B. How a Major Creditor Views the New Proposals

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Before dealing with the Brady proposals specifically, let me say that the commercial banks in addition to generating ideas themselves have been, and remain, receptive to new ideas on how the debt of rescheduling LDCs should be managed.

That is not to say that we will not appraise each idea in a professionally critical fashion. Neither do we feel obliged to accept those ideas merely because we have no similarly structured alternative plan. When we first saw Secretary Brady's ideas in print we felt that they should be given a fair consideration. They have received such consideration and, not to put too fine a point upon it, have been found wanting.

The Problems with Brady

We have five major points of issue with the Brady Plan:

i) The significance of the relief ultimately accorded to the LDCs and HIMCs needs to be questioned seriously.

ii) There is a high risk of sending the wrong signals to the borrowers — good and bad alike.

iii) It requires only one credit group, the commercial banks, to take a hit.

iv) It is based upon a major misconception regarding the banks' role as providers of medium and long term finance for LDCs and HIMCs.

v) It seriously understates the degree of public sector responsibility by largely ignoring the part played by government policies in exacerbating the debt crisis.

Before dealing with each point separately, I would make the 'umbrella' point that all these factors coming together as they do under Brady produces a most unsatisfactory result, in that it raises expectations in debtor countries to unrealistic levels that will be difficult to meet. Furthermore, it threatens to divert attention away from what we consider to be the most important ingredient of the process and that is the reform efforts and structural adjustment in the indebted countries themselves.

To take each point in turn:

i) Significance of Relief

There must be considerable doubt whether indebted countries' expectations in terms of the quantum of relief they will receive by way of the Brady proposals can in fact be fulfilled. My economist colleagues have undertaken a study which shows that for the four major Latin American debtors, Argentina, Brazil, Mexico and Venezuela, savings in cash flow terms over the period 1990-92 are likely to total some US$12 bn or just over 17 per cent. For the purpose of their studies, relief was front loaded but the final picture could emerge somewhat worse, as no account was taken of any increase in interest payments to the World Bank or IMF on the funds used in debt or debt service reduction schemes.

This leads to the somewhat anachronistic feature of the Brady plan, new money is to be coupled with debt relief. It makes no commercial sense for a banker to incur losses through debt and debt service reduction on the one hand and provide new money (which may feed through with further buy back schemes, bearing in mind the fungibility of money) on the other.

It is at this point that we should also explode the myth of returning flight capital. Although claims have been made that flight capital is returning to Mexico, I do not know how this is being measured as its departure in the first place can at best only be 'guesstimated'. Flight capital only returns once a track record of stable economic management has been established. Frankly this will take years.

ii) The 'Wrong Signals' Risk

There is a significant risk that countries benefiting from debt and debt service reduction may interpret this as the first step along a road leading to a more generalised form of debt forgiveness. (Banks are into debt for equity, debt for goods but most emphatically *not* debt forgiveness).

There is a risk also in respect of those countries that have fulfilled their payment obligations, often at considerable cost. Where is the incentive for them, the virtuous, to continue making such payments? This is coupled with a matching risk that banks, as a result of their debt and debt service reduction experiences, will be less inclined to support even those LDCs whose loans are still performing, thus precipitating further rescheduling requests.

iii) One Creditor Group Participation

It is apparently only the commercial banks who are to

be considered as contributors by way of debt and debt service reduction. There is a general assumption that all official sector exposure is maintained at its full face value. But, apart from the question of public sector responsibility, the issue of debt relief is too large for it to be borne solely by one creditor group. The multilaterals and governments have preached continuously over a number of years to the commercial banks about burden sharing. They too should be prepared to practice what they preach.

iv) The Misconception of Banks' Roles in Financing LDCs

The official sector has failed to recognise that the withdrawal of the banks from this type of financing, far from being an aberration, is a return to the traditional style of relationship between countries and the commercial banking community. This is one based primarily on the financing of trade.

The explosive growth in medium term bank exposures to LDCs resulted from two oil price shocks. The official sector was more than happy to stand by and watch the banks recycle oil surpluses. Economist colleagues tell me that from 1966-69, on average, bank lending accounted for 13 per cent of the major Latin American borrowers' debt. This expanded to 44 per cent in the 1974-77 period and leapt further to 55.6 per cent in 1978-81, just prior to the crisis breaking. It peaked at just over 63 per cent in 1984 after we put in all that new money, a fact often conveniently overlooked in the US Treasury, and since then it has fallen below 60 per cent. In my view, this figure will continue to fall as banks restrict themselves to financing short term trade and limit medium term exposure to projects likely to generate hard currency to meet servicing costs and ultimate repayment.

v) Public Sector Responsibility

The economic environment facing the LDCs was not of the commercial banks' making. The greatest influence arose from policy decisions made primarily within the OECD. Creditor country governments actively encouraged the recycling by commercial banks of petro dollar surpluses, not once but twice.

Floating rate debt, sustainable in the 1970s, became increasingly expensive for the LDC borrowers in the 1980s. The rise in interest rates was part of a policy framework in industrial countries, the US in particular, designed to combat the inflationary impact of the second oil price shock primarily through a tightening in monetary policies. It is arguable that the increase in interest rates went well beyond levels we could reasonably have anticipated when the funds were originally lent. Indeed, the high real rates have not proved a temporary phenomenon and, whilst precise linkages may be difficult to prove, I believe that strong connections exist between the high interest rates and dollar volatility of recent years and structural imbalances in the OECD, most notably the twin US deficits.

Leading on from there, surging nominal and real interest rates in the early 1980s were major contributing factors to the downturn in OECD economic activity. One estimate calculates the impact on non-oil LDCs of global recession and higher interest rates in 1981-82 as exceeding $140 bn.

Recession fuelled the fires of protectionism, and there is no doubt that its growth in industrial countries has made it even more difficult for LDCs to achieve the level of export growth needed to meet the debt service bill. Protectionist pressures have not abated and according to estimates made by the World Bank, such pressures will have cost LDCs at least $60 bn in 1989, almost ⅔rds of their projected interest bill of $100 bn.

In the face of such evidence, it is hard to see how the commercial banks can accept the burden alone and a positive outcome still be anticipated.

Where Next?

The limited ability and willingness of the commercial banks to extend new finance to the LDCs should be quite clear by now. We do not question the desirability of foreign policy goals such as the spreading and strengthening of democracy, but it must be accepted that banks are commercial institutions and our operations must reflect our primary obligations to depositors and shareholders. Writing off debt concurrently with lending new money makes no commercial sense whatever.

Accepting that the banks will return to their more traditional roles of trade and project financing, this leaves the long term financing gap to be filled. The return to private direct investment offers, in my view, the greatest potential for channelling resources to the LDCs. These flows however, will only arise once the adjustment process is well bedded in and consistent economic performance established. In the meantime, the official sector will have to assume the burden if only for the reason that the twin problems of debt and development are too important to be left entirely to bilateral negotiations between commercial bank creditors and debtor countries.