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# ARTICLES

## A PERSPECTIVE ON THE DEBT CRISIS

Jerome I. Levinson\*

### INTRODUCTION

The debt crisis, which is the high level of indebtedness of a significant number of developing countries in Latin America, Asia, and Africa is generally considered a severe inhibition on the ability of those countries to modernize structures within their own societies so as to become economically and internationally competitive and socially and politically more stable societies.<sup>1</sup> The international community must address what role external finance plays in this underlying chronic condition in light of the extraordinary level of indebtedness contracted in the last fifteen years.<sup>2</sup> The issue is particularly appropriate to address in Washington D.C., because there is currently a ferment of ideas concerning this subject in this city.

The question basically revolves around what: (a) the debtor countries; (b) the private commercial banks; (c) the creditor Governments; and (d) the multilateral financing institutions should contribute to a resolution of the problem. More specifically, increased attention now focuses on the question of reduction of outstanding indebtedness of the

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1. See THE WORLD BANK, WORLD DEBT TABLES, EXTERNAL DEBT OF DEVELOPING COUNTRIES, I ANALYSIS AND SUMMARY TABLES xxviii (1987-88) [hereinafter THE WORLD BANK] (noting the total indebtedness of these regions at the end of 1986).

2. See UNITED STATES GENERAL ACCOUNTING OFFICE, INT'L BANKING: SUPERVISION OF OVERSEAS LENDING IS INADEQUATE, 27 (May 1988) [hereinafter GAO REPORT] (noting that Brazil owes 23.62 billion as of October 1987, Mexico owes 23.22 billion, and South Korea owes 6.38 billion to U.S. commercial banks).

debtor countries: do debt reduction schemes contribute to such a resolution or complicate it still further by discouraging "new" money packages of lending? This paper will attempt to place the current debate in perspective, draw some lessons from the past, and hazard some thoughts as to the future.

### PHASE I: A CORNUCOPIA OF FINANCE 1974-1982

In the late 1960s, the onset of a simultaneous economic expansion in the major industrialized nations led to a fundamental change in the supply-demand equation in the trade of international crude oil supplies, that favored the producing nations. The immediately available supply of crude oil was not keeping up with the demand. This condition was exacerbated by the increased awareness of environmental considerations in the industrialized countries, which placed a premium upon the availability of low sulphur—"sweet" crude oil, as it is known in the trade. Negotiations between the oil producing exporting countries (OPEC) and the multinational oil companies reflected this tightening supply of crude oil in relation to demand.<sup>3</sup> The crisis assumed explosive dimensions in the aftermath of the October 1973 Yom Kippur War between Israel, Egypt, and Syria.<sup>4</sup>

The United States ran out of spare capacity, that is, the capacity to increase the production of crude oil almost immediately.<sup>5</sup> The 1973 Arab oil embargo of the United States then masked severe production problems in major oil reservoirs in Saudi Arabia, resulting in large part

3. See *Multinational Corporations and United States Foreign Policy: Hearings Before the Subcomm. on the Multinat'l Corp. of the Senate Comm. on Foreign Rel.*, 93rd Cong., 2d Sess. (Part 5) 176-90 (1974) [hereinafter *1974 Hearings on Multinat'l Corp.*] (statement of George T. Piercy, Senior V.P. and Director, Exxon Corp.). These negotiations occurred in Tehran and Tripoli in late 1970 and 1971. *Id.* at 211. The testimony describes the loss of spare capacity in the late 1960s and early 1970s outside of the Persian Gulf area and how this contributed to a weakening of the bargaining position of the multinational oil companies with the cartel of OPEC; see *id.* at 211-17 (questioning of Senators Edmund Muskie (D-Me.), and Frank Church (D-Id.) on this issue); see also *Multinational Corporations and United States Foreign Policy: Hearings Before the Subcomm. on the Multinat'l Corp. of the Senate Comm. on Foreign Rel.*, 93 Cong., 2d Sess. (Part 7) 331-41 (1974) [hereinafter *Multinational Corps. and Foreign Policy*] (prepared statement of George T. Piercy, Senior V.P. and Director, Exxon Corp.).

