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Treasury Secretary James Baker's "Program for Sustained Growth" for the International Debt Crisis: Three Steps Toward Global Financial Security

I. Introduction

Over the past decade commercial banks have dramatically increased their loans to Lesser Developed Countries (LDCs)¹ in response to a corresponding rise in LDC demand for private loans. The predominant factor in this rise has been the need to finance LDC balance of payments deficits.² Since 1982, the LDCs have repeatedly fallen short in their attempts to maintain payments on their debt obligations to Western banks.³ This has triggered a series of reschedulings⁴ of this foreign debt and considerable uncertainty as to the general health of the global economy.

The threat of domestic bank failures, resulting from defaults⁵ by LDCs on their commercial debts, prompted the United States Congress in 1983 to enact legislation designed to promote sound banking practices on the part of United States multinational banks,

1. For the purposes of this comment, "Less Developed Countries" include those countries of Latin America and the Third World that have borrowed substantial sums from Western commercial banks. References in this comment to debts owed by LDCs include debt obligations of both the LDC governments and their instrumentalities, as well as those of private borrowers within each LDC.

2. The "balance of payments" refers to the status of a country's international accounts. These international accounts reflect the balance of the country's merchandise, i.e., total exports of goods less total imports, the balances of services (invisibles), the long-term capital account, and the short-term capital account. PAYER, *THE DEBT TRAP, THE IMF AND THE THIRD WORLD* 6 (1974).

3. Although this comment is primarily concerned with United States' banks, banks throughout the Western world are in the midst of an international debt crisis resulting from LDC inability to repay loans.

4. Loan renegotiation usually becomes necessary when a country's foreign reserves and export earnings are insufficient to cover the cost of imports and debt service, placing the country on the verge of default. LDCs can attempt to renegotiate loans from any of their three sources of credit: the International Monetary Fund, governments, and banks. *A Nightmare of Debt*, *ECONOMIST*, March 20, 1982, at Survey 22-37 [hereinafter cited as *A Nightmare of Debt*]. Renegotiation can involve rescheduling and refinancing. *Id.* at 22. Rescheduling entails extending a debtor's repayment schedule. *Id.* at 22. Refinancing entails providing new loans to pay off old ones and is preferred by banks because it allows them to earn additional fees. *Id.* at 22.

5. "Default" as used in this comment denotes an absolute and final failure by a debtor state to pay either the interest or the principal due its creditors. To prevent default, creditors renegotiate the loan by providing additional loans or extending the time for repayment. *See supra* note 4.

the principal United States lenders to the Third World.⁶ That legislation, the International Supervision Act of 1983,⁷ requires federal banking regulatory agencies to impose restrictions on the foreign lending practices of domestic banks.⁸ Through these restrictions Congress hoped to insure the stability of the United States domestic banking system.

On October 8, 1985, United States Treasury Secretary James Baker proposed yet another response to the global debt situation. Secretary Baker's proposal essentially calls for an international social compact involving debtor countries, international lending agencies⁹ and commercial banks. Under the plan debtor countries must first adopt market-oriented policies aimed at creating "more flexible and productive economies."¹⁰ Second, the International Monetary Fund (IMF)¹¹ and the World Bank¹² must encourage these market-oriented policies in return for additional lending. Finally, commercial banks must increase loans to the LDCs.

6. According to the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency, as of June 1983, the 17 United States multinational bank holding companies included: Bank America Corporation; Bank of Boston Corporation; Bankers Trust New York Corporation; Chase Manhattan Corporation; Chemical New York Corporation; Citicorp; First-Chicago Corporation; First Interstate Bancorp; Irving Bank Corporation; Manufacturers Hanover Corporation; Marine Midland Bank; Mellon National Corporation; J.P. Morgan & Co., Incorporated; Security Pacific Corp.; and Wells Fargo & Company. See News Release, Federal Reserve Board, June 13, 1983 reprinted in 22 INT'L LEGAL MATERIALS 930, 931 (1983).

7. ILSA § 901-913, 12 U.S.C. §§ 3901-12 (Supp. II 1984).

8. See *American Bank Regulation: Different Order, Same Chaos*, THE ECONOMIST, Feb. 4, 1984, at 77-78. Under the Current regulatory framework, the Federal Reserve Board (the Fed) supervises more than 5000 bank holding companies in the United States. *Id.* at 78. The Office of the Comptroller of the Currency (COC) regulates nationally chartered banks. *Id.* The Federal Deposit Insurance Corporation (FDIC) insures bank deposits and regulates banks which are not members of the Federal Reserve system by setting standards which banks must meet to qualify for deposit insurance. *Id.*

9. See *infra* notes 11-12.

10. PROGRAM FOR SUSTAINED GROWTH: JOINT ANNUAL MEETING OF THE INTERNATIONAL FUND AND THE WORLD BANK, October 8, 1985 (statement of Secretary of the Treasury, James Baker, III) at 3 [hereinafter cited as PROGRAM FOR SUSTAINED GROWTH] (reproduced at Appendix A).

11. Articles of Agreement of the International Monetary Fund, December 27, 1945, 60 Stat. 1401, T.I.A.S. No. 1501, 2 U.N.T.S. 39. The International Monetary Fund (IMF) was established at the United Nations Monetary and Finance Conference at Bretton Woods, New Hampshire in 1944 to encourage international cooperation on monetary matters, including maintaining stable exchange rates and overseeing the payment of international debts. The IMF plays the role of both borrower and lender by borrowing money from countries able to lend and using this money to make loans to needier countries. In addition, the IMF makes short-term loans to nations rich and poor, with balance of payments deficits in concert with private banks and individual governments. Whether the IMF makes a loan depends on the borrowing country's compliance with IMF policy.

12. Articles of Agreement of the International Bank for Reconstruction and Development, Dec. 27, 1945, 60 Stat. 1440, T.I.A.S. No. 1502, 2 U.N.T.S. 78 [hereinafter cited as International Bank Agreement]. This bank (known as the World Bank) was also established by the Bretton Woods agreement. See *supra* note 11. The Bank makes direct loans for specific projects such as highways and power plants in developing countries. It currently lends about twelve billion dollars a year and unlike the IMF, it does not impose tight controls on a borrower's economy.

This comment will offer a brief overview of the factors leading up to the present international debt crisis. The second and third prongs of Secretary Baker's Program for Sustained Growth will then be analyzed with particular emphasis on the roles Secretary Baker recommends that the IMF, the World Bank, and multinational commercial lending institutions play in resolving the LDC debt crisis. Last, actions that must be taken by the LDCs as well as LDC demands for trade liberalization will be discussed, along with the effects such trade liberalization would have on the LDC debt situation.

II. Background of the Crisis

In 1982 the United States Government and all major American multinational lending institutions¹³ publicly acknowledged that a debt crisis severe enough to threaten the entire United States banking system existed in loans extended to third world nations. That crisis, and the threat it imposes on the American way of business is still continuing and has been exacerbated by global economic conditions.

The essence of the problem is that most, if not all, of the major lending institutions in the United States advanced huge amounts of money to Third World Nations. It now is clear that those nations are unable to repay those loans.

A. *The Source of the Problem*

Lending to the LDCs took off in 1973-74 when the Organization of Petroleum Exporting Countries (OPEC) announced oil price increases. The OPEC nations deposited the surplus cash generated by these price increases in Western commercial banks.¹⁴ The commercial banks then needed to find suitable borrowers to use the excess cash.

International lenders settled on LDCs as the main recipient of the excess petrodollars because many of the LDCs appeared creditworthy.¹⁵ The more developed LDCs in particular — Mexico,

13. See *supra* note 6.

14. Gilpin, *Oil Cut to Hurt Poorer Nations*, N.Y. TIMES, March 7, 1983, at D1, Col. 3. The inflow of dollars and other currencies as a result of oil price increases far exceeded the amounts OPEC members needed to pay for imports. Therefore, they sought ways to invest their oil earnings. Unwilling to bear the risk and trouble of direct lending to oil-importing LDCs, OPEC members deposited a substantial portion of their surplus in United States banks and their overseas branches. From 1974-1976, OPEC members deposited \$49 billion of their surplus in commercial banks. STAFF OF SENATE COMM. ON FOREIGN RELATIONS, 95th Congress, 1st Sess., REPORT ON INTERNATIONAL DEBT, THE BANKS AND U.S. FOREIGN POLICY 14-15 (Comm. Print 1977). In the years 1977 through 1979 the oil-exporting states invested an even larger part of their surplus of \$99.7 billion, about \$15.9 billion accumulated in Britain as Eurocurrency deposits. United States banks received \$6.1 billion and bank deposits in other states amounted to \$28.9 billion. IMF SURVEY, July 7, 1980, at 212.

15. Until about 1975 Latin American states performed fairly well in terms of a pri-

Brazil and Argentina — had established substantial industrial bases and enjoyed economic growth rates.¹⁶ Moreover, these more developed states contained vast natural resources and showed a significant potential for continued growth. The banks assumed that such growth would generate the revenue necessary to repay external debts.¹⁷

The LDCs welcomed the petrodollars. Commercial credit was greatly preferred over loans from such institutions as the IMF because it was generally advanced without any conditions attached. The IMF, by contrast, typically conditioned large drawings from its currency reserves on the recipient state's agreement to institute an austerity program.¹⁸ These austerity programs were designed to increase the borrowing country's ability to earn enough foreign exchange with which to repay the IMF.¹⁹ Such programs often de-

primary indicator of credit-worthiness — the ratio of external debt payments to exports (debt-service ratio). Pine, *International Bankers Take Steps to Restore Faith in their System*, WALL ST. J., Sept. 15, 1982, at 1, Col. 6.

16. Between 1950 and 1980 gross domestic product (GDP) of developing countries increased at an annual rate of 5.4% which represents a remarkable performance compared with the pre-war period. TRADE AND DEVELOPMENT REPORT, Report by the Secretariat of the United Nations Conference on Trade and Development 33 (1981).

17. H. Wallich, *International Lending and the Role of Bank Supervisory Cooperation: Remarks at the International Conference of Banking Supervisors 3* (Sept. 24, 1981) (quoted in Reisner, *Default by Foreign Sovereign Debtors: An Introductory Perspective*, 1982 U. ILL. L.F. 5). Dr. Wallich commented on the extent to which banks may have underestimated the risks of lending to foreign sovereigns:

[I]t is sometimes thought that the usual rules of lending risk do not apply to sovereign borrowers. It has been said that lending to countries is less risky than lending to businesses or individuals because a country, unlike a business or individual, will always be around. Country lending, it is sometimes said, is free of final bankruptcy and definitive loss. All that is needed is occasional rescheduling that gives the lender breathing space and does not significantly affect the earnings or capital of the lending banks. In my judgment, this is too complacent an attitude.

18. Robichek, *The International Monetary Fund: An Arbiter in the Debt Restructuring Process*, 23 COLUM. J. TRANSNAT'L L. 143, 149 (1984).

The IMF is an inter-governmental institution in which creditor and debtor countries are joined, whereas banks in most cases are privately owned and responsible to their private depositors and stockholders whose interests they must protect. The tasks of the IMF are basically regulatory in the area of the exchange rates and exchange practices of its member countries, and are advisory in these and other areas of public policy that affect their balance of payments positions. Its financial resources are intended to help these countries abide by the code of international conduct which the IMF has developed and continues to develop in the public policy areas within its jurisdiction. The banks are profit-oriented financial institutions

Given its regulatory and advisory tasks, the IMF imposes conditionality in all public policy areas that are relevant to a country's balance of payment performance. This is not only intended to ensure debt repayment, but a country's financial recovery to the point where repayment imposes less strain on it than does the relief from strain provided by the financial assistance. The undertakings which banks exact from borrowers essentially are confined to the financial and legal terms of the loan and satisfactory assurance of loan repayment, but as experience has shown, without sufficient consideration of the strain which loan repayment imposes on the borrowing country.

19. Programs of conditionality impose economic austerity measures on LDCs and thereby reduce the risk of default on their loans from banks. Under a program of conditional-

pressed domestic economic growth and proved politically unpopular.²⁰ Unconditional financing by commercial banks thus permitted LDCs to avoid the economically and politically painful austerity measures required by IMF financing.

The availability of petrodollars and the lack of conditions placed on commercial financing induced LDC commercial borrowing to soar after 1973. By 1980, commercial banks had extended in excess of 40 billion dollars in loans to non-oil exporting LDCs, a 300 percent rise in lending over seven years.²¹ By the end of the decade, the nine largest United States banks held loans to LDC accounting for over 200 percent of the bank's capital.²² The exposure of the next fifty largest United States banks totalled 100 percent of their capital.²³

B. Further Complications

The lending campaign which began with the OPEC price increases contained the seeds of the present crisis. Since banks lent to LDCs at low loan spreads,²⁴ a relatively small default threatened to erase any profit made on those loans. A somewhat larger default would cut into other revenues and perhaps even into bank equity. Furthermore, the banks had concentrated on lending to a few of the more developed LDCs.²⁵ Later, these low spreads and high loan con-

ity, the IMF and the LDC formulate and impose austerity measures after considering the LDCs' social, political and economic considerations. Gold, *Balance of Payments Transactions of the International Monetary Fund* in INTERNATIONAL FINANCIAL LAW 237, 242-44 (R. Rendell ed. 1980). These measures are intended to correct the LDCs' balance of payments deficits within a specified time period — usually one to three years. The more commonly used measures include: currency devaluation, restrictions on subsidy programs and other government spending, modification of wage and price controls, ceilings on expansion of credit by the central bank and limits on additional external borrowing. Guitian, *Fund Conditionality and the International Adjust Process: the Changing Environment of the 1970's*, FINANCE & DEVELOPMENT, March 1981, at 8, 11. See generally J. GOLD, CONDITIONALITY (IMF PAMPHLET SERIES NO. 31, 1979) [hereinafter cited as IMF PAMPHLET SERIES NO. 31].

