Senate Banking Committee in April 1987 and our May 1988 report on federal supervision of overseas lending, we concluded that the federal bank regulators had not required adequate levels of loan loss reserves to reflect the diminished

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[1] The other major component of the increase was subordinated debentures.

[2] While most of the bank reserves were not "earmarked" for the LDC exposure and were included as general loan loss reserves, most bank analysts concluded that the increased reserves were directed at the LDC exposure.

value of the LDC loans. They have authority to require such reserves under the International Lending Supervision Act of 1983. One useful measure of this diminished value is the price that these loans command on the secondary market for the loans. We believe that the regulators should use these data in setting reserve requirements. Adjustments from this starting point should be made when analysis demonstrates that they are warranted. If this market appraisal were used to determine the appropriate level of reserves, $49 billion of reserves would be needed.

We continue to believe that reserves must be adequate to ensure that the banks accurately reflect the diminished value of this LDC exposure. Such reserves help ensure the safety and soundness of the banking system, both by preparing a bank that creates or increases a reserve to subsequently write off an impaired loan and by clearly and fairly depicting the financial condition of the banks.

The need for a solution

From the standpoint of the LDCs themselves, the need for a solution remains. Both economically and politically, the debt burden hinders these nations' attempts to develop. Many of these nations borrowed in the belief that earnings on exports of primary goods would be adequate to service the debt. Since the start of the debt crisis in the fall of 1982, however, many LDC loan recipients have experienced insufficient growth in their export earnings to service their debt and most have seen a net transfer of resources abroad. Their export sectors were hurt by large declines in primary product prices, slow economic growth rates in the early 1980s among many countries that import goods from the LDCs, and increased protectionism in some importing countries. From 1982 to 1987, for the Baker Plan's group of 15 heavily indebted countries[3], real per capita output fell at an average rate of 0.8 percent per year. For the group of 17 heavily indebted countries[4], a $8.9 billion net inflow of capital in 1981 became a substantial and persisting net outflow through 1987. Funds were generated to fund this outflow of capital in many cases through austerity programs that significantly reduced imports. However, even those highly restrictive measures were not enough and new borrowing was needed to have sufficient funds to cover the full debt service burden.

Debt continued to be rescheduled into the future; new lending from the commercial banks effectively only capitalized interest on the old debt; net resources continued to be transferred from the heavily indebted LDCs to the industrialized world; investment in these LDCs remained at low levels and per capita real output declined. The result, as reported recently by the World Bank, was

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[3] The nations are Argentina, Bolivia, Brazil, Chile, Colombia, Cote d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

[4] The 15 nations in footnote 2, plus Costa Rica and Jamaica.

that the debt of these 17 countries increased from $391 billion to $529 billion from the beginning of the debt crisis through 1987.

The debt crisis has forced LDC governments to undertake painful adjustment and austerity programs, often at the risk of losing domestic political support. At a time when real per capita incomes have fallen for these nations as a group, it has been difficult to politically justify these programs, particularly when they are seen by the public to have been imposed by outsiders and for the benefit of creditors. Nevertheless, such adjustment is necessary. Prior to the onset of the debt crisis, many LDCs had insufficient investment in their export sectors due to a variety of factors including inappropriate incentives, mismanagement, and corruption. For many nations, the same problems remain. In some areas, furthermore, the problem of inadequate investment in the LDCs is exacerbated by "flight capital," as local residents send their money out of the country to safer havens in developed countries.

Past attempts to resolve the debt problem

The search for a solution has gone on as long as the debt crisis. The initial response to the debt crisis in late 1982 was a case by case approach in which the debtor would receive new loans from the International Monetary Fund and commercial banks in return for following austerity policies recommended by the Fund--lowering government spending and monetary growth rates, devaluing exchange rates and reducing imports and increasing exports. These policies were supposed to overcome what was then thought to be a short term liquidity crisis by generating sufficient foreign exchange to service external debt. However, despite the costs borne by the LDCs--slow or negative economic growth, declining living standards--debt owed by the LDCs continued to mount.