4. *Multinat'l Corps. and Foreign Policy*, *supra* note 3, at 513-15 (exhibit 11). The cables from Aramco to its owner companies in the United States—Exxon, Texaco, Standard Oil Company of California, and Mobil—detail the instructions from Saudi Arabian authorities to cut back oil production. *Id.*

5. See *1974 Hearings on Multinat'l Corp.*, *supra* note 3, at 176-179 (statement of G.T. Piercy, Senior V.P. and Director, Exxon Corp.) (examining spare capacity in the oil industry).

from the failure of water injection facilities to function as planned.<sup>6</sup> As a result of this breakdown, Saudi Arabia would have had to curtail production of crude oil or risk permanent damage to the producing reservoirs (less oil would have been ultimately recovered if production continued under prevailing conditions). The embargo, therefore, came at a convenient time both for the government of Saudi Arabia and the multinational oil companies that made up the Aramco consortium.<sup>7</sup>

In the aftermath of the embargo, oil producers dramatically increased the price of crude oil. Between October 1973 and January 1974, the international price of crude oil increased nearly fivefold over its price in 1971.<sup>8</sup> In August 1974, the United States Secretary of the Treasury, William Simon, observed that the revenues of the oil producing countries in the OPEC cartel were running at an annual rate of \$100 billion, of which \$60 billion needed recycling.<sup>9</sup> Secretary Simon was referring to the fact that the greatest part of the \$100 billion accrued to those oil producers who could not spend all of their oil revenues on imports from the oil consuming states. Unless they curtailed oil production, they would earn approximately \$60 billion that would need

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6. *Multinational Corps. and Foreign Policy*, *supra* note 3, at 483-503 (exhibits 3-6). The subcommittee hearings examined additional technical details on water injection as a means to increase output, and the resulting problems. *Id.* at 483-503. The trip reports by engineers of Standard Oil Company of California analyze the failure of the water injection program. *Id.* at 491.

7. *Id.* at 442, 445 (testimony of William W. Messick, Executive Staff, Production Aramco) (citing numerous oil production problems). The Arabian American Oil Company was a joint venture consortium of companies organized as a Delaware Corporation. The four companies that owned Aramco were Exxon, Mobile, Texaco, and Standard Oil Company of California (SOCAL). *Id.* SOCAL was the company that originally discovered oil in Saudi Arabia. *Id.* In 1936, SOCAL and Texaco formed Aramco to administer the Bahrain and Saudi Arabian crude concessions, the new Bahrain refinery, and the Eastern marketing outlets which, from then on, were collectively known as the "Caltex" companies. *Id.* In 1947, agreement was reached between Caltex and Exxon and Mobil (then known respectively as the Standard Oil Company of New Jersey, and Standard Vacuum Company) to sell a percentage of the stock in Aramco to Exxon and Mobil. *Id.* The final stock ownership resulted in Exxon, SOCAL and Texaco each receiving 30 percent of the stock ownership interest in Aramco by buying out the ownership interests on the American companies. *Id.* at 78-82 (statement of Barbara J. Svedberg, Former Trial Att'y of the Antitrust Division, United States Dep't of Justice) (discussing the development of the Middle East oil concessions); *see also id.* at 192-215 (testimony of Joseph J. Johnston, Senior V.P. Arabian Am. Oil Co. (Aramco)) (describing the operations of Aramco and its relationship with its prior shareholder companies). *See generally* I. ANDERSON, *ARAMCO, THE U.S. AND SAUDI ARABIA* (1981) (describing the history of Aramco from the company point of view).

8. *Multinat'l Corporations and United States Foreign Policy: Hearings Before the Subcomm. on Multinat'l Corps. of the Senate Comm. on Foreign Rel.*, 93rd Cong., 2d Sess. 259 (1974) (Part 9) (testimony of William E. Simon, Secretary of Treasury) [hereinafter *Simon Testimony*]. The testimony notes that oil prices doubled during 1971-1973, and increased fourfold between 1973-1974. *Id.* at 245.