20. Conditionality imposes political, economic and social costs. See generally IMF PAMPHLET SERIES NO. 31, *supra* note 19, at 14-15. These costs can prove too high for LDCs and in some cases the LDC abandons the program or attempts to circumvent the process by borrowing the needed funds from private sources. *Id.* at 14. In such cases, because effective economic adjustments are not made, the LDCs' continuing deficits must be financed by increasingly larger borrowings. Adede, *Loan Agreements between Developing Countries and Foreign Commercial Banks — Reflections on Some Legal and Economic Issues*, 5 SYRACUSE J. INT'L. L. & COM. 235, 243-246 (1978). See also, *The IMF and Latin America*, THE ECONOMIST, Dec. 11, 1982 at 69-76 [hereinafter cited as *The IMF and Latin America*]; *Brazil: The Morning After*, THE ECONOMIST, March 12, 1983, at 3.

21. See BANK FOR INTERNATIONAL SETTLEMENTS (BIS), FIFTY-FIRST ANNUAL REPORT, 1980/81 (Table 3.20) (1982).

22. Dod, *Bank Lending to Developing Countries*, 67 FED. RES. BULL. 647, 655 (1981).

23. *Id.* at 647, 650. Latin American countries accounted for some 55% of the total debt at the end of 1982. *The Maze of Latin American Debt*, N.Y. TIMES, Mar. 13, 1983 § 3, at 4, col. 3.

24. A "loan spread" is the difference between the rate of interest on a loan and the return a bank pays on its deposits or other sources of funds.

25. In June 1982, for example, the top five Latin American borrowers — Mexico, Bra-

centrations made withdrawal from further lending to the LDCs all but impossible.²⁶

Many events after 1980 magnified the dangers created by these lending policies, the most significant of which was the increase in the United States interest rates.²⁷ The rates depressed commodity prices by discouraging importers from maintaining inventories. Demand for commodities fell, prices declined, and LDC export earnings dropped considerably.²⁸ Surpluses of OPEC deposits were also depleted as oil prices fell, further contracting the availability of credit.²⁹

Meanwhile, LDCs had employed much of their borrowed money to pursue projects which did not generate foreign exchange.³⁰ Scheduled repayments accumulated well beyond the LDCs' ability to meet

zil, Argentina, Chile and Venezuela — accounted for 91% of total lending by United States banks to the entire region. The two largest debtors — Mexico and Brazil — accounted for almost 66% of the total. Heineman, *Third-World Debt Problem*, N.Y. TIMES, March 10, 1983, at D1, col. 3. For a summary of the exposure faced by United States banks, see Volcker, *The Recycling Problem Revisited*, CHALLENGE, Jul.-Aug. 1980, at 3; Bennet, *Top Bank's Third World Loans Detailed*, N.Y. TIMES, March 13, 1983, at D3, col. 1.

26. The banks had invested so much money in LDC loans that the continued viability of the banks themselves depended on LDC loan repayments. See Quirk, *The Big Bank Bailout*, THE NEW REPUBLIC, Feb. 21, 1983, at 19.

27. A growing number of commercial loans provided for floating interest rates. Each percentage point of increase in interest rates therefore represents an additional foreign exchange outflow for LDCs paying interest on their loans. *Problems of the International Debt: Hearings before the Committee on Foreign Affairs House of Representatives*, 98th Cong., 2nd Sess. 63 (1984) (statement of Vice President — Overseas Development Council Richard E. Feinberg) [hereinafter cited as *International Debt Problems*]. Floating interest rates on LDC loans are calculated in two steps. First, a formula in the loan agreement is used to arrive at the London Interbank Rate, the "LIBOR" or "base" rate, for a given interest period. The "margin" or "spread," a percentage in excess of LIBOR fixed by the loan contract, then is added to the base rate. See Mitchell & Wall, *The Eurodollar Market: Loans and Bonds*, INTERNATIONAL FINANCIAL LAW 53, 62 (R. Rendell ed. 1980). The average spread above LIBOR on LDC loans between 1973 and 1981 ranged from approximately 0.8% to 1.6%. *A Nightmare of Debt*, *supra* note 4 at Survey 77 (chart). As the LIBOR rate fluctuates to reflect banks' increased capital costs, LDCs bear higher interest rates on their loans.

High interest rates caused by United States budget deficits directly hurt developing countries because they determine the interest rates developing countries have to pay. In addition, these rates indirectly hurt developing countries by strengthening the dollar and reducing the dollar price for which the LDCs can sell their goods. While their products are bringing in fewer dollars, the dollar amount of their debt remains unchanged. See *International Debt Problems*, *supra* note 27, at 7 (statement of Senior Fellow, Institute of International Economics William R. Cline).

28. See *supra* note 27. Falling oil prices, for example, threatened imminent default for Mexico, which depended on petroleum sales for 70% of its export earnings. And in Latin America interest payments in 1983 totalled approximately \$40 billion. That number represented about 42% of all Latin American export earnings. See Kuynski, *Latin American Debt: Act Two*, 62 FOREIGN AFFAIRS 18, 19 (1983).

29. Hershey, *Mideast Oil States Feeling Pinch, Said to Reduce Western Holdings*, N.Y. TIMES, Feb. 28, 1983, at A1, Col. 4.

30. Gilpin, *The Maze of Latin America's Debt*, N.Y. TIMES, March 13, 1983, § 3, at 4 Col. 3. One commentator summarized the phenomenon as follows:

Instead of using the loans to build up export industries, many of the large Latin American borrowers decided to invest in those things that could service domestic markets. Improving roads, transportation, and other basic infrastructure projects, as well as raising private consumption were also important objectives.

Id.

them.³¹ The banks, concerned about a potential default, began to curtail new credit extensions.³² In the United States, many small regional banks that had followed larger banks by lending to LDCs through syndicated loans³³ all but cut off further loans.³⁴

As the LDCs accumulated these large external debts and even higher debt-service ratios, the following pattern emerged: 1) the debtor state allowed its financial conditions to deteriorate until it was unable to meet interest payments; 2) the commercial bank lenders then refused to reschedule or refinance loans unless the debtor state agreed to IMF conditions, which central bankers encouraged;³⁵ 3) debtors officially requested IMF assistance and accepted an IMF prescribed austerity program that lowered the domestic standard of living and facilitated social and political discourse;³⁶ and 4) the lending institution, with much apprehension, gave new credit or rescheduled the debt. The resulting new loans carried relatively short terms, high interest rates, and large renegotiation fees.

III. Secretary Baker's Program for Sustained Growth

On October 8, 1985, the United States Treasury Secretary James Baker addressed the Joint Annual Meeting of the International Monetary Fund and the World Bank.³⁷ Without criticizing the actions of the commercial banks, Secretary Baker proposed an alternative response to the global debt situation. Mr. Baker's proposal contained three prongs and essentially called for an international social compact involving debtor countries, international lending agencies and commercial banks. Under the first prong of Mr. Baker's proposal, debtor countries would be required to adopt market-oriented policies aimed at creating more flexible and productive econo-

31. Almost 35% of total Latin American debt — or \$103.8 billion of \$297.1 billion fell due in 1983. *Id.*

32. The slowdown in lending to LDCs began in late 1979 and early 1980 when "concerns about general economic developments led banks to seek out borrowers with the highest credit standing." *Organization for Economic Cooperation and Development (OECD) foresees decline in International Lending to Some \$100 billion*, IMF SURVEY., Aug. 4, 1980, at 236-237.

33. Syndications divide a loan among a number of participating banks and thus diversify the individual bank's portfolios by spreading the risk among the lenders. See A. ANGELINI, M. ENG & F. LEES, *INTERNATIONAL LENDING, RISK OF THE EUROMARKETS*, 84-88 (1979).

34. Bennet, *Less Risk More Worry for the Banks*, N.Y. TIMES, Oct. 10, 1982 § 3, at 1, Col. 3.

35. Since 1956, the Paris Club, an organization of central bankers that has played a significant role in the rescheduling of debtor nation loans, for example, usually insists that a debtor state agree to an IMF austerity program before the Club will assist the debtor in rescheduling its debt. For more on the Paris Club, see *A Nightmare of Debt*, *supra* note 4, at 22-41.

36. See *supra* notes 19-20.

37. This speech was given in Seoul, Korea where Secretary Baker focused his comments on policies for growth within the context of the international debt strategy.

mies. Under the second, the IMF³⁸ and the World Bank³⁹ would encourage these new market-oriented policies in return for additional lending. The final element of the plan requires commercial lending institutions, generally multinational banks located in the United States, to increase their lending to the debtor nations.

The following analysis of Secretary Baker's Program deals first with the second prong and the importance of the IMF and the World Bank to the success of the Secretary's proposal. Then the third prong and what commercial lending institutions must do is analyzed. Last, LDC requests for trade liberalization will be discussed in light of the international debt crisis.

A. The Second Prong — The Importance of the IMF and the World Bank

1. *The IMF.*—The IMF engaged in its first lending operations in 1947. The IMF's negotiated austerity programs, however, were not initiated until the latter portion of the 1950's,⁴⁰ a few years after the creation of the standby arrangement. The process used in those negotiations and the results they achieved established the principle of conditionality now imposed in all typical IMF lending operations.⁴¹

During the next decade, the IMF began to play a catalytic role by helping member countries raise external finances from other sources.⁴² The principle of conditionality was an important underpinning to the IMF's role as a catalyst.⁴³

Secretary Baker's proposal heightens the importance of the IMF and the role it plays. Under the plan the IMF, instead of merely seeking to avert defaults by debtor nations, would take the initiative in finding long term solutions to the problems of international debt. It would do this by creating an interest rate compensatory financing facility⁴⁴ and by assisting in the coordination of the

38. See *supra* text accompanying note 11.

39. See *supra* text accompanying note 12.

40. See IMF PAMPHLET SERIES NO. 31, *supra* note 19, at 10.

41. See *supra* note 19. See also J. GOLD, LEGAL AND INSTITUTIONAL ASPECTS OF THE INTERNATIONAL MONETARY SYSTEM; SELECTED ESSAYS 412 (1979); J. Richardson, UNDERSTANDING INTERNATIONAL ECONOMIES: THEORY AND PRACTICE 72 (1980) [hereinafter cited as INTERNATIONAL ECONOMICS].

42. See INTERNATIONAL ECONOMICS, *supra* note 41, at 73.

43. Currently, the IMF certifies the propriety of a country's economic management by committing its own resources in support of an adjustment program. This endorsement tends to assure would-be foreign lenders and investors that the country's external account position is, or is approaching, sustainability. See PROGRAM FOR SUSTAINED GROWTH, *supra* note 10, at IV.

44. Many of the LDCs' recent problems in serving their debt stem from abrupt increases in real interest rates within lending countries. In order to offset increases in the LDCs' debt burden generated by rising real interest rates, the IMF should establish a Compensatory Financing Facility (CFF). See *A Debt Partnership*, THE ECONOMIST, Apr. 2, 1983, at 9. A given rise in interest rates would trigger the LDCs' ability to draw from the CFF, thus compensating LDCs for debt serving costs generated by measures beyond their control.

monetary policies of its member states.⁴⁵

The IMF is the logical choice to assume this role because it is the only institution which combines the functions necessary for the successful adjustment of LDC balance of payments through the use of major debt financing.⁴⁶ The IMF also has the requisite legitimacy needed to carry out this role. It is the international organization through which 146 states have provided a pool of funds for meeting their transitional financial needs.⁴⁷ Its member states thus generally regard the IMF as the appropriate vehicle for evaluating their national economic programs.⁴⁸

In 1982 the role the IMF played in averting LDC defaults illustrates the central position that the IMF has already assumed in addressing these types of problems. Throughout that year, the IMF provided short-term emergency credit to debt-burdened LDCs that were unable to service the interest on their external debt and were forced by their commercial creditors to go to the IMF for assistance.⁴⁹ Without IMF intervention, commercial lenders would have refused to renegotiate outstanding debts or to extend new loans to pay for food, energy and other needed imports.⁵⁰ Thus, resort to the IMF became essential to the LDCs.

A new phase in the relationship between the IMF and commercial banks began in 1984 with the conclusion of the multi-year re-

45. Regarding the IMF's suitability to coordinate the monetary policies of its member states, Secretary Baker stated:

The IMF played a major role in advising member nations in the development of policies necessary to promote adjustment and growth. Emphasizing growth does not mean deemphasizing the IMF. Through both its policy advice and balance of payments financing, the Fund has played a critical role in encouraging needed policy changes and catalyzing capital flows. It must continue to do so. One such aspect of this role would entail member nation cooperating by maintaining uniformity of interest rates. Such coordination would stabilize the LDCs debt payments and their ability to plan for long-term economic growth.

See PROGRAM FOR SUSTAINED GROWTH, *supra* note 10, at IV.

46. Volcker, 69 FED. RES. BULL. 80, 82 (Feb. 1983).

47. *Id.*

48. *Id.* In addition, it is essential for the debtor nations that the IMF undertake this role. The international financial institutions (i.e., the IMF) must continue to implement lending practices promoting adjustment and growth in conjunction with the debtor nation's decision to restructure their economies. These efforts should be mutually enforcing. See PROGRAM FOR SUSTAINED GROWTH, *supra* note 10, at II. Sound policies in the principal debtor countries will not only promote growth, but will also stimulate the needed private bank lending. *Id.* Moreover, it will be important that these policies be supported by the IMF, complemented by the Multilateral Development Banks (MDBs). These institutions can help encourage and catalyze both needed policies and financing. *Id.* at II.

49. Government officials realized that only an agreement with the IMF to undertake internal austerity measures would restore the confidence of commercial lenders. See *The IMF and Latin America*, *supra* note 20, at 69.

50. *Id.* See also Hoge, *Debt Crisis Forces Suit by Brazil*, N.Y. TIMES, Nov. 15, 1982 at D1, Col. 6; Schumaker, *Argentina Agrees on Spending Cuts to Cut IMF Loan*, N.Y. TIMES, Oct. 28, 1982 at A1, Col. 1; IMF SURVEY, March 21, 1983, at 92-93; IMF SURVEY, March 7, 1983, at 65; Schumaker, *Argentina's Debt: Why Banks Worry*, N.Y. TIMES, Sept. 1, 1982 at D1, Col. 2.

structuring agreement (MYRA) for Mexico. This agreement was intended to lay the foundation for a resumption of "spontaneous"⁵¹ bank lending by stretching the principal maturities falling due in the next few years over a longer period of time.⁵² As part of the agreement, Mexico asked the IMF for "enhanced surveillance" from 1986 to 1990 after the present extended IMF arrangement expires in 1985.

