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Statement of the Shadow Financial Regulatory Committee on **Latin American Debt**

December 4, 1989

The government's continuing involvement in the international debt problem is likely to cost U.S. taxpayers billions of dollars, as this Committee noted in its criticism of the Reagan Administration's Baker Plan (Statement No. 1, February 1986). The Bush Administration's Brady Plan encourages the World Bank and the International Monetary Fund to make additional loans to debtor nations. Because the U.S. taxpayer puts up about 20% of the World Bank and International Monetary Fund capital, taxpayers will pay a substantial part of the cost of bailing the banks out of their bad loans. Furthermore, the additional loans will not resolve the international debt problem. Restructuring should be left to the debtors and creditors without government involvement.

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Two major developments have changed the outlook for the international debt problem in recent months. Both suggest that creditor banks do not plan much new lending in Latin America.

First, negotiations with Mexico under the Brady Plan left creditor banks three options. They could reduce principal by exchanging outstanding loans for bonds valued at 65% of the face value of the loans, or reduce interest rates by exchanging loans for bonds bearing a 6.25% interest rate, or agree to make a substantial amount of new loans. The Mexican government has announced the response from holders of 60% of the nearly $53 billion of medium- and long-term debt covered by the agreement. Only 10% of the banks decided to offer additional loans; 50% chose to reduce principal and 40% to reduce interest rates. If all lenders choose in the same proportions, Mexico's annual debt service will fall by $900 million, and outstanding debt will fall by $8 billion.

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Second, major banks in the U.S. and U.K. increased their reserves against medium- and long-term loans to heavily indebted countries. On average, eleven U.S. banks with significant exposure now have a 60% reserve against medium- and long-term debt. Reserves at major U.K. banks run between 50% and 70%, and reserves of other European banks are approximately 50% of their medium- and long-term loans.

The Brady Plan, like the Baker Plan before it, will fail to provide any significant increase in private lending. At a time when banks are increasing reserves against old loans, substantial new lending is unlikely. With old debt selling in the secondary market at a small fraction of its face value, new loans that are subordinated to earlier loans are not attractive investments for banks or other private lenders.

The Brady Plan anticipates a substantial increase in loans and guarantees from the World Bank, other development banks, and the International Monetary Fund (IMF). The World Bank will increase its loans, but it (and others) will also face rising demand for loans to Eastern Europe. The IMF has received net repayments of $3 billion in recent years, but after an increase in capital, it will again become a net lender to debtor countries. Since these international agencies obtain their capital from the governments of the major industrial countries, an increasing share of the debt of troubled countries will become an indirect liability of the taxpayers in the U.S. and other countries.

Increasing the developing countries' debts postpones a long-term solution and delays reforms. The major problems of the debtor countries are a result of wasteful policies, large subsidies to inefficient enterprises, low prices for public services, and other inefficient uses of resources at home. Additional lending often finances capital flight from the debtor countries by providing foreign exchange that politically favored individuals can obtain. Although it is difficult to define or measure capital flight with precision, citizens of major debtor countries hold assets abroad ranging from 50% to more than 100% of the outstanding debt.

The principal problem for the debtor countries is to improve the operation of their economies. This requires reduced subsidies, lower inflation, an end to capital outflow, and new policies to attract capital held abroad by foreigners and the debtor countries' own citizens. Improvement will come only if there are major reforms, including privatization, deregulation, and tax reduction. Mexico's recent reforms and a reduced fear of devaluation has attracted a small capital reflow this year. Also, Mexico and the U.S. agreed on October 3 to negotiate reductions in tariff and non-tariff barriers

in the next few years. Removal of these barriers is the most desirable way to help Mexico. This includes barriers in the U.S. to Mexican exports of steel, textiles and agricultural products and Mexico's barriers against a wide range of goods and services.

Chile has followed policies of this kind. Chile's reforms have produced high growth with relatively low inflation and a substantial reduction in outstanding international debt. The Chilean experience serves as an example for other countries. Debt has been reduced. State-owned industries have been sold, in many cases using debt-for-equity-exchanges. Chile has also arranged to repurchase some of its outstanding debt at a discount from face value.

For several years, banks' new loans to debtor countries have been less than the repayments and interest due from those countries. Additional lending by creditors to cover the service of outstanding debt delays a solution. The next step in the debt problem requires reforms in the debtor countries sufficient to attract direct investment and capital repatriation. Without major reforms, the debtor countries will not be able to return to the market or fully service their debt.

Repayment of outstanding debt and arrangements for settlement of arrears should be left to debtors and creditors. It is now universally recognized that the debt is worth less than its face value. Debtors and creditors should be left to negotiate settlement values without assistance from or interference by governments and international agencies. Removal of governmental involvement will increase the incentives for creditors and debtors to reach agreements.

Government regulators should require U.S. financial institutions to value debt at market prices on their books. This, too, will encourage meaningful negotiations.

It is the Committee's policy that members abstain from voting on policy statements in instances in which they have a direct or professional involvement in the matter that is the subject of the statement. Accordingly, Richard Aspinwall abstains from voting on this statement.