9. *Id.* at 237.

to be placed somewhere.<sup>10</sup>

Simon developed a program that enabled these oil producers and other official agencies of foreign governments to purchase United States Government securities at market prices directly from the United States government by special procedures, bypassing the financial markets.<sup>11</sup> This program had the advantage of assuring the foreign government purchasers confidentiality and at the same time helping to finance the United States government's fiscal deficit. The exact amount of these transactions was not revealed;<sup>12</sup> however, they were insufficient to eliminate the financial surpluses of the Persian Gulf oil producers resulting from the run up in oil prices. A significant part of the surplus still had to be placed in the financial markets.

The London market was particularly attractive. A market in dollars outside of the United States had developed in London in which there were no reserve requirements and virtually no regulatory standards.<sup>13</sup> Each of the New York money center banks, as well as the larger United States West Coast, Middle West, and regional banks established branches or subsidiaries in London.<sup>14</sup> Major Japanese and Continental European financial institutions also established operations in London to cash in on the petrodollar bonanza.<sup>15</sup> The London market, therefore, became the means through which a great part of the financial surpluses of the OPEC oil producers was absorbed by the Western financial world.<sup>16</sup>

As Secretary Simon put it, "we observed that the private financial system was doing a remarkable job of handling very large expanded operations."<sup>17</sup> "As for the role of governments in facilitating the flow of

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10. *Id.*

11. *Id.* at 238; *see also id.* at 276 (explaining the program in response to a question by Senator Percy).

12. *The Witteveen Facility and the OPEC Financial Surpluses: Hearings Before the Subcomm. on Foreign Econ. Pol'y of the Senate Comm. on Foreign Rel.*, 95th Cong., 1st Sess. 7-8 (1977) [hereinafter *1977 Hearings on Witteveen Facility*] (statement of Eugene Sherman, V.P., Merrill Lynch Gov't Sec., Inc.).

13. STAFF OF THE SENATE SUBCOMM. ON FOREIGN ECON. POL'Y OF THE COMM. ON FOREIGN REL., 95TH CONG., 1ST SESS. (1977), REPORT ON INT'L DEBT, THE BANKS AND U.S. FOREIGN POL'Y 23 [hereinafter INT'L DEBT].

14. *Id.* at 10-11.

15. *Id.* at 26-27.

16. *See* INT'L DEBT, *supra* note 13, at 15-23 (offering a good account of the origin of the Euro-currency market); *see also American Foreign Economic Policy: an Overview: Hearings Before the Subcomm. on Foreign Economic Policy of the Senate Comm. on Foreign Rel.*, 95th Cong. 1st Sess. at 89-92 [hereinafter *American Foreign Economic Policy*] (statements of Robert Mundell, Professor, Columbia University, and Lawrence Krause, Senior Fellow, Brookings Institute) (examining the necessity of a "financial intermediary" for the OPEC monetary surplus).

17. *Simon Testimony*, *supra* note 8, at 237.

money in the recycling process," said Simon, "the first responsibility of governments is to maintain those economic and financial conditions conducive to sound economic activity."<sup>18</sup> In other words, the task of recycling the vast financial surpluses that few oil producing states accumulated was to be left to the private banking sector. In Simon's view, the private banking sector could be expected to act responsibly in making sound credit judgments and not lend beyond prudent limits.<sup>19</sup>

Upon accepting these interest bearing short-term deposits, the commercial banks faced the problem of how to lend them out at a profit. The oil importing Western industrial powers no longer provided a promising market. As a response to the massive oil price increases of 1973 and 1974, these countries adjusted their economies by adopting severe deflationary policies.<sup>20</sup> Economic activity in the United States, Western Europe, and Japan declined.<sup>21</sup> In then recessionary economic conditions, industrial enterprises saw no need to borrow to expand capacity.<sup>22</sup> For the oil importing developing countries, however, the fact that the Western financial institutions were rich with cash deposited with them by the oil producing states was fortuitous. Rather than "adjust" to the oil price increases by deflating their economies, they preferred to borrow to pay their current oil bills and maintain high rates of economic growth.<sup>23</sup> In effect, recycling the financial surpluses of the oil producers meant that the oil producers became creditors of the economically strongest country in the West, the United States, and of the great multinational banks of the Western industrialized countries.<sup>24</sup> These banks, in turn, took the credit risks of lending to the economically weaker oil importing states.<sup>25</sup> The risk of default by these weaker

18. *Id.* at 238.