All IMF members are currently subject to some surveillance in the form of an annual staff review of their economic situations, prospects and policies. On the basis of "Article Four consultations,"⁵³ staff reports are prepared and discussed by the IMF Board of Directors. These reports are available, however, only to the governments of the member countries.

The "enhanced surveillance" established under the Mexican MYRA differs from the above form of surveillance in two respects. In addition to a full-fledged Article IV consultation and staff report to review Mexico's program and policy targets for the year ahead, there will be a mid-year review of the progress achieved against the plan. Secondly, the IMF staff reports will also be made available to Mexico's creditor banks as well as to IMF member governments.⁵⁴ This "enhanced surveillance" concept greatly increased the central role of the IMF in determining international debt strategy.

The IMF has made it clear, however, that commercial banks cannot expect "on/off"⁵⁵ signals from enhanced surveillance. The

51. In a number of cases, commercial banks conditioned their own loan commitments or disbursements on those of the IMF. Since IMF disbursements are only made when specific performance criteria are met, this was tantamount to the banks linking their lending to "on/off" signals from the IMF. This was the exception rather than the rule, however. Most bank lending before 1982 was "spontaneous" and most borrowing countries were not subject to IMF conditionality. See INSTITUTE OF INTERNATIONAL FINANCE OVERVIEW, Vol. 1, No. 2 (1985) at 5 [hereinafter cited as INTERNATIONAL FINANCE]. (For a discussion on the Institute of International Finance see *infra* text accompanying note 149.)

52. See *supra* note 4.

53. Under the Articles of Agreement of the IMF, the Fund is charged with overseeing the international monetary system in order to ensure its effective operation. See International Bank Agreement, *supra* note 12. 60 STAT. 1401, T.I.A.S. No. 15d, 2 U.N.T.S. Article IV, Section 3(b) provides that "the Fund shall exercise firm surveillance over the exchange rate policies of members and shall adopt specific principles for the guidance of all members with respect to those policies." THE IMF ANNUAL REPORT 61 (1983). In general, Fund surveillance focuses on the examination of the overall economic situation of a member country in order to access the appropriateness of its policies with respect both to the sustainability of its external position and to the effects on other member countries. *Id.* at 61-62.

54. The "enhanced surveillance" concept is a recent phenomenon. It is impossible to say how many countries will ultimately be subject to "enhanced" IMF surveillance. Enhanced surveillance will only be available if a country asks the IMF for it and if the IMF Board of Directors agrees to the request. Another qualification for enhanced IMF surveillance would be that the country have a good adjustment record and already have made considerable progress down this road. A further condition would probably require that the country in question have concluded a multi-year restructuring agreement with its bank creditors. See INTERNATIONAL FINANCE, *supra* note 51, at 6.

55. *Id.*

IMF will not establish performance criteria for debtor nations and indicate when they are violated. Enhanced surveillance will therefore not provide the "on/off" signals given by standard IMF arrangements.⁵⁶ Commercial banks will have to make individual credit assessments and decisions concerning the appropriate link between the economic performance of the debtor nation and any future lending activity.

Notwithstanding these reservations, Secretary Baker promoted the concept of enhanced surveillance in a statement before the House Committee on Banking, Finance and Urban Affairs:

Our debt strategy has emphasized the need to reduce both external and domestic imbalances to help lay the basis for longer-term growth. This has required a strong central role for the IMF in debt strategy. That central role should continue, as a means of encouraging needed policy changes and catalyzing capital flows. In some cases, the use of "enhanced surveillance" may provide a sound basis for catalyzing financing in support of good performers.⁵⁷

Under Secretary Baker's proposed Program, then, the IMF would play a primary role.

2. *The World Bank.*—The World Bank's⁵⁸ operations are in many ways similar to those of a commercial bank. It is a profit-making institution that borrows and lends at close to market rates of interest.

The Bank's equity consists of paid-in capital from the member countries and retained earnings, in approximately equal parts.⁵⁹ The Bank has never paid dividends to its members, but rather chooses to retain its earnings to support additional lending.⁶⁰

The Bank's resources, in addition to its equity, come from borrowing. About thirty percent of the Bank's debt is held by central banks and governments, who hold its obligations as part of their foreign exchange reserves.⁶¹ The remainder is borrowed on private mar-

56. The relations between the International Monetary Fund and a borrowing country have long played an important role in determining the lending policies of commercial banks and other official lenders. Conclusion of a stand-by arrangement is considered the IMF's seal of approval and is confidence building measure. In the few cases in which banks had agreed to reschedule a country's principal maturities before 1982, the IMF played an instrumental role in bringing about such restructurings as these were generally contingent on the conclusion of an IMF supported adjustment program for the country in question. *See id.* at 5.

57. *See Hearings Before the Comm. on Banking, Finance and Urban Affairs*, October 22, 1985, at 4 (statement of Secretary of the Treasury James Baker) [hereinafter cited as *Treasury News*].

58. *See supra* text accompanying note 12.

59. *See Clausen, A Financial Appraisal of the Bank*, 19 *FINANCE & DEVELOPMENT* 9 (1982) [hereinafter cited as *A Financial Appraisal of the Bank*].

60. *Id.*

61. *Id.*

kets all over the world. The Bank asserts that its private debt is highly diversified by country, currency, source, maturity and technique of borrowing.⁶² The average maturity of its debt is seven years, at fixed rates of interest.⁶³ By contrast, commercial bank borrowing is primarily short-term and is often matched against variable rate loans.⁶⁴

The World Bank is in business for the purpose of making loans. The Bank lends to developing countries at a profitable rate of interest,⁶⁵ almost always for specific projects⁶⁶ which would not be financed by private markets. The World Bank works closely with a country to develop and appraise a project, providing technical assistance and advice. This process takes, on average, more than two years before a project is submitted for loan approval.⁶⁷ There has never been a default or loss on a World Bank loan, in part, because of the Bank's careful preparation.⁶⁸

To date, private banks and the IMF have been the principal agents in dealing with current LDC debt-payment problems. The World Bank has largely remained uninvolved with either the problem or the solution. The Bank has mainly concentrated on turning substantial profits on its project loans. For its size, however, — \$60 billion in subscribed capital and 5800 employees — the Bank is a relatively small lender, providing only approximately \$12 billion a year to countries whose debt exceeds \$600 billion.⁶⁹

Under Secretary Baker's proposal, the role of the World Bank would change, shifting the emphasis in lending away from belt-tightening and rapid repayment⁷⁰ and toward longer-term loans. Secretary Baker's Program also envisions a change in the World Bank's lending criteria to emphasize structural changes in the borrowing

62. *Id.*

63. Borrowing from the World Bank at a predetermined price is an invaluable certainty. See *A Bank for All Seasons*, THE ECONOMIST, Sept. 4, 1982, at Survey 18 [hereinafter cited as *A Bank for All Seasons*].

64. See *supra* note 27 and accompanying text.

65. The terms of the loans, while profitable for the World Bank, are usually better than those available from the commercial banks because of the World Bank's ability to borrow on favorable terms from low inflation, low interest rate countries like Japan, Germany, Switzerland and, at one time, the United States. See *A Bank For All Seasons*, *supra* note 63, at Survey 24-25.

66. As a major project lender, the World bank has extended \$90 billion of credit to developing countries on a project financing basis. *Id.* *A Financial Appraisal of the Bank*, *supra* note 59, at 9.

67. *A Financial Appraisal of the Bank*, *supra* note 59, at 9.

68. *Id.*

69. Scherschel, *A New Try at Curing World's Debt Problems*, U.S. NEWS & WORLD REPORT, Oct. 21, 1985, at 35.

70. The World Bank has recognized that long-term adjustment in external payments deficits could be accomplished either by reducing programs for investment and development, which conflicted with its mandate, or by providing a program of financial measures and structural adjustments supported by external borrowing. See *Bank Head Pushed Policy of Growth*, N.Y. TIMES, Oct. 7, 1985, at A10, col. 6.

countries' economies. This would encourage, for example, development of private enterprise and a reduction in state-owned businesses.⁷¹

At the same time, Secretary Baker wants the Bank to undertake more co-financing — joining private banks for the purpose of participating in private lending. To encourage private banks to join in such lending, the Administration, under Secretary Baker's Program, would ask the World Bank to provide loan guarantees to qualified LDCs. Last summer, the World Bank provided such guarantees on \$150 million in loans to Chile.⁷²

Secretary Baker also recommended in his Program⁷³ that a serious effort to coordinate the programs of the World Bank and the Inter-American Development Bank (IDB)⁷⁴ be undertaken. Working together, the two situations could increase the disbursements to principal debtors by roughly fifty percent from the current annual level of 12 billion.⁷⁵

If lending increases, as envisioned in Secretary Baker's plan, then both the World Bank and the IDB will be required to borrow in world capital markets. The ability to borrow at low rates that these institutions currently enjoy is an asset that must be maintained.⁷⁶ Therefore, any new lending undertaken by the IDB and World Bank must support sound economic programs that enhance the borrower's ability to service its debt and grow.⁷⁷

71. Secretary Baker has suggested that such methods as divestment of state-owned industries and lowering tax rates would facilitate positive structural changes in LDC economies. See PROGRAM FOR SUSTAINED GROWTH, *supra* note 10, at IV. See also Baker Steers a New Course, TIME, Oct. 21, 1985, at 62 [hereinafter cited as *New Course*]; Riding, *Brazil Acts to Tame State Ownership*, N.Y. TIMES, Nov. 25, 1985, at D8. The debtor nations must also take measures to slow down their capital flight so that money from their new loans does not simply go into foreign bank accounts. *New Course, supra*.

72. The World Bank coaxed private banks to lend more to Chile by itself underwriting the later years of a big loan rescheduling package. See *World Bank is Under Pressure From U.S. to Expand Its Role in Global Debt Crisis*, WALL ST. J. Oct. 1, 1985, at 36. In addition, the World Bank recently put into effect a fifteen year proposal to attract foreign investment in Third World countries by guaranteeing the foreigners' stakes against expropriation. However, these efforts have been timid. *Id.*

73. PROGRAM FOR SUSTAINED GROWTH, *supra* note 10, at V.

74. The Inter-Development Bank (IDB) was founded in 1959 to aid in the development of Latin America. The IDB provides a multilateral mechanism for the transfer of capital to developing states as an alternative to other assistance and permits the lending of funds on the basis of relatively neutral economic and financial criteria. Moreover, IDB credit provides financing which is consistent with the requirements of long-term development plans. See Krasner, *Power Structure and Regional Development Banks*, 35 INT'L ORGAN. 305-316 (1981).

Secretary Baker stated that since the most serious debt programs are found in Latin America, "special emphasis should be placed on strengthening the IDB's policies to enable it to be a more effective partner in support of growth-oriented structural reform. See PROGRAM FOR SUSTAINED GROWTH, *supra* note 10, at IV.

75. See PROGRAM FOR SUSTAINED GROWTH, *supra* note 10, at IV.

76. See *supra* note 65.

77. In order to facilitate increased lending by the IDB and the World Bank, it would be critical to assess the extent to which the institutions strengthen their lending policies. There must be well-defined economic and country strategies tailored to enhance economic reforms

3. *Present Outlook for the IMF and World Bank.*—Both the IMF and the World Bank are being called upon under Secretary Baker's Program to create solutions to serious international debt problems. There is a real danger, however, that new lending activity will merely postpone essential adjustments in the balance of payments and the structure of the economies of the debtor nations.⁷⁸

The IMF and World Bank should tailor their lending programs to provide support for economic structural adjustments. These structural adjustments would permit the LDCs' balance of payments to accommodate growth and development.⁷⁹ The value of the lending by these institutions exceeds mere monetary value. Through technical advice and assistance and through the discipline imposed as conditions of the loans, the IMF and World Bank promote national programs for growth that otherwise would not be implemented.⁸⁰ Moreover, the additional confidence in the economy that is generated by these programs helps to maintain a flow of private capital.⁸¹

The United States economy is increasingly dependent on exports, and the LDCs constitute a large and growing market for American products. As a percentage of gross national product, United States exports have more than doubled in the last twenty years,⁸² and in 1981 twenty-nine percent of those exports were sold to developing countries, compared with only twenty-four percent in 1973.⁸³ As accurately envisioned by Secretary Baker's proposal, United States interests would be best served by continuing its strong financial support of the world community through the IMF and the World Bank.⁸⁴ Using these instrumentalities, lending programs could

within LDCs which encourage growth. See PROGRAM FOR SUSTAINED GROWTH, *supra* note 10, at V.

78. Increase in lending to debtor nations who fail to make any economic readjustment efforts will be fruitless. "Countries which are not prepared to undertake basic adjustments and work within the framework of the case-by-case debt strategy, cooperating with the international financial institutions, cannot expect to benefit from this three-point program." *Id.* at V.

79. "The core of any successful effort lies in the adjustment actions of the borrowing countries themselves — all else rests on the perception and the reality of their own efforts to rebuild a base for sustained growth with reduced reliance on external funds." See *International Debt Problems*, *supra* note 27, at 103 (statement of Paul Volcker). In most cases, those actions have been constructed in cooperation with, and have received the financial support of, the International Monetary Fund. *Id.*

80. See *supra* text accompanying notes 18-19.

81. The immediate cause of the debt problem — the global recession and high interest rates — coincided with the planning decision by many banks to place lower priority on lending to developing countries. The need then is to strengthen the confidence of depositors and investors in international capital markets and to restore the creditworthiness of the major debtor nations. The objectives must be to minimize current losses, to create conditions that will permit debtors to maintain debt service and resume growth, and to build international structures favorable to a renewal of sound lending patterns. THE IMF ANNUAL REPORT 61 (1983).