To correct a policy that was clearly not working, in October 1985, Treasury Secretary Baker proposed his growth-oriented initiative. Although the Baker Plan continued the case-by-case approach, it viewed the debt crisis as a long-term solvency problem that debtors could outgrow if they received sufficient new lending from the developed world and undertook market-oriented reforms of their economies. Market-oriented reforms would attract foreign and domestic investment, while $29 billion in new lending over 3 years --$20 billion from commercial banks and the rest from multilateral institutions--would ease the LDC debt burden and free resources needed for LDC growth.

However, despite its changed focus, the Baker Plan cannot be called a success. Sufficient private lending was not forthcoming. And the adverse developments in the LDCs occurred despite relatively favorable global economic conditions such as lower world interest rates and substantial growth in many industrialized countries in the mid- to late 1980s.

However, some progress was made during the past few years. Banks and several major debtors have undertaken innovative debt reduction techniques, apparently recognizing that the debt was not worth its full face value and probably much would not be fully repaid. For the most part, negotiations between the banks and the debtors have been on a case-by-case basis. Restructuring packages have included new options such as exit bonds, and swapping debt for equity investment, local currency, or other debt.

Recent proposals

Recognizing that the Baker Plan has not worked as intended, the administration, with the endorsement of President-elect Bush, has been re-examining that plan. And, under the 1988 omnibus trade act, the Department of the Treasury must report the interim results of their assessment of a debt management authority to Congress by March 1989.

At the same time, a large number of other plans has been advanced. We have identified more than 25 plans which have been proposed recently for solving the debt crisis. Most of the plans begin with several common assumptions:

1 No solution to the debt crisis is possible without substantial economic reforms in the LDCs.

2 Structural reform will be costly to various interest groups in the LDCs and will likely be disruptive in the short run.

3 LDC debt is not worth its face value, and full repayment is not realistic in the foreseeable future.

4 Some level of concessions will be required from the current creditors.

Some of the plans or proposals call for outright forgiveness of the debt. While this may be the only realistic way out for the poorest nations, most observers believe that it is not a feasible solution for most debtor nations. First, the cost of such forgiveness to the developed nations would be staggering. Second, while forgiveness would seem to alleviate a major barrier to economic development in the LDCs, some observers believe that it actually could prevent the LDCs from any future access to private capital and thus hinder economic development. Most importantly, however, unconditioned debt forgiveness does not provide for the types of structural changes in the LDCs that will improve their long-run prospects for growth.

Other proposals link creditor concessions to reform in the LDCs. In addition, some include creation of an international debt facility or the provision of guarantees for LDC debt by multilateral lending institutions or the governments of creditor nations. The purpose of these guarantees is to encourage lenders to grant debt relief to the LDCs by guaranteeing payment of the remaining debt.

In evaluating the various proposals for solving the LDC debt crisis, we believe the following criteria should be considered:

1 All of the plans will be costly, and would spread the costs among a wide range of parties: the LDCs, U.S. banks, the U.S. government, foreign banks and governments, and multilateral financial institutions. All parties that stand to gain from a resolution of the debt crisis should contribute to the solution by bearing some of the cost.

2 The program should provide incentives that reward debtor nations that undertake politically painful economic reforms that successfully contribute to a debtor nation's economic rationalization and ability to pay. For example, the benefits of any debt relief should be available to increase investment in productive capacity in the LDCs thus promoting economic growth.

3 LDC debtors greatly differ in their ability to service their debt. A program to resolve the debt crisis should assure that the appropriate amount of debt relief is given to each country, rather than granting the same level of relief to all debtors, regardless of need.

4 All direct and indirect costs, such as loan guarantees, should be identified and accounted for. Budgetary constraints cannot be circumvented by creating contingent liabilities in place of direct budgetary expenditures. At some point such liabilities come due.

Conclusions

At the center of the conundrum is the realization that while concessions by lenders and guarantees by some government vehicle are important components of a solution, the ultimate solution over the long run rests on the developing countries' willingness and ability to undertake substantial economic and other necessary reforms. If such reforms are undertaken, then lender concessions will help to reduce the adjustment burden on the LDCs, facilitating the necessary structural adjustments on the LDCs' part. This can minimize any claims against any guarantor (or international debt facility arrangement). However, if an LDC does not stick to the economic adjustment and reform plans on which both concessions and guarantees are predicated, there will be no long run benefits for the LDC and considerable cost for the guarantors.