19. *See id.* at 237 (observing that the European private sector was successfully doing this).

20. *See* BELASSA, TOWARD RENEWED ECONOMIC GROWTH IN LATIN AMERICA 68 (1986) (commenting on doubled debt-service ratio between 1973-1978).

21. *International Monetary Fund, World Economic Outlook, A Survey*, 4 Occasional Paper 7-8, (June, 1981).

22. *Id.*

23. Hartland & Thurberg, *Sources and Implications of the Global Debt Crisis*, 9 WASH. Q. 95 (1986). This article contains a very good discussion of the two oil price shocks of 1973-74 and 1979-80, following the fall of the Shah. *Id.* The authors note the non-OPEC LDCs continued to expand their economies after the first oil shock, but not after the second one, in part due to different policy responses in the industrialized countries. *Id.*

24. 1977 *Hearings on Witteveen*, *supra* note 12, at 8 (statement of Eugene Sherman, V.P. Merrill Lynch Gov't Sec., Inc.).

25. *Id.* at 23. Senators Javits and Church summarized the results of the policy in graphic terms:

Senator Javits. It seems to me that the only thing that is really wrong with it is that the U.S. Government becomes obligated for these vast amounts of funds.

states, then, was assumed not by the oil producers who had created the need to borrow because of increased oil prices, but by the banks—with the central banks of the industrialized countries standing behind them.<sup>26</sup>

Moreover, the existence of the Eurodollar market in London, later a multi-currency market,<sup>27</sup> enabled developing countries to escape the supervision of the World Bank and the International Monetary Fund (IMF). Not only governments could borrow in the Eurodollar market, but also autonomous government-owned entities with separate legal personalities and their own financial resources independently borrowed, often without the guarantee of repayment by the central government. Private enterprises in the borrowing countries as well as official financial institutions appeared to have unrestricted access to these banks' resources with minimum, if any, accountability.<sup>28</sup>

In a monograph written for the Twentieth Century Fund, the Brazilian economist Marcílio Marques Moreira, later Ambassador to the United States, observed with respect to Brazil that these resources complemented domestic savings.<sup>29</sup>

We are facing a monumental—the Chair and I both feel this—and extremely dangerous problem because we are holding the bag. We are holding it for the developing countries; we are holding it for the commercial banks. By we, I mean Uncle Sam. This very, very much concerns me.

Mr. Sherman. Yes, Senator. In this environment, the United States has become the lender of the last resort for all purposes.

Senator Javits. For everybody.

Mr. Sherman. Yes.

Senator Church. Yes, that is the very point I wanted to make. This is all very jolly, except that it demonstrates that the recycling of petrodollars is coming to us, and I suppose to some extent to other wealthy industrial countries, to their banks and increasingly through the commercial banks and their treasuries. Then it is up to us to extend the credit of the third world countries. We are left holding the bag. We are obligated to repay these treasury bills, notes, and bonds to the OPEC governments with large surpluses that continue to mount with each passing year.

We lend the money to the debtor countries so that they may buy the oil and other imports and we are left in an exposed position.

*Id.* at 15-16.

26. *Id.*

27. *Int'l Debt*, *supra* note 13, at 15. One comment that arose from the testimony states, "Technically liabilities denominated in any currency which are on deposit in banks located outside the country issuing the currency can be called eurodollars, or euromarks or euroyen." *Id.*

28. *1977 Hearings on the Witteveen Facility*, *supra* note 12, at 37-38 (statement of Eugene Sherman, V.P. Merrill Lynch Gov't Sec., Inc.).