82. COUNCIL OF ECONOMIC ADVISORS, ECONOMIC REPORT OF THE PRESIDENT 184-189, 186 (1982).

83. *Id.*

84. Farnsworth, *U.S. May Back Higher Lending by World Bank*, N.Y. TIMES, Oct. 7, 1985, at A1, col. 5. The United States proposed \$500 million over the next three years to be

be assured to be as effective as possible, promoting adjustment and growth for the economies of the LDCs.

B. The Third Prong — Increased Lending by Commercial Banks

1. Providing New Money.—A successful resolution of the debt crisis requires global economic recovery and the implementation of austerity programs by the governments of debtor countries. The debt crisis will also be resolved only if commercial banks are willing to roll over⁸⁵ and restructure⁸⁶ existing debts and increase net lending to troubled borrowers.⁸⁷ New money is essential to a non-disruptive adjustment process.

Bank directors and management have legal and economic responsibilities to shareholders and depositors. If new money is in the best interests of the bank, it must also be in the best interests of the shareholders and depositors. The conclusion that new money will reduce a bank's long term exposure while preserving and securing future business with the restructuring debtor and its domestic industry justifies the supply of fresh money.⁸⁸

There is, however, no necessity, incentive, or legal requirement for banks to contribute new money in the same ratio as their original loan participation.⁸⁹ Supplying fresh money may also be unaccept-

put into a special five billion dollar fund that Secretary Baker is expected to propose to help the poorest countries. A first year United States offering could be \$75 million. This money would not need approval by Congress because it would be part of a bilateral assistance program of the United States.

85. "Roll-over" is the process by which banks, instead of demanding payment when a remittance of principal falls due, renew loans and thus delay ultimate repayment. Banks do not, however, officially roll-over interest payments, but they do convert those payments into new loans, with similar results.

86. See *supra* note 4 and accompanying text.

87. During the first half of 1982, international bank lending increased at roughly the same rate as in the first half of 1981; but the growth of bank lending, especially to developing countries, dropped in the second half of the year. Total net bank lending to the non-oil developing countries, which had reached about \$50 billion in 1980 and 1981, declined to \$25 billion in 1982, with only \$6 billion occurring in the last six months of that year. THE IMF ANNUAL REPORT 77 (1983).

88. A bank's willingness to contribute new money depends on its regulatory and accounting systems, earnings performance, capital levels and reserve positions. One commentator stated that the decision to commit new money is really based on the diagnosis of whether the current debt problem is an insolvency or an illiquidity problem. For a country, insolvency exists if the future stream of export earnings under reasonable conditions is inadequate to enable the country to meet expected debt service payments. Such an inability over the next decade or two would mean the country is insolvent and that foreign banks and governments would be wiser to try and recover a fraction of the face value of the existing debt rather than to lend more money. See *International Debt and Policy, Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs, 98th Cong. 1st Sess. 235, 241-243 (1983)* [hereinafter cited as *House Hearings on International Bank Lending*].

If the export earnings, after a limited period of two or three years, permit normal debt servicing, then the country's problem is one of illiquidity and continued foreign lending is appropriate. If there is a liquidity problem, a halt in lending would be precisely the wrong thing to do; this would force a country into insolvency and turn a good debt into bad debt. *Id.*

89. See *House Hearings on International Bank Lending, supra* note 88, at 15.

able for those banks which already have considerable loan loss reserves.⁹⁰ Uncertainty, coupled with a genuine fear that other banks may withdraw totally, makes the decision to increase lending a difficult one. This difficulty is magnified by the possibility that the bank's competitive position domestically may decrease in comparison to national competitors who have less exposure overseas or who do not need to share in the burden of new lending.

There is almost no public encouragement for banks to contribute new money. Media attention on international lending practices has exacerbated public perception of the degree of risk involved in lending to LDCs. As a result, some banks have been publicly criticized for assuming those risks. In light of these facts, some banks have curtailed lending⁹¹ and fewer banks have been willing to contribute new money in addition to old loans.⁹² The burden on the remaining banks to supply the needed funds has therefore increased.⁹³

The remaining question is where will the sources of new long and short term money be found? Official lenders, such as the IMF and World Bank must provide and guide the use of long-term funds. Additionally, a majority of the commercial banks with outstanding loans to LDCs must provide new short-term money, even though they are under no legal obligation to do so. Secretary Baker has argued that such financing could be used to meet both short-term financing and longer term investment needs in developing countries. If commercial banks must rely on themselves to raise new money, however, there may be significant regulatory implications.

90. *Id.*

91. *See supra* text accompanying note 32.

92. When the Mexican foreign exchange crisis burst upon the financial world in 1982, the major United States commercial bank lenders had loans outstanding to Mexico, Brazil and Argentina totalling 137% of their capital. *International Financial Markets and Related Problems: Hearings Before the House Comm. on Banking, Finance and Urban Affairs*, 98th Cong., 1st Sess. 381, 386 (1983) (statement of Richard S. Dale, Brooking Institute) [hereinafter cited as *International Financial Markets*]. Given that loans to these countries exceeded the bank's capital, if the loan values on the banks' books were to be written down to actual worth (or the debtor countries were to repudiate the loans and cause their value to be recognized as zero) the capital of these banks would be impaired. *Id.*

93. Secretary Baker has argued that official lenders, such as the IMF must realize that their increased participation in sharing the burden is necessary to induce these reluctant banks to provide new money:

If creditor governments, in an age of budget austerity, are to be called upon to support increases in multilateral development bank lending to the debtor nations, and if the recipient nations are asked to adopt sound economic policies for growth to avoid wasting that financing, then there must also be a commitment by the banking community — a commitment to help the global community make the necessary transition to stronger growth.

Our assessment of the commitment required by the banks to the entire group of heavily indebted, middle income developing countries would be net new lending in the range of \$20 billion for the next three years.

See PROGRAM FOR SUSTAINED GROWTH, supra note 10, at V.

2. *Banking Regulation — Prior Regulation.*—The Interagency Country Exposure Review Committee (ICERC) was created in 1979 to implement Congress' statutory directive to evaluate country risk.⁹⁴ The adoption of this uniform approach to the examination of overseas lending marked the first coordinated federal attempt to monitor foreign lending.⁹⁵ The ICERC was charged with monitoring bank exposures, evaluating banks' internal systems for managing country risk, assessing the credit-worthiness of particular countries, identifying problems that could arise because of transfer risk,⁹⁶ and bringing these problems to the attention of bank management.⁹⁷

The ICERC, however, failed to prevent the escalation of risky sovereign debt. Banks could ignore the committee classifications

94. "Country risk" is the risk "associated with conditions in the nation where the borrower resides." Walter, *Country Risk and International Bank Lending*, 1982 U. ILL. L. F. 71. Such risk may take into account the stability of the government, the country's balance of payments, and the general health of the economy.

Regarding the ICERC:

[T]he Interagency Country Exposure Review Committee . . . was formed in 1979 and is composed of representatives of the COC [Comptroller of the Currency], the Fed and the FDIC. It meets three times a year and considers about 20 countries at each meeting, evaluating their current economic situation and future economic prospects. Judgments made by the Committee are disseminated to bank examiners for use in evaluating loan portfolios of individual commercial banking institutions A typical presentation includes a review of the country's recent economic trends, current economic policies, and projections of the future direction of the economy, as well as any important structural factors, such as the quality of natural resources, that should be brought to the Committee's attention. The focus in these presentations is on the country's current and prospective ability to service its external debt.

House Hearings on International Bank Lending, *supra* note 88, at 34-35.

95. The supervision and examination of the foreign and domestic activities of United States banks is divided among three regulatory bodies: the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC) and the Comptroller of the Currency (COC). The FRB is responsible for foreign activities of state member banks and bank holding companies; the FDIC is responsible for insured state non-member banks and the COC supervises national banks. THE OPERATIONS OF U.S. BANKS IN THE INTERNATIONAL CAPITAL MARKETS: MINORITY STAFF OF HOUSE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, 96th Cong., 1st Sess., 25 (1979).

96. For purposes of this comment, transfer risk means the possibility that an asset cannot be serviced in a currency of payment because of a lack of or restraints on the availability of needed foreign exchange in the country of the obligor. 49 Fed. Reg. § 5591 (1984) (to be codified at § 20.7(d)).

97. *International Financial Markets*, *supra* note 92, at 84-89 (statement of Paul Volcker, Chairman of the Board of Governors of the Federal Reserve System).

The ICERC employs a system for categorizing borrower nations according to transfer risk. *See supra* note 96. Countries are subject to ICERC classification only when an interruption in external payment occurs or appears imminent. Based on ICERC review of a nation's reasons for nonpayment, its prospective sources of financing, and its potential for renewed debt-servicing, ICERC classifies the nation's loan as substandard, doubtful or loss. *International Finance Markets*, *supra* note 92, at 87-88.

In addition to assessing transfer risk, ICERC classifies the debt-serving potential of borrowing nations as strong, middle or weak. When a bank's exposure to a weak country exceeds 10% of its total capital or when exposure to a middle country exceeds 15% of total capital, the federal bank examiners note the condition in their bank examination report. The purpose of this is to alert the bank to the situation. No action, however, is required of the bank. *International Finance Markets*, *supra* note 92, at 86-87.

without fear of sanction from the ICERC; market sanctions did not exist because the classifications were not public.⁹⁸ The failure of the ICERC approach has led one commentator to advocate passage of more binding safeguards to prevent banks from failing as the result of a single country's default.⁹⁹

The utilization of more effective tools to encourage bank prudence, however, could lead to political complications. Regulators and others wishing to solve the international debt crisis must be careful to engineer improved bank practices without damaging relations with foreign friendly states or further destabilizing the current debt situation.

3. *The International Lending Supervision Act of 1983 — Current Regulation.*—The International Lending Supervision Act of 1983 (the Act or ILSA)¹⁰⁰ requires that federal banking agencies¹⁰¹ impose restrictions on the foreign lending practices of domestic banks¹⁰² to ensure greater stability of the domestic banking system.

The first major provision of the Act directs “[e]ach appropriate federal banking agency to require the banking institutions within its jurisdiction to create special reserves when repayment of foreign loans becomes questionable.”¹⁰³ The Act's proponents envisioned that reserves would be needed when a foreign borrower has exhibited an inability to make payments on its indebtedness over an extended period of time.¹⁰⁴ The Act also compels a lender to create a special reserve in specifically defined situations in which, “no definite prospects exist for the orderly restoration of debt service.”¹⁰⁵ Congress

98. Although these foreign obligor classifications are not made public, bankers affirm that since 1983 more foreign states had been downgraded to loan categories. This has encouraged bankers to exercise more caution about further lending to such nations. For example, in March 1984, all loans to Venezuela were downgraded to a “sub-standard” classification. In November 1984, selective loans to Argentina were also reclassified as “sub-standard” by the ICERC and by the federal bank regulators. N.Y. TIMES, Nov. 9, 1984, at D1, col. 6.

99. The British scholar strongly criticized the ICERC supervisory mechanism and the reluctance of the regulators to allocate credit. *International Financial Markets*, supra note 92, at 388 (statement of Richard S. Dale, Brookings Institute).

100. International Lending Supervision Act of 1983, Pub. L. No. 98-181, 97 Stat. 1153, 1278 (codified at 12 U.S.C.A. §§ 3901-3912 (1983) [hereinafter cited as ILSA or the Act].

101. See supra note 95.

102. United States policy, as expressed under The International Lending and Supervision Act, is to restrain the banks in their foreign lending while accommodating the international system's need for a continued in-flow of funds to developing countries. This in-flow of funds is viewed as necessary to avoid the world-wide domino effect that would result if one or more major countries became unable to pay its external bills.

103. International Lending Supervision Act § 905(a)(2), 12 U.S.C. § 3904(a)(2) (Supp. II 1984). Normal loan loss reserves or allowances for possible loan losses include reserves which banks maintain for regulatory, supervisory, or disclosure purposes.

104. ILSA § 905(a)(1)(A), 12 U.S.C. § 3904(a)(1)(A) (Supp. II 1984).

105. *Id.* The ILSA mandates that banks with particularly high levels of LDC default exposure establish special reserves against potential losses from foreign loans. *Id.* Under the Act, federal banking agencies are to assess the quality of a banking institution's international loans when determining whether a special loan loss reserve is necessary. Examples of factors to

vested in the federal banking agencies the power to define the parameters of the reserve requirements.¹⁰⁶

(a) *Regulations Promulgated Under the ILSA.*—Since the enactment of the International Lending Supervision Act, the federal banking agencies have promulgated international banking requirements pursuant to the Act.¹⁰⁷ The regulations issued by the Federal Reserve Bank (Fed) in conjunction with the Federal Deposit Insurance Corporation (FDIC) and Comptroller of the Currency (COC) govern reserves against potential foreign loan losses, establish international loan fee accounting conventions,¹⁰⁸ and require the disclosure and reporting of international assets.¹⁰⁹ The new regulations

be considered in making this determination include: 1) failure by the public or private borrower to make full interest payments on external indebtedness; 2) failure to comply with the terms of any restructured indebtedness; and 3) failure by the foreign country to comply with any IMF or other stabilization programs. *Id.*

106. Although Congress vested the power to define the parameters of the reserve requirements in the federal banking agencies, Congress specifically set forth in the Act the accounting treatment for such reserves. Banks are to charge special reserves against their current income, and are not to include such reserves as part of capital or as part of normal loan loss reserves. See *supra* note 103. It is not clear, however, whether the amount banks must hold in new, separate reserves are fungible with normal reserve funds in covering loan losses not associated with foreign lending, or whether banks can use normal loan losses to cover international loan losses. It can be assumed that the reserves are fungible since the Act limits the use of new reserves only for regulatory, supervisory or disclosure purposes. See 12 U.S.C. § 3904(a)(2).

107. ILSA § 910(a), 12 U.S.C. § 3909(a) (statutory authority for federal agencies to issue regulations). The final regulation for all three agencies was issued on Feb. 9, 1984. See Allocated Transfer Risk Reserve, 49 Fed. Reg. §§ 5590-91 (1984) (to be codified at 12 C.F.R. §§ 20.1, 20.2, 20.7-20.8); *id.* at §§ 5591-93 (to be codified at 12 C.F.R. §§ 211.41-211.43); *id.* at § 5593 (to be codified at 12 C.F.R. § 351.1); see also 50 Fed. Reg. § 39980 (1985) (to be codified at 12 C.F.R. § 211.1-211.7).