29. M. MOREIRA, *THE BRAZILIAN QUANDARY*, A TWENTIETH CENTURY FUND PAPER 22 (1986). Moreira stated:

These resources were mainly aimed at capital accumulation, not financial speculation; they complemented domestic savings and did not encourage capital flight (the proof is that the accumulated current account deficits were larger than the

What was true of Brazil, to a greater or lesser degree, was also evident in other countries at equivalent stages of development which had access to financing in the Eurocurrency markets. The productive plant in these countries owned by the state or local entrepreneurs or some combination of them rapidly expanded. South Korea, Taiwan, Singapore, and Mexico, within a decade, emerged as leaders in the production of steel, automotive parts, and electronic plants for the world market. Although not yet in the class of Europe and Japan, these Newly Industrializing Countries (NICs) were becoming world class players in the international economy.<sup>30</sup>

### A Fly in the Ointment

But there was a basic flaw in the borrowing strategy of the NICs: the nature of the markets in which they were borrowing. The money borrowed in the aftermath of the oil price revolution often had a maximum eight-to-ten year maturity structure, some of it under innovative financing techniques due in a single "bullet" payment. The interest rate at which banks in London lent surplus funds to each other, the London Interbank Offered Rate (LIBOR), was most commonly adjusted at six-month intervals, depending upon prevailing market conditions.<sup>31</sup> Hence, this "floating" rate could be increased frequently if worldwide interest rates rose over the life of a loan. The rapid buildup of debt in those conditions was highly vulnerable to any shock that had the effect of raising rates for the increasingly indebted NICs. That shock occurred in 1979 with the revolution in Iran that toppled the Shah and his conservative government, and replaced it with a regime that, at least initially, preached austerity and reduced levels of oil production.

The multinational oil companies had allowed their oil stock inventories to run down to minimum levels. In the aftermath of the Iranian upheaval, fearing another oil shortage, the oil companies scrambled to

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increase in net debt during the period); they were not the result of an overvaluation of the cruzeiro; and although they might have been used for oversized projects, they were neither spent on extravagant arms purchases (the military regime preferred to export armaments rather than to import them), nor on luxury consumption (even oil in Brazil is predominantly used for production, transportation, and distribution of goods, rather than for recreational driving or residential heating). To paraphrase Veblen, the most serious sin might have been overindulgence in conspicuous investments.

*Id.*

30. Not all of the borrowing was devoted to expanding productive capacity. Borrowing financed capital flight and conspicuous consumption. And some countries, like Argentina, were hard pressed to show that borrowing led to additional producing facilities.

31. See *Int'l Debt*, *supra* note 13, at 17.



replace depleted inventories and, in the process, bid up the price of crude oil, which more than doubled in 1980. The NICs, which in the aftermath of the first oil "shock" had borrowed heavily to maintain investment levels and high economic growth rates, now found themselves having to borrow to pay interest on past loans and, increasingly, to pay for current oil bills rather than for productive investment.<sup>32</sup>

The Carter Administration initially sought to rejuvenate the United States economy after the recessionary years that followed the oil price revolution of 1973. By 1979, however, the economic expansion had overheated, inflation was in double digits, and the prime rate was dramatically rising.<sup>33</sup> The appointment by President Carter of Paul Volcker as Chairman of the Board of Governors of the Federal Reserve System signalled a determination to cool off the economic boom.<sup>34</sup> Monetary policy was slammed into reverse. By the time the Reagan Administration assumed office in January 1981, an economic slowdown in the United States was already well underway. The new Administration heartily endorsed the slowdown as a means to brake and, ultimately, reverse inflationary expectations.<sup>35</sup>

This slowdown was not limited in its economic effects to the domestic economy of the United States. The United States was the largest economy in the world and, relative to other countries, open to a wide range of imports. It constituted the most important market for the exports of the NICs, as well as those of the fully industrialized countries.<sup>36</sup> As the

32. INT'L MONETARY FUND, ANNUAL REPORT 21-22 (1985) [hereinafter IMF ANNUAL REPORT].

33. *Id.* at 2; see also MORGAN GUARANTEE TRUST CO. OF N.Y., WORLD FIN. MARKETS, COUNTERING WORLD DEFLATION 1-3 (Dec. 1985) [hereinafter COUNTERING WORLD DEFLATION].

34. W. WRISTON, "Was I exacting? Sure. Was I occasionally sarcastic? Of course," INSTITUTIONAL INVESTOR, June 1987, 17, 20. Wriston blames Volcker for the onset of the debt crisis:

What nobody knew was that Volcker was going to lock the wheels of the world. And when he threw the U.S. into the deepest recession since 1933, it spread to the whole world. And that's what started, the quote international debt crisis: Export ratios that looked very good the month before he took office looked like a disaster a year later.

*Id.*

35. IMF ANNUAL REPORT, *supra* note 32, at 2 (1985). See also COUNTERING WORLD DEFLATION, *supra* note 33, at 1.

36. IMF Annual Report, *supra* note 32, at 21.

The U.S. recovery was not of fundamental importance to countries seeking export-led adjustment . . . U.S. imports from Asian and European developing countries increased by some 80 percent between 1980 and 1984 . . . . In contrast, other industrial countries' imports from these regions were comparatively flat. The pattern was the same, though growth was more muted, for the Western Hemisphere.

*Id.*

United States economy went into reverse, the demand for imports dropped precipitously.<sup>37</sup> Export earnings of the NICs declined commensurately, but the financial obligations they had contracted with the major international banks remained. The conditions were ripe for an international financial crisis. That crisis was precipitated in August 1982 when Mexican authorities travelled to Washington and informed U.S. Treasury officials that they could not meet the interest payments on their outstanding debts.<sup>38</sup>

### Unheeded Warnings

As early as 1975, the Multinational Corporations Subcommittee of the Senate Foreign Relations Committee sought to ascertain the risks to the Western banking system in the recycling strategy that Secretary Simon had celebrated in his testimony before the Subcommittee. On September 11, 1975, the Subcommittee held a session closed to the public because the issues to be explored were considered too sensitive to be discussed in an open session.<sup>39</sup>

The Subcommittee tried to determine whether there was a concentration of deposits from the oil producing states in a small number of major United States banks. It also tried to determine whether those banks had become financially vulnerable by virtue of having lent large amounts relative to their capital to the oil importing developing coun-

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37. *Id.*

38. *Mexico Seeking Postponement of Part of Debt*, N.Y. Times, Aug. 20, 1982, at 1 (discussing Mexican meeting with New York banks); *Debt-Ridden Mexico Gets U.S. Help*, Wash. Post, Aug. 19, 1982, at B3 (discussing Mexican plight and the one billion contribution from the United States); see STAFF OF JOINT ECONOMIC COMM., CONGRESS OF THE UNITED STATES, 99TH CONG. 2D SESS., *THE IMPACT OF THE LATIN AMERICAN DEBT CRISIS ON THE U.S. ECONOMY I* (May 1986) [hereinafter *LATIN AMERICAN DEBT CRISIS STUDY*] (stating that the Latin American debt crisis became public when Mexico announced its inability to service its debts in 1982); see also Fidler, *Debt Fatigue in Latin America*, Fin. Times, Aug. 31, 1988, at 12.

39. *Multinat'l Corps. and United States Foreign Policy: Hearings Before the Subcomm. on Multinat'l Corps. of the Senate Comm. on Foreign Rel.* (Part 15) 94th Cong. 1st Sess. 17 (1975) (Executive Session, subsequently made public) [hereinafter *Multinat'ls and United States*]. In addition to the Senators and staff of the Subcommittee, present at the hearing were Hon. Philip E. Coldwell, Governor, Federal Reserve System; Hon. Henry C. Wallich, Governor, Federal Reserve System; Hon. Paul Volcker, President, New York Federal Reserve Bank; Hon. Thomas Enders, Assistant Secretary for Economic Affairs, Department of State; Hon. Edwin Yeo, Under Secretary for Monetary Affairs, Department of Treasury; C.A. Costanzo, Vice Chairman, First National City Bank of New York; Gaylord Freeman, Chairman of the Board, First National Bank of Chicago; Lewis Preston, Vice President, Morgan Guaranty and Trust Bank; Leland S. Prussia, Cashier, Bank of America; Gary Welch, Legal Staff, Federal Reserve; William Ogden, Chase National Bank; Lisle Widman, Department of the Treasury.

tries that could have difficulty in meeting their future debt service payments to these banks.<sup>40</sup> The information was not published by any United States Government Agency nor was it collected or analyzed by the United States Government.<sup>41</sup> The Subcommittee sought to collect the data through use of a questionnaire.