108. The regulations enacted by the Fed, the FDIC and the COC, see *supra* note 104, were promulgated under the authority of ILSA § 910(a)(1), 12 U.S.C. § 3909(a)(1). The Act seeks to "avoid excessive debt burdens on debtor countries" by forbidding banks from charging any fee exceeding the administrative cost of restructuring "unless the fee is amortized over the life of the restructured loan." *Id.* See 49 Fed. Reg. 5594, 5596-99 (1984) (to be codified at 12 C.F.R. §§ 20.7, 20.9, 211.42, 211.45, 351.2). Section 910(a)(1) reflects Congressional belief that additional fees paid to banks for extensions of existing international loans represent an added interest charge to compensate for the additional credit risks incurred with the rescheduled principal. Under this philosophy, such fees should therefore be amortized over the effective life of the loan. See *Proposed Solutions to the International Debt Problems: Hearings on S. 502 and S. 698 Before the Senate Comm. of Banking, Housing and Urban Affairs*, 98th Cong., 1st Sess. 60 (1983) (statement of C. T. Conover, Comptroller of the Currency) [hereinafter cited as *Proposed Solutions*].

Banking regulations addressed the fact that front-end fees (fees that are often taken into income in the period a loan is made, providing a boost to current earnings) are not amortized and may, as a result, increase a bank's incentive to lend by creating a deceptive short-term appearance of increased income when the entire fee is added to the bank's current income. *Id.* See 49 Fed. Reg. 5594, 5596-99 (1984) (Accounting of International Loan Fees) (to be codified at 12 C.F.R. §§ 20.7, 20.9, 211.42, 211.45, 351.2).

109. These regulations were promulgated under the authority of ILSA § 907, 12 U.S.C. § 3906. Section 907 mandates increased disclosure of international lending data. It requires "each banking institution with foreign country exposure risk to submit" information at least quarterly about the exposure to the appropriate regulatory agency. *Id.* at § 3906(a). 49 Fed. Reg. 5587 (1984) (to be codified at 12 C.F.R. § 20.10(a)(1)); *id.* at § 5587 (1984) (to be codified at 12 C.F.R. § 211.44(a)(1)); *id.* at § 5587 (1984) (to be codified at 12 C.F.R. § 351.3(a)(1)). (Furthermore, banks now are required to make public the figures concerning

identify the reserves that banks must establish against potential losses on foreign loans as "Allocated Transfer Risk Reserves" (ATRRs).¹¹⁰ The regulations specify that ATRRs shall represent ten percent of the principal amount of each international asset for the first year and fifteen percent in subsequent years unless the federal banking agencies jointly determine otherwise on a case-by-case basis.¹¹¹ The new regulations also list the factors that the federal banking agencies will consider in determining the amount of the ATRR required for each international asset.¹¹²

The special loan loss reserve requirements under the Act and the ATRR requirements under the regulations provide a significant economic deterrent to continued LDC lending by domestic banks because the banks must now deduct new reserve amounts from their earnings.¹¹³ Since the passage of the Act, major domestic banks have had to raise their loan loss reserves in response to pressure from federal banking agency examiners.¹¹⁴ Increased loan loss reserves have

foreign country exposure in relation to banks assets. *Id.* at § 3906(b). The chairmen of the federal banking agencies have stated that public disclosure will allow bank depositors and investors to scrutinize foreign loans more closely. *See Proposed Solutions, supra* note 108, at 28 (joint statement of William M. Issac, C.T. Conover and Paul A. Volcker). First, it will cause banks to make more prudent loans by forcing them to disclose their loans more frequently. Second, depositors and investors will require adequate reserves and greater risk diversification in return for continued and increased investment with the banks. *Id.*

110. ILSA § 905, 12 U.S.C. 3904 (Supp. II 1984); 49 Fed. Reg. §§ 5590-5593 (1984) (to be codified at 12 C.F.R. §§ 20.8, 211.43, 351.1(b)).

111. ILSA § 905(a)(1), 12 U.S.C. 3904(a)(1) (Supp. 1984). The federal banking agencies will jointly determine which foreign assets are subject to reserves and banks will be notified of the amount of reserves for each of those assets. These reserves are intended to require banking institutions to recognize uniformly the transfer risk and diminished value of international assets which have not been serviced over an extended period of time.

112. 49 Fed. Reg. 5590 (1984) (to be codified at 12 C.F.R. § 20.8(a)(b)(i),(ii),(iii); *id.* at 5592 (1984) (to be codified at 12 C.F.R. 211.43(a)(b)(i),(ii),(iii); *id.* at 5593 (1984) (to be codified at 12 C.F.R. § 351.1(b)(1)(2)). The specific amount and timing of the reserve would vary by country and might also vary by the type of asset. The Fed stated that in determining a foreign loan reserve amount, the banking agencies would consider: 1) the length of time a bank's foreign assets were impaired, 2) the actions the debtor took to restore debt service, and 3) the prospects for restoring asset quality and other factors the banking agencies deem relevant. *Id.* at § 905(a)(1).

113. ILSA § 905(a)(2), 12 U.S.C. § 3904(a)(2). In some cases, an ATRR may not be a hinderance to lending. The banking agencies preamble to the final regulations states that, "an ATRR normally would not be required initially for net new lending when the additional loans are made in countries implementing economic adjust programs," such as programs approved by the IMF, designed to correct the countries' economic difficulties in an orderly manner. 49 Fed. Reg. § 5588 (Assets to be covered by the Allocated Transfer Risk Reserve (ATRR)(1)) (1984). The reasoning behind this is that new loans would improve the quality of outstanding credit, and thus be consistent with the Act's objective of improved supervision of international lending. *See generally* ILSA § 901-913, 12 U.S.C. §§ 3901-3912.

114. PROPOSALS FOR LEGISLATION TO INCREASE THE RESOURCES OF THE INTERNATIONAL MONETARY FUND: HEARINGS BEFORE THE SUBCOMM. ON INTERNATIONAL FINANCE AND MONETARY POLICY OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 98th Cong., 1st Sess., 320 (1983) (statement of C.T. Conover, Comptroller of the Currency) [hereinafter cited as PROPOSALS FOR IMF RESOURCES]. "Some U.S. banks are not realistically recognizing the value of foreign loans with extended repayment difficulties. Banks should adjust the value of the assets, rather than carrying them on their books at full value." *Id.* at 356-57. William Isaac, Chairman of the FDIC, also testified that, "[m]any banks have acted

therefore reduced earnings for most United States multinational banks.¹¹⁵

It is likely that faced with both the prospect that lower earnings are likely because of strict reserve requirements and the realization that debtor LDCs may remain unable to pay some of their foreign debt obligations, domestic banks will cut back significantly on their foreign lending activity.¹¹⁶ Although one of the goals of the Act is to safeguard the banking system against aggressive lending to LDCs,¹¹⁷ the Act and the regulations passed under it¹¹⁸ may tend to aggravate the present debt crisis by curtailing lending vital to LDC solvency.¹¹⁹ In order to promote a lasting solution to the international debt crisis, agency regulatory measures adopted under the Act must help reduce the current high level of LDC default exposure of domestic banks¹²⁰ and ensure that banks do not exceed prudent levels of foreign default exposure in the future.¹²¹ The regulations, however, must not cause an LDC credit squeeze so severe as to set LDC economic recovery back indefinitely.¹²²

A dominant regulatory concern has been striking an appropriate balance between reducing domestic bank exposure to potential LDC default and avoiding an acute undersupply of credit to LDCs, a situation which could trigger the very risk of LDC default that Congress sought to prevent.¹²³ For example, reckless bank lending to debtor nations would cause further deterioration in the quality of a commercial bank's asset portfolio. Such deterioration might cause a run on the bank's deposits,¹²⁴ or, in the event some of the larger debtor nations default on their borrowing, lead to bank insolvency.¹²⁵ On

responsibly and provided specific reserves to reflect foreign loans at a realistic carrying value. Others have not. When severe and extended problems warrant, banks should specifically reserve against certain loans. *Id.* at 388. Paul A. Volcker, Chairman of the Federal Reserve agreed with his colleagues, maintaining that special reserves will indirectly cause greater loan diversification. *See Proposed Solutions, supra* note 108, at 29.

115. *Behind the Banking Turmoil*, *BUS. WEEK*, Oct. 29, 1984, at 100 (Citicorp reported a 0.5% decline in third quarter earnings instead of flat earnings for that period because the bank added \$26 million to loan loss reserves).

116. Robotyn, *The State of the Banks*, *N.Y. REV. BOOKS*, Nov. 4, 1982, at 7.

117. *See generally* ILSA § 901-913, 12 *U.S.C. §§ 3901-3912* (Supp. 1984).

118. *See supra* note 107.

119. *See supra* text accompanying note 87.

120. *See supra* notes 25 and 26 and accompanying text.

121. *See* Cohen, *Special Feature, U.S. Regulation of Bank Lending to LDCs: Balancing Bank Overexposure and Credit Undersupply*, 8 *YALE J. WORLD PUB. ORDER* 200 (1982) [hereinafter cited as *U.S. Regulation of Bank Lending to LDCs*].

122. Robotyn, *Debt-Bomb Threat*, *TIME*, Jan. 10, 1983, at 42 [hereinafter cited as Robotyn] (possibility of large scale defaults on LDCs).

123. There is a strong possibility that commercial banks making excessive loans to LDCs could risk financial collapse in the event of LDC default. *Id.*

124. *See Greenspan Warning on Loans*, *N.Y. TIMES*, Jan. 3, 1983, at D2, Col. 1. Alan Greenspan, member of the Presidential Council of Economic Advisors under the Nixon and Ford administrations, warned that depositor concern over the international debt situation might result in runs on deposits from banks engaged in lending to LDCs. *Id.*

125. *See Top Banks' World Loans Detailed*, *N.Y. TIMES*, March 18, 1983, at D3, Col.

the other hand, a cutback in credit available to debtor nations could cause financial havoc by forcing debtor nations to default on foreign debt.¹²⁶ Although providing additional credit to finance LDC trade deficits and interest due on existing debt is not a sound long-term financing arrangement, the continued availability of credit for LDCs in the short-run may be essential to forestalling LDC foreign loan defaults.¹²⁷ The effectiveness of the Act in promoting greater stability in the world financial system will depend upon whether the Act and subsequent regulations can protect against the twin perils of LDC credit undersupply and bank overexposure.¹²⁸

(b) Effectiveness of the ILSA and the Regulations Promulgated Under It.—Initially, the International Lending Supervision Act had a broad impact and imposed severe restrictions on the banking industry's foreign lending practices. A closer look at the restrictions imposed, however, reveals that the Act and the regulations promulgated under it may not have solved the perceived problem. In particular, the congressional language in the Act concerning the policy of continued extensive cooperation between federal banking agencies and the IMF¹²⁹ may have reduced the effectiveness of the regulatory program.

The Act provides that the regulatory agencies shall not require banks to maintain ATRRs for net new lending when additional loans are made to countries implementing economic adjustment programs such as those sponsored by the IMF.¹³⁰ The reasoning behind this provision was that new loans would improve the quality of outstanding credit and thus be consistent with the Act's objective of improved supervision of international lending.¹³¹ Requiring these special reserves supports the policies set forth under the Act and the regulations by basing the determination of whether a bank has impaired its assets to a degree necessitating the establishment of special reserves in part on the foreign country's compliance with IMF economic recovery programs.¹³²

1.

126. There is concern that dramatic contraction of credit available to LDCs is occurring as money-center banks seek to reduce exposure to LDC deficit on foreign loans. Continued lending by private banks is essential in light of projected capital requirements of between \$75 billion and \$80 billion through 1986. See Robotyn, *supra* note 122, at 7; See PROGRAM FOR SUSTAINED GROWTH, *supra* note 10, at V.

127. See *supra* text accompanying note 122.

128. See U.S. Regulation of Banking Lending to LDCs, *supra* note 121, at 225.

129. See *infra* text accompanying note 133.

130. See *supra* note 113.

131. EMERGENCY STATEMENT ON EXAMINATION TREATMENT OF INTERNATIONAL LOANS, 1 FED. BANKING L. REP. (CCH) ¶ 2075, at 1971-72 (Dec. 15, 1983).

132. 12 U.S.C. § 3904(a)(1)(A). A potential default may be evidenced in some circumstances by the debtor's failure to comply with IMF economic programs.

Ideally, supporting IMF programs benefits the United States.¹³³ It is important to note that a regulatory scheme that stresses compliance with IMF programs as a factor in determining whether loans made to foreign countries require special reserves is based on the assumption that IMF austerity programs¹³⁴ are, in the majority of cases, an assurance of repayment. If this assumption proves to be incorrect in a significant number of cases, the Act and the regulations might be allowing the external debt of foreign countries to increase without any assurance of repayment.¹³⁵

The International Lending Supervision Act is an expression of Congressional concern for the health of the United States banking system in light of the LDC debt problem. In the long run, the Act will probably discourage banks from over-lending to LDCs and improve the financial soundness of those banks by increasing capital adequacy ratios¹³⁶ and foreign loss reserves.¹³⁷ There is a potential, however, that the proposed twenty billion dollars in new commercial-bank lending to Third World countries will be severely hindered by certain sections of this Act.¹³⁸

4. *Role of Commercial Institutions.*—Commercial banks¹³⁹

133. See PROPOSALS FOR IMF RESOURCES, *supra* note 114, at 308 (statement of Paul A. Volcker, Chairman of the Federal Reserve Board). Mr. Volcker stated:

To be sure, some of the IMF advances to borrowing countries, whether or not the United States is the immediate source of the funds, are likely, directly or indirectly, to be spent on U.S. exports. Some of the funds may promptly find their way back into the U.S. banking system or credit markets.

But those technical comparisons should not obscure the basic point of the IMF commitment. The strengthening of the IMF is an integral part of the overall effort to defend the stability of the international financial system. The success of that effort will not be measured by the amount of dollars drawn, but by its contribution to confidence that governments can and will work together to assure that the financial system can and will withstand strains and pressures, continuing to function effectively in the interest of every country.

That concern is not abstract or altruistic. The international financial system is not separable from our domestic banking and credit system. The same institutions are involved in both markets. A shock to one would be a shock to the other. In that very real sense, we are not considering esoteric matters of international finance, or primarily what is in the interest of heavily indebted developing countries, although that is involved. We are talking about dealing with a threat to the recovery, the jobs, and the prosperity of our own country, a threat essentially without parallel in the post-war period.

134. See *supra* note 19.

135. Cf. BUS. WEEK, Feb. 6, 1984, at 60.

136. The ILSA directs the banking agencies to cause banks to strengthen their capital bases and to establish minimum capital guidelines for banking institutions. ILSA § 906, 12 U.S.C. § 3907 (Supp. II 1984). In 1984, under the minimum capital guidelines of the Comptroller of the Currency and the Federal Reserve Board, multinational banking institutions were required to maintain a primary capital to total assets ratio of at least five%. The Federal Reserve Board also set specific capital ratio targets for the seventeen largest holding banks. See 49 Fed. Reg. 30,318 (1984) (to be codified at 12 C.F.R. §§ 208, 225, 263).

137. See *supra* notes 111-12 and accompanying text.

138. 12 U.S.C. § 3904(a)(2), § 3904(a)(1)(A), § 3904(a)(1). See *supra* text accompanying notes 102-09.

139. For purposes of this section, references to "banks" means commercial lending insti-

received Mr. Baker's proposal for increased lending with caution and without enthusiasm.¹⁴⁰ Most commercial banks dread making any new loans to developing countries where they already have too many risky loans outstanding.¹⁴¹ One major reason for this cautiousness on the part of the banks is that appeals for the relaxation of special reserve requirements for new loans to LDCs have been rejected by the federal banking agencies.¹⁴² Notwithstanding this hesitancy regarding Secretary Baker's proposal, bankers realize that cooperation with Secretary Baker's concerted approach to the debt situation is essential.¹⁴³

Global economic conditions seem likely to place a significant constraint on international lending to developing countries immediately following Secretary Baker's proposal. Commercial banks will also need to continue to strengthen their own positions. The combination of these two factors will limit the banks' abilities to provide significant new loans to developing countries.¹⁴⁴ Nevertheless, a positive attitude on the part of the banks will demonstrate a readiness to play a constructive role with other lenders in restoring a prudent and sustainable flow of finance to credit-worthy borrowers.¹⁴⁵

A priority for commercial banks will be to continue to improve the capital base on which future ability to provide new loans depends.¹⁴⁶ An important aspect of this process is the need for individual lenders to maintain an adequate level of earnings to make possible the raising of new resources.¹⁴⁷ Banks therefore place particular importance on the continuing service of interest payments on international loans.¹⁴⁸

tutions or multinational banks. *See supra* note 6.

140. Koepf, *Baker Steers a New Course*, TIME, Oct. 21, 1985, at 62.

141. In response to this, Secretary Baker stated that if banks participate in his proposal for increased lending it will be because banks find it in their self-interest. It is possible that reschedulings and new loans will make bad loans into good loans. *See Treasury News supra* note 57, at 5-6.

142. Langley and Zweig, *Volcker Rejects Bank Appeals to Relax Reserve Requirement on Foreign Loans*, WALL ST. J., October 22, 1985, at 7, col. 1.

143. Press Conference attended at the Institute of International Finance (IIF), October 29, 1985, Washington, D.C. [hereinafter cited as Press Conference Attended]. General support was expressed for the objective set out in Secretary Baker's proposal of creating conditions conducive to sustained growth in the debtor countries, permitting them to "grow out" of the debt problem. Sound economic and financial policies in both creditor and debtor countries are at the heart of any such effort. For a discussion of the IIF see *infra* text accompanying note 149.

144. *See supra* notes 85-87 and accompanying text.

145. *See supra* notes 85-87 and accompanying text (statement of Managing Director of the IIF, Mr. Andre de Lattre).

146. *Id.*

147. *Id.*

148. The banks recognize that the continued payment of interest from debtor nations is unlikely. Therefore, in addition to removal of regulatory impediments, banks want creditor governments to make more trade credits available to debtor nations. This proposal satisfies Secretary Baker's plan to stimulate growth in debtor nations. However, the overriding theme of the banks is to "let someone else make the first move." Press Conference Attended, *supra*

Banks also intend to continue, through the Institute of International Finance,¹⁴⁹ discussions with borrowing countries for the purpose of improving the flow of information on economic developments and policies. The banks believe that mutual understanding on the basis of shared information with borrowers is likely, in the long-run, to provide the best prospect for a sound relationship between borrowers and lenders.¹⁵⁰

For their part, commercial banks will continue to consider spreading out the maturity of borrowers' debt once a true commitment to an adjustment strategy is firmly in place.¹⁵¹ The banks' success, however, will depend largely on the ability of industrialized nations to maintain low and stable inflation rates with correspondingly stable interest rates.¹⁵² In a situation where the perceived risks and uncertainties attached to international lending are seen to be high for private lenders, banks are concerned that official creditors also play an appropriate part.¹⁵³

The IMF continues to play a crucial role in supporting adjustment.¹⁵⁴ In countries where adjustment efforts need to be prolonged, the IMF should have both adequate resources itself and sufficiently flexible access limits to allow it to give the LDCs the continuing help they need.¹⁵⁵ When IMF programs are successfully completed, banks are concerned that adequate alternative sources of financing be made available to enable countries to repay the Fund. In particular, they see an important role for the IDB both in terms of project lending¹⁵⁶ and structural adjustment loans.¹⁵⁷

A durable resolution of the debt problem over the coming years

note 143.

149. In the period since 1982, many individual commercial banks have strengthened their own positions, particularly by increasing their capital base and by making additional provisions against loan losses. During this period, the IIF was formed to improve the flow of information about borrowing countries' prospects and policies. See Press Conference Attended, *supra* note 143 (Background Note prepared by IIF staff).

150. *Id.*

151. See *supra* note 79.

152. Industrial countries need to direct their best efforts towards the adoption of measures leading to an immediate reduction in interest rates or international markets. See *International Debt Problems*, *supra* note 27, at 67 (statement of Richard E. Feinberg, Vice President, Overseas Development Council). A decline in interest rates would immediately reduce the capital outflow. However, if the balance-of-payments outlook for the important debtor nations does not improve, or if interest rates go much higher, pressures will mount for more action on the negative side of the capital flow equation. *Id.*

The major debtors are already pressing for lower interest rates. The banks have been willing to reduce some of their fees, but they tend to resist such concessions as a "cap" on interest rates, especially if payments above a cap are cancelled. Banks would probably object less to the postponing or capitalization of some interest payments, provided regulators relaxed penalties for doing so. *Id.*

153. See *supra* text accompanying note 133.

154. See *supra* text accompanying note 133.

155. See *supra* notes 18-20.

156. See *supra* text accompanying notes 74-77.

157. See *supra* text accompanying notes 74-77.

will require primarily sound economic policies in the borrowing countries.¹⁵⁸ Only in this way can developing countries attract an adequate supply of finance on acceptable terms. During the transition period close cooperation between sovereign borrowers, international financial institutions and commercial banks will be required.¹⁵⁹

C. Actions Required of the LDCs and Creditor Nations — The First Prong

1. *Actions to be taken by the LDCs.*—Under Secretary Baker's proposal, the essential element to a successful resolution of the LDC debt crisis is increased participation by debtor countries. This aspect of Mr. Baker's proposal is the most speculative.¹⁶⁰ A real resolution can occur only if the developing countries adopt proper economic policies that promote economic efficiency, competitiveness, and productivity.¹⁶¹ Sound policies in the principal debtor countries will not only promote growth, but will also stimulate the needed private lending.¹⁶² These policies must be supported by the IMF and complemented by the multinational development banks.¹⁶³ These institutions can help encourage and catalyze both needed policies and financing.¹⁶⁴ Efforts by any country to "go it alone" are likely to seriously damage its prospects for future growth.¹⁶⁵

2. *Trade liberalization by creditor nations.*—LDC cooperation at the domestic level with plans and policies proposed under Secretary Baker's Program for Sustained Growth is not enough to ensure economic rehabilitation. Creditor nations must also cooperate by liberalizing their trade policies. Trade liberalization would promote LDC exports and thus spur local economies into generating the

158. There is a close relationship between debt problems, financing and trade in the strength of a region's payment capacity. Economic growth will be stimulated through increased exports, renewed flow of financing, and the maintenance of import capacities at appropriate levels. *International Debt Problem*, *supra* note 27, at 65 (statement of Richard E. Feinberg, Vice President, Overseas Development Council).

159. PROGRAM FOR SUSTAINED GROWTH, *supra* note 10, at VII.

160. This aspect deals with the human element — a total nation — as opposed to regulated lending institutions, the IMF, and the World Bank. The success of this plan depends on the actions and behavior of a total nation and not just one particular part of that nation. If these debtor nations choose not to comply with Secretary Baker's proposal, all efforts by other participants in this process will be worthless.

161.

Countries which are not prepared to undertake basic adjustments and work within the framework of the case-by-case debt strategy cooperating with the international financial institutions, cannot expect to benefit from this proposed program. Additional lending will not occur.

PROGRAM FOR SUSTAINED GROWTH, *supra* note 10, at II.

162. See *supra* text accompanying note 151.

163. See *supra* text accompanying notes 79-81.

164. See *supra* text accompanying notes 79-81.

165. "In today's highly interdependent world economy, efforts at economic isolationism are doomed to failure." PROGRAM FOR SUSTAINED GROWTH, *supra* note 10, at II.

funds necessary for the repayment of foreign debt.

Currently the preeminent international rules regulating trade are those embodied in the General Agreement on Tariffs and Trade (GATT).¹⁶⁶ The GATT originally was intended only to govern reciprocal tariff reductions.¹⁶⁷ The general principals of conduct contained in the GATT regarding nontariff barriers were intended to ensure, in conjunction with the establishment of an International Trade Organization (ITO),¹⁶⁸ the effectiveness of the tariff concessions negotiated under the protection of the GATT.¹⁶⁹ When the ITO failed to become a reality, the obligations in the GATT became the principal legal framework for world trade.¹⁷⁰

With the collapse of the Bretton Woods system in 1971, the oil crisis in 1973, and the onset of the world-wide recession in developed countries in 1974, the previously liberal international trade environment turned sour. Thus, the need for international trade reform was great, however, the legal economic context was unfavorable to such reform.¹⁷¹ Even so, according to the Multilateral Trade Negotiation (MTN) of September 1973,¹⁷² the GATT negotiations still had two goals: first, to expand and liberalize world trade and second, to improve the trading strength of the developing countries.¹⁷³ These goals

166. General Agreement on Tariffs and Trade, *opened for signature*, Oct. 30, 1947, 61 Stat. A3, T.I.A.S. No. 1700, 55 U.N.T.S. 187 [hereinafter cited as GATT].

167. See J. JACKSON, *WORLD TRADE AND LAW OF GATT* 32-58 (1969) [hereinafter cited as JACKSON].

168. The initial formation of the GATT focused on the formation of an International Trade Organization. After a series of international conferences the Final Act of the ITO Charter (Havana Charter) was signed in Havana in March 1948. KOUL, *THE LEGAL FRAMEWORK OF UNCTAD IN WORLD TRADE* 19-21 (1977).

169. These general principles of conduct on nontariff barriers, were not, however, strictly tied to each agreement on particular tariff concessions. Rather, these principles were intended to have general applicability to all products. JACKSON, *supra* note 167, at 35-58.

170. For a thorough discussion of the development of and relationship between the ITO and GATT, and the failure of the ITO to materialize, see *id.*

171. Additionally, relatively high unemployment rates, stagnant economic growth and further shifts of comparative advantage in favor of developing countries contributed to the emergence of protectionist pressures in developed countries. Balassa, *The "New Protectionism" and the International Economy*, 12 *J. WORLD TRADE L.* 409 (1978).

172. The Multilateral Trade Negotiation (MTN) is often called the "Tokyo Round" because it was launched in Tokyo in 1973. The agreements resulting from the Tokyo Round were completed in 1979. See *AGREEMENTS REACHED IN THE TOKYO ROUND OF THE MULTILATERAL TRADE NEGOTIATIONS*, H.R. DOC. NO. 153, 96th Cong., 1st Sess., pt. 1 (1979) [hereinafter cited as MTA]. Ministers from developed and some developing countries initialed the MTA in Geneva on April 12, 1979. S. REP. NO. 249, 96th Cong., 1st Sess. 4, *reprinted in* [1979] *U.S. CODE CONG. & AD. NEWS*, pt. 6A, at 3, 12.

173.

The negotiations shall aim to: 1) Achieve the expansion of ever-greater liberalization of world trade and improvement in the standard of living and welfare of the people of the world . . . *inter alia*, through the progressive dismantling of the international framework for the conduct of world trade. 2) Secure additional benefits for the international trade of developing countries so as to achieve a substantial increase in their foreign exchange earnings, the diversification of their exports, the acceleration of the rate of growth of their trade . . . and a better balance between developing and developed countries in the sharing of the

were embodied in what has come to be known as the Tokyo Declaration.¹⁷⁴ Since this 1974 Tokyo Declaration, commentators in the international development field have urged that with a continuing effort, successful management of the debt problem can continue so long as certain fundamentals are respected. By persistent and effective adjustment efforts and continued growth among the industrial countries as a whole, LDCs will be able to competitively promote their products in the world market.¹⁷⁵ This goal, however, will rest largely upon LDCs keeping inflation and budgetary deficits down.¹⁷⁶

The developing countries traditionally demanded that industrially advanced countries grant tariff preferences on manufactured goods and semi-manufactured goods imported from poorer countries. Tariff preferences could effectively expand the export earnings and promote the industrialization of the LDCs. LDCs argue that preferential entry to developed-country markets would enable them to expand their exports of manufactured goods and allow them to compete with the goods of the developed countries.¹⁷⁷

Developed countries have unwillingly granted preferences, but have limited their effectiveness through the use of exemptions, tariff quotas, and "market disruption" escape clauses.¹⁷⁸ Although preferences may have symbolic value from the standpoint of international equity, the less developed countries have begun to realize that other forms of trade liberalization would prove beneficial in increasing their foreign exchange earnings and promoting exports.¹⁷⁹

advantages resulting from this expansion

DECLARATION OF MINISTERS approved at Tokyo on 14 September 1973, para. 1, *reprinted in* GENERAL AGREEMENT ON TARIFFS AND TRADE, BASIC INSTRUMENTS AND SELECTED DOCUMENTS (20th Supp.) 19, 19-20 (1974) [hereinafter cited as Tokyo Declaration].

174. *Id.*

175. *International Debt Problems*, *supra* note 27, at 115-16 (statement of Chairman Fascell).

176. *Id.*

177. To illustrate the effects of tariff preferences, assume that developed country A imports shoes from both B, another developed country and from C, a developing country. Developed country B's export price is 100 compared with developing country C's export price of 120. If country A initially imposes a 50% value on all imported shoes, the import price plus duty of B's and C's shoes are 150 and 180 respectively. In this situation, country A clearly chooses to import from the other developed country B.

Suppose, however, that A retains the 50% value on B's exports while levying no duty on developing country C's exports (a 100% preferential margin). Country C's exported shoes will now be competitive in country A at a price up to 150 (price plus duty of imports from B). Prior to granting the preference, A paid customs receipts of 50 (the duty imposed on imports from developed country B) to itself. By granting such preferences, therefore, developed country A will not import shoes from developing country C, resulting in a transfer of real resources to C in an amount equal to the foregone customs revenue. A. KRUEGER, *LIBERALIZATION ATTEMPTS AND CONSEQUENCES* (National Bureau of Economic Research 1978).

178. *See infra* text accompanying note 181.

179. Prior to the Tokyo Round of Multilateral Trade Negotiations, one study of market access revealed that overall, the most restricted products are those whose export the developing countries could most easily expand. *See generally* H. LYDALL, *TRADE AND EMPLOYMENT: A STUDY OF THE EFFECTS OF TRADE EXPANSION ON EMPLOYMENT IN DEVELOPED AND DEVELOPING COUNTRIES* (1975). Moreover, the most heavily protected products in the developed

The post-1973 era, however, has been characterized by a steady increase in protectionist trade measures.¹⁸⁰ Under the guise of preventing "market disruption"¹⁸¹ nations have imposed numerous quantitative restrictions in the form of Orderly Market Agreements (OMAs)¹⁸² and Voluntary Exports Restraints (VERs).¹⁸³ In addition, the number of unreported government-to-government and industry-to-industry "understandings" to limit exports to a "reasonable level" may greatly exceed the number of OMAs and VERs. The LDCs fear that developed countries will continue imposing trade restrictions in the form of quotas, OMAs, and VERs to limit new developing country exports.

The LDCs' need for export revenue became great¹⁸⁴ since the post-1973 increase in oil prices caused great disparity in the balance of payments of non-oil producing developing countries. But because increased oil prices significantly depleted the buying power of oil-importing developed countries, the transfer of resources from the richer countries to the poorer non-oil producing nations has

countries tend to be those whose impact would be most responsive to a trade liberalization policy. *Id.* at 19. Examples of exports of special importance to developing countries include textile, clothing, footwear and certain food products. *Id.* These manufactured and semi-manufactured goods are especially attractive to developing nations because they lend themselves to labor-intensive production on a small or medium scale based on a local supply of natural resources. *Id.*

180. See *supra* note 171 and accompanying text.

181. Foreign imports may prove to have more of an impact on local economies in developed nations than first suspected. For example, if there have been layoffs in the industry, and a company or its hometown have been hit hard, it may be appropriate to look at imports as the potential cause. These problems can be remedied, however, by very specific forms of relief. The Trade Act of 1974, for example, provides for a limit on imports only to those areas where American workers, firms and communities have been injured by increased imports. Trade Act of 1974, Pub. L. No. 96-39, § 1106(d)(1) 93 Stat. 1979, 312 (codified at 19 U.S.C. § 2253(a)(4) (1976 and Supp. IV 1980).

182. An "Orderly Market Agreement" is merely a bilateral restraint agreement. However, the definition of such agreements may vary according to the international agreement in which it is used. For instance, the Trade Act of 1974, defines only OMAs as "orderly market agreements with foreign countries limiting the export from foreign countries and the import into the United States . . ." Trade Act of 1974, Pub. L. No. 96-39 § 1106(d)(1), 93 Stat., 1979, 312 (codified at 19 U.S.C. § 2253(a)(4) (1976) & Supp. IV 1980). OMAs are treated in the 1974 Trade Act as an official import relief measure, along with unilateral quantitative import restrictions. *Id.* at §§ 2253(b)-(k) (1976 & Supp. IV 1980). OMAs are unusually implemented by a government explicitly and formally in light of specific agreements negotiated between exporting and importing countries. See UNCTAD, GROWING PROTECTIONISM AND THE STANDSTILL ON TRADE BARRIER AGAINST IMPORTS FROM DEVELOPING COUNTRIES, 9 U.N. Doc. TD/B/C2/194 (1978) [hereinafter cited as UNCTAD].

183. "Voluntary Export Restraints" are also bilateral restraint agreements. See *supra* note 182. VERs occur essentially as a result of bilateral negotiations between industries (rather than governments) in importing and exporting countries. They must, however, have the support of their governments. Implementation is left to the industry in the exporting country. See UNCTAD, *supra* note 182, at 5. Textile quotas are an excellent example of VERs.

184. Against a background of restrictive trade policies, representatives of developing countries stress the need for trade liberalization. Liberalization, they feel, will permit the poorer countries to fully develop their export potential in low-cost manufactured goods. United Nations Conference on Trade and Development (UNCTAD), Comprehensive Measures Required to Expand and Diversify the Export Trade of Developing Countries in Manufacturers and Semi-Manufacturers, U.N. Doc. TD/230 & Supp. 1 (1979) at 1.

declined.¹⁸⁵

As early as 1947, in the initial negotiations for the International Trade Organization, representatives of the less developed countries wanted to grant to the ITO "wide authority for all waiver of discriminatory practices, if these were intended to foster economic development."¹⁸⁶ When the ITO did not absorb the General Agreement on Tariffs and Trade (GATT),¹⁸⁷ the "Economic Development and Reconstruction" chapter of the Havana Charter became moot.¹⁸⁸ The fundamental concept contained in the Charter that different developing countries should receive special treatment according to their different stages of economic development, however, has persisted. This concept raises, in turn, the ultimate question of whether new efforts are necessary to effectively integrate the activities of the GATT, the International Monetary Fund, and the World Bank.¹⁸⁹

Since the disintegration of the Bretton Woods System,¹⁹⁰ international monetary affairs have taken a course of "abandonment." The IMF lost its control over borrowing nations' conduct when these nations adopted floating exchange rates.¹⁹¹ The GATT's role is inseparable from those of the IMF and World Bank, however, during this period of abandonment, these three have remained separate institutions, with only minimal consultation among them. In order to liberalize trade and foster development in the developing countries through trade, the IMF, the World Bank and the GATT must work more closely together.¹⁹² In order to liberalize trade and foster devel-

185. Deteriorating economic conditions in the developed countries since the beginning of the Tokyo Round hinder the task of liberalization. Stagflation has intensified concern over unemployment, and hence the need to protect domestic jobs from competitive low cost imports. *Id.*

186. G. PATTERSON, *DISCRIMINATION IN INTERNATIONAL TRADE: THE POLICY ISSUE* (1945-1965), 323 (1966) [hereinafter cited as PATTERSON].

187. *See supra* notes 166-67 and accompanying text.

188. *See supra* note 170 and text accompanying notes 169-70.

189. PATTERSON, *supra* note 189, at 324.

190. *See supra* note 11.

191. *See supra* note 27.

192.

The growth of protectionism is a concern to the IMF in relation to the adjustment problems of developing countries. Trade restrictions are major impediments to the process of global adjustment because they obstruct the exchange of goods on the basis of comparative costs and retard needed structural change in the domestic economies of countries imposing them. Because of the severe external constraints facing many of the developing countries, the possibility of achieving significant reductions in trade restrictions will depend on the leadership provided by the industrial countries. In this connection, the undertaking of the GATT at its meeting in 1982 "to resist protectionist pressures in the formulation and implementation of national trade policy and in proposing legislation" and "to avoid measures which would limit or distort international trade "is to be welcomed." *General Agreement on Tariffs and Trade, Press Release No. 1328* (Geneva), No. 29, 1982 at 3-4.

It now remains to translate these intentions into concrete policy actions so

opment in the developing countries through trade, the IMF, the World Bank, and the GATT must work more closely together.¹⁹³

IV. Conclusion

A developing country's inability to service its debt could precipitate bank crises in many developed countries including the United States. At a minimum such events could eliminate the reserves of any major commercial bank with a high degree of international exposure, thus significantly reducing the shareholders' equity in those banks. More dramatically, a default by one LDC could create a domino effect, leading other nations to default on their external debts. The resulting avalanche of defaults could cause several banks to fail, setting off stock market crashes and ultimately leading to a world-wide depression.

Secretary Baker's "Program for Sustained Growth" can prevent this imminent world-wide catastrophe. By coordinating the efforts of the IMF, the World Bank, commercial banks, and the LDCs, the Program would catalyze commercial global growth. The success of the Program depends, however, on the cooperation of all the parties. The principal debtor nations must first make policy decisions to restructure their economies.¹⁹⁴ Second, commercial banks must provide adequate resources to support these efforts.¹⁹⁵ Third, the IMF and the World Bank must promote these efforts through national programs for growth which in turn will generate confidence in the LDC economies.¹⁹⁶ This additional confidence in the LDC economies will in turn help to maintain a flow of private capital into those countries.

Cooperation is the key. Without it the world will continue to live with the increasingly likely possibility of a major depression. With it, positive steps can be taken pursuant to Secretary Baker's Program to improve the economies and credit ratings of the various debtor LDCs and avoid a world-wide economic catastrophe.

Nancy A. Aliquo

as to resume progress toward an open multilateral trading environment, which is in the interest of both developed and developing countries.

IMF ANNUAL REPORT 63-64 (1983).

193. See PROGRAM FOR SUSTAINED GROWTH, *supra* note 10, at VIII.

194. *Id.*

195. *Id.*

196. *Id.*

APPENDIX A

A. STATEMENT OF THE HONORABLE JAMES A. BAKER, III SECRETARY OF THE TREASURY OF THE UNITED STATES

BEFORE THE
JOINT ANNUAL MEETING OF
THE INTERNATIONAL MONETARY FUND AND THE
WORLD BANK
OCTOBER 8, 1985
SEOUL, KOREA

Chairman Touré, Managing Director de Larosiere, President Clausen, fellow Governors, and distinguished guests:

It is a pleasure to be here for the 40th annual meeting of the International Monetary Fund and the World Bank. Strong, effective international financial institutions are as essential to our economic well being today as they were 40 years ago.

Our host country, Korea, is a nation whose economic success is surpassed only by its warm hospitality. Korea's market-oriented approach and strong emphasis on private initiative are a lesson for us all.

I. Foundation for Growth

I would like to focus my comments today on policies for growth within the context of the international debt strategy. Sound policies and sustained, low-inflation growth in the industrial countries must provide the essential foundation for a successful debt strategy, and are a prerequisite for stronger growth in the debtor countries.

The major industrial countries have already made considerable progress in this direction. Two weeks ago in New York the Finance Ministers and Central Bank Governors of the Group of Five industrial nations underscored the progress which had been achieved, particularly with regard to the convergence of economic performance toward sustained, low-inflation growth. They also announced a set of policy intentions that will help to consolidate and extend that progress and to improve and sustain growth for the longer term.

We emphasized, for our own countries, the central importance of reducing structural rigidities, strengthening incentives for the private sector, reducing the size of government, and improving the investment environment. We also rededicated our governments to resisting protectionist pressures that threaten our own prosperity and the opportunities for others. We must jointly accelerate our efforts to launch a new round of trade negotiations within the GATT.

These industrial nations agreed that the significant progress already achieved in promoting a better convergence of their economic performance had not been fully reflected in exchange markets and that some further orderly appreciation of the main non-dollar currencies against the dollar was desirable. We expressed our willingness to cooperate more closely to encourage this when to do so would be helpful.

This package of measures had an immediate, significant impact on exchange markets which continues to be positive, and reflects the importance of the commitments made.

I am convinced that if each of the major industrial nations fulfills its policy intentions and maintains or improves access to its markets, we will have taken a major step toward more balanced and sustainable growth, while providing a solid framework for improving the debt situation in the developing world.

II. Strengthening the Debt Strategy

Fellow Governors, it is essential that we begin the process of strengthening our international debt strategy.

Three years ago the international financial community developed a flexible, cooperative, case-by-case strategy to address the debt problem and lay the basis for growth in the debtor nations. In three years:

- Aggregate current account deficits in developing countries have been sharply reduced from from \$104 billion in 1982 to \$44 billion this year.
- Growth in developing countries has been restored to about 4 percent, compared to less than 2 percent in 1982.
- This growth has been fueled by sharp increases in developing nations' exports, including a 21 percent increase in their exports to the United States last year.

These developments reflect improved growth and sharply lower interest rates in the industrial nations, as well as adoption of improved policies within most debtor countries. These policies have been given important support by reschedulings and rollovers amounting to approximately \$210 billion, and by net new commercial bank lending.

The international financial institutions have also played an important role in the progress that has been achieved. The IMF in particular has very capably played a leadership role, providing guidance on policies and temporary balance of payments financing, both of which have catalyzed commercial bank flows.

Despite this progress, some serious problems have developed. A number of principal debtor countries have recently experienced set-

backs in their efforts to improve their economic situations, particularly with regard to inflation and fiscal imbalances, undercutting prospects for sustained growth. Bank lending to debtor nations has been declining, with very little net new lending anticipated this year. The sense of increasing reluctance among banks to participate in new money and debt rescheduling packages has introduced serious uncertainties for borrowers, in some cases making it more difficult for them to pursue economic reforms.

These problems need to be addressed, promptly and effectively, by building upon the international debt strategy in order to improve the prospects for growth in the debtor countries. This is an enterprise which will require, above all, that we work together and that we each strengthen our commitment to progress.

If the debt problem is to be solved, there must be a "Program for Sustained Growth", incorporating three essential and mutually reinforcing elements:

- First and foremost, the adoption by principal debtor countries of comprehensive macroeconomic and structural policies, supported by the international financial institutions, to promote growth and balance of payments adjustment, and to reduce inflation.
- Second, a continued central role for the IMF, in conjunction with increased and more effective structural adjustment lending by the multilateral development banks (MDBs), both in support of the adoption by principal debtors of market-oriented policies for growth.
- Third, increased lending by the private banks in support of comprehensive economic adjustment programs.

I want to emphasize that the United States does not support a departure from the case-by-case debt strategy we adopted three years ago. This approach has served us well; we should continue to follow it. It recognizes the inescapable fact that the particular circumstances of each country are different. Its main components, fundamental adjustment measures within the debtor nations and conditionality in conjunction with lending, remain essential to the restoration of external balance and longer-term growth.

We need to build upon the current strategy to strengthen its ability to foster growth. There must be greater emphasis on both market-oriented economic policies to foster growth and adequate financing to support it.

In essence, what I am suggesting is that adequate financing can be made available through a combination of private creditors and multilateral institutions working cooperatively, but only where there are reasonable prospects that growth will occur. This will depend

upon the adoption of proper economic policies by the developing countries. Financing can only be prudently made available when and as effective policies to promote economic efficiency, competitiveness and productivity — the true foundations of growth — are put in place. We cannot afford to repeat the mistakes of the past. Adjustment must continue. Adjustment programs must be agreed before additional funds are made available, and should be implemented as those funds are disbursed.

These efforts should be mutually reinforcing. Sound policies in the principal debtor countries will not only promote growth, but will also stimulate the needed private bank lending. And it will be important that these policies be supported by the IMF, complemented by the MDBs. These institutions can help encourage and catalyze both needed policies and financing.

In today's highly interdependent world economy, efforts at economic isolationism are doomed to failure. Countries which are not prepared to undertake basic adjustments and work within the framework of the case-by-case debt strategy, cooperating with the international financial institutions, cannot expect to benefit from this three-point program. Additional lending will not occur. Efforts by any country to "go it alone" are likely to seriously damage its prospects for future growth.

I would like to elaborate on the actions that will be required by each participant in this three-point program.

III. Structural Change in the Principal Debtors

The essence of the need for structural change in the principal debtors is captured in two quotations I would like to share with you.

First:

"The only way to overcome our economic crisis is to tackle at their root the structural problems of our economy to make it more efficient and productive."¹

And second:

"Economic growth will have solid foundations only if we reestablish trust and stimulate private enterprise, which must be the flagship of our economic development. . . We will promote authentic institutional change in the economic sector."²

These are not the words of a U.S. Secretary of the Treasury. They are statements made in July of this year by the Presidents of Mexico and Brazil. I believe they reflect a growing sentiment in

¹ President de la Madrid at Mexican Bankers Association Annual Meeting, July 22, 1985.

² President Sarney in a televised address to the nation, July 23, 1985.

Latin America.

It is essential that the heavily indebted, middle income developing countries do their part to implement and maintain sound policies. Indeed, without such policies, needed financing cannot be expected to materialize. Policy and financing are not substitutes but essential complements.

For those countries which have implemented measures to address the imbalances in their economies, a more comprehensive set of policies can now be put in place, which promises longer term benefits from stronger growth, higher standards of living, lower inflations, and more flexible and productive economies. These must not only include macroeconomic policies, but also other medium and longer term supply-side policies to promote growth.

We believe that such institutional and structural policies should include:

- increased reliance on the private sector, and less reliance on government, to help increase employment, production and efficiency;
- supply-side actions to mobilize domestic savings and facilitate efficient investment, both domestic and foreign, by means of tax reform, labor market reform and development of financial markets; and
- market-opening measures to encourage foreign direct investment and capital inflows, as well as to liberalize trade, including the reduction of export subsidies.

This broader approach does not mean that policy areas that have been the focus of efforts to date — in particular fiscal, monetary, and exchange rate policies — can receive less attention. Indeed, macroeconomic policies have been central to efforts to date and must be strengthened to achieve greater progress. These policies should consist of:

- market-oriented exchange rate, interest rate, wage and pricing policies to promote greater economic efficiency and responsiveness to growth and employment opportunities; and
- sound monetary and fiscal policies focused on reducing domestic imbalances and inflation and on freeing up resources for the private sector.

The cornerstone of sustained growth must be greater domestic savings, and investment of those savings at home. Macroeconomic and structural policies which improve economic efficiency, mobilize domestic resources, and provide incentives to work, save, and invest domestically will create the favorable economic environment necessary for this to occur. Such an environment is also critical to attract supplemental foreign savings.

As a practical matter, it is unrealistic to call upon the support of voluntary lending from abroad, whether public or private, when domestic funds are moving in the other direction. Capital flight must be reversed if there is to be any real prospect of additional funding, whether debt or equity. If a country's own citizens have no confidence in its economic system, how can others?

There are essentially two kinds of capital inflows: loans and equity investments. Foreign borrowings have to be repaid — with interest. Equity investment, on the other hand, has a degree of permanence and is not debt-creating. Moreover, it can have a compounding effect on growth, bring innovation and technology, and help to keep capital at home.

We believe that the debtor nations must be willing to commit themselves to these policies for growth in order that the other elements of a strengthened debt strategy can come into place.

IV. Enhanced Effectiveness of the International Financial Institutions

The international financial institutions must also play an important role in strengthening the debt strategy to promote growth. However, we must recognize that the international financial institutions cannot have sufficient resources to meet the debtor nations' financing needs all by themselves. An approach which assumes that the IMF and the World Bank are the sole answer to debt problems is simply a non-starter. For most developing countries other sources must play a more important role. These include private sector borrowing, increased export earnings, foreign equity investment, and repatriation of capital which has fled abroad. All these routes should be pursued.

Among the international financial institutions, the IMF has played a major role in advising member nations on the development of policies necessary to promote adjustment and growth. There has been a particular focus on monetary, fiscal, and exchange rate policies, although increasing attention is being paid to other areas such as trade liberalization, pricing policies, and the efficiency of government-owned enterprises.

Emphasizing growth does not mean deemphasizing the IMF. Through both its policy advice and balance of payments financing, the Fund has played a critical role in encouraging needed policy changes and catalyzing capital flows. It must continue to do so. But it must also develop new techniques for catalyzing financing in support of further progress. "Enhanced surveillance," for example, can sometimes provide an effective means of continued IMF involvement.

The Fund should give higher priority to tax reform, market-oriented pricing, the reduction of labor market rigidities, and to open-

ing economies to foreign trade and investment. This will help assure that Fund-supported programs are growth-oriented. It will be particularly important for the Fund to work closely with the World Bank in this effort.

I would now like to turn more directly to the role of the MDBs, which need to be brought into the debt strategy in a stronger way, without diminishing the role still to be played by the IMF.

The World Bank, and indeed all MDBs, have considerable scope to build on current programs and resources, and to provide additional assistance to debtor nations which is disbursed more quickly and targeted more effectively to provide the needed stimulus to growth.

There is ample room to expand the World Bank's fast-disbursing lending to support growth-oriented policies, and institutional and sectoral reform. An increase in such lending can serve as a catalyst for commercial bank lending.

A serious effort to develop the programs of the World Bank and the Inter-American Development Bank (IDB) could increase their disbursements to principal debtors by roughly 50 percent from the current annual level of nearly \$6 billion.

Increased disbursements would require greater borrowing by the MDBs in world capital markets. Their ability to borrow at low rates is a precious asset which must be preserved. Therefore, their lending must be in support of sound economic programs that enhance the borrower's ability to service its debt and grow.

It should be possible, with a concerted effort by both the World Bank and borrowers, to streamline World Bank operations in order to reduce considerably the time period required to formulate and implement such assistance programs. This will expedite the actual disbursement of funds.

The value and role of an indigenous, competitive private sector needs to be recognized and developed more fully than it has in the past. The Bank, for its part, should actively promote the development of the private sector and, where appropriate, provide direct assistance to this sector. In addition, the Bank should seek to assist, both in a technical and financial capacity, those countries wish to "privatize" their state-owned enterprises, which in too many cases aggravate already serious budget deficit problems.

Given the importance of increasing commercial bank flows to the principal debtors, there is also an urgent need for efforts to expand the Bank's co-financing operations. These efforts should be pursued vigorously to increase the effectiveness of the Bank in helping its borrowers to attract private finance, and should have substantial potential in the context of this three-point program.

The enhanced program of the International Finance Corporation, with an expanded capital base, and the recently negotiated Multilateral Investment Guarantee Agency (MIGA) are two important Bank Group initiatives in support of developing countries. Both organizations can do much to assist their members in attracting non-debt capital flows as well as critical technological and managerial resources. We urge all Bank Members and particularly the principal debtors to give their full support to establishment of the MIGA.

If developing countries implement growth-oriented reform; if commercial banks provide adequate increases in net new lending to good performers; and if increased demand for quality IBRD lending demonstrates the need for increased capital resources, we would be prepared to look seriously at the timing and scope of a general capital increase.

We believe the World Bank's efforts can be supplemented actively by the regional development banks. Since some of the most serious debt problems are found in Latin America, special emphasis should be placed on strengthening the IDB's policies to enable it to be a more effective partner in support of growth-oriented structural reform.

In the case of an IDB capital increase, it will be critical to assess the extent to which the institution strengthens its lending policies. There must be well-defined economic and country strategies tailored to enhance economic reforms which encourage growth. Given a firm commitment by the IDB to move in this direction, we believe that it should be permitted to introduce a major program of well targeted non-project lending. In the meantime, such lending could be associated with World Bank programs until the IDB has implemented the necessary reforms.

V. Increasing Lending by the International Banking Community

The international banking community has played an important role during the past three years. I am, however, concerned about the decline in net bank lending to debtor nations over the past year and a half, particularly those nations which are making progress. All of us can appreciate the commercial banks' concerns, but we believe these concerns would dissipate if the banks were confident that new lending is in support of policies for growth in the developing nations.

If creditor governments, in an age of budget austerity, are to be called upon to support increases in multilateral development bank lending to the debtor nations, and if the recipient nations are asked to adopt sound economic policies for growth to avoid wasting that financing, then there must also be a commitment by the banking community — a commitment to help the global community make

the necessary transition to stronger growth.

Our assessment of the commitment required by the banks to the entire group of heavily indebted, middle income developing countries would be net new lending in the range of \$20 billion for the next three years. In addition, it would be necessary that countries now receiving adequate financing from banks on a voluntary basis continue to do so, provided they maintain sound policies.

I would like to see the banking community make a pledge to provide these amounts of new lending and make it publicly, provided the debtor countries also make similar growth-oriented policy commitments as their part of the cooperative effort. Such financing could be used to meet both short-term financing and longer-term investment needs in the developing countries, and would be available, provided debtors took action and multilateral institutions also did their part.

We would welcome suggestions from the banking community about arrangements which could be developed in order to ensure that adequate financing to support growth is available.

VI. The Poorest Countries

Before concluding my statement, I would like to focus briefly on the problems of another set of debtor countries, the low-income debtors with protracted balance of payments problems. Special efforts are being made to assist these countries, but more can and should be done to improve their longer-term prospects.

The United States believes that the resources provided by the Trust Fund reflows provide a unique opportunity to help address the economic problems of the poorest countries with protracted balance of payments difficulties. Recent experience demonstrates that successful resolution of the economic problems of these countries requires a comprehensive approach, including fundamental structural policy changes, as well as sound macroeconomic policies.

The \$2.7 billion in Trust Fund reflows present us with an opportunity to utilize IMF resources, possibly supplemented by funds from other sources, in support of such comprehensive economic programs. The effectiveness of such programs would be enhanced by close cooperation between the Fund and Bank. In some cases, this could best be accomplished by a joint approach by the two institutions in support of comprehensive programs.

The United States is also prepared to consider a bolder approach, involving more intensive IMF and World Bank collaboration. We believe that this approach would help ensure that the institutions provide sound, mutually consistent advice on the full range of policies to promote growth.

The United States, which supported African countries with \$1.7 billion in bilateral aid in 1985, would be prepared to consider seeking resources in support of such a far-reaching approach if other donors were prepared to make equitable contributions.

We recognize that some may have reservations about such an approach, viewing it as complicated and difficult to implement. I can understand some of those concerns, and believe they suggest the need for further reflection on certain aspects of this proposal. But, we cannot let parochial resistance or unfounded suspicions block an idea that can significantly help the poorest countries and strengthen ties between the Fund and the Bank. I urge you to give this approach further consideration during the months ahead.

VII. Conclusion

In conclusion, much has been accomplished in the past few years in addressing the pressing economic problems of the early 1980s and preparing the foundation for future global growth. We must now join together to consolidate our progress in building stronger economies for the future.

Sound policies and growth in the industrial world can provide a solid foundation for strengthening and adapting the current international debt strategy. Let us not lose the present opportunity. I have proposed a three-point "Program for Sustained Growth" to provide renewed impetus for resolving the debt problem. We must not deceive ourselves. There are no easy solutions, and none of us can escape our responsibilities.

The principal debtor nations must make the hard policy decisions to restructure their economies. The commercial banks must provide adequate resources to support these efforts. The MDBs must increase the efficiency and volume of their lending.

Moving from proposal to implementation will be a demanding exercise and cannot be accomplished overnight. As we adapt our strategy, we must continue to look to the IMF as the catalyst for new financial flows. And with these new flows will come new hope.

We will be building on the efforts of the past. The needs are clearly recognized by borrowers and creditors alike. Fundamentally, there is no disparity of interest among our nations. We have a common interest in growth — sustained growth that rests on productivity, innovation and investment. Let us begin our efforts now.