Karin Lissakers, a Subcommittee staffer, in a question to Gaylord Freeman, Chairman of the Board, First National Bank of Chicago, asked: "[I]f Indonesia or Zaire or Brazil, or any of the larger international powers, should default not only against your bank but against five of the largest banks in the United States, what would be the impact?"<sup>42</sup>

Speaking for the banks, Freeman assured the Subcommittee that, "the loan side is pretty well covered by the recurrent examination of the experienced examiners of the Comptroller's office and the FDIC and the liability side is not a prospective source of significant problems."<sup>43</sup> By the liability side, Freeman meant that holding short-term deposits from the oil producing countries posed no risks of sudden destabilizing withdrawals. The assembled bankers, the officials of the Federal Reserve and the Treasury agreed with Freeman that there was no problem—that the Banks lent no more than was prudent, that federal regulators were efficient and on top of the problem, and, that there was no risk of the borrowing countries suddenly defaulting on their loans.<sup>44</sup>

In 1977, the Subcommittee on Foreign Economic Policy of the Senate Foreign Relations Committee, which succeeded the Multinational Corporations Subcommittee when it was voted out of existence in October 1976 by the Full Senate Foreign Relations Committee, further pursued the matter with officials of the Carter Administration. Anthony Solomon, Under-Secretary for Monetary Affairs of the Department of the Treasury, observed in testimony before the Subcommittee:

[T]he question has been raised as to whether this rapid and unprecedented enlargement of lending activity and debt has reached a danger point for the monetary system, either in the sense that large numbers of countries have borrowed beyond their capacity to service debt or in the sense that our banks and other institutions are overextended.<sup>45</sup>

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40. *Id.* at 78.

41. *Id.* at 82-84.

42. *Id.* at 45 (statement of Karin Lissakers, Subcomm. Staff Member).

43. *Id.* at 39 (statement of Gaylord Freeman, Chairman of the Board, First National Bank of Chicago).

44. *Id.*

45. 1977 *Hearings on the Witteveen Facility*, *supra* note 12, at 22 (testimony of Anthony Solomon, Under-Secretary for Monetary Affairs, U.S. Dep't of Treasury).

Answering his own formulation of the issue, Solomon stated: "It is our considered judgment that the system as a whole is not in any such position of imminent danger, either as a result of excessive borrowing by large numbers of debtor nations or as a result of our financial institutions being overstretched."<sup>46</sup> Solomon noted that if the borrowed funds are properly used to support productive investment and to strengthen the borrower's current account position, the debt need not constitute a serious future burden.<sup>47</sup>

But the Senators were not convinced. Senator Jacob Javits emphasized that there was no margin for error:

The difficulty with that theory is: It fails completely to take account of contingencies, increase in price of OPEC oil, particular pressure in particular places because of political situations in those places, the burden of debt becoming so great compared to developmental needs—that is, Brazil—that a situation which looked very good in credit terms may not look so good at a given time. . . .<sup>48</sup>

Senator Frank Church questioned whether the borrowed money was being used for productive purposes, citing a study by the American Express Company:

In 1977, they estimated one-fourth of new loan money will go to repayment of the loans and by 1981, half . . . . What is happening is that this new loan money is not going into the expansion of economic growth, increased exports, to enable these foreign countries to pay for their imports without having to borrow still more heavily. Just the opposite is happening.<sup>49</sup>

Senator Paul Sarbanes expressed skepticism as to the incentive for the private banks to exercise prudence in their lending:

You think the private lenders have to a considerable extent been proceeding on the premise when they make loans to sovereign governments, that there is no possibility of default in those loans, first, because the sovereign government won't want it to happen. But in any event even if they were not able to carry the burden, that is the sovereign governments, particularly with respect to American banks, the United States is not going to permit that to take place. Therefore, they really don't have to exercise much care with respect to making those loans.<sup>50</sup>

But these warnings were not heeded. Secretary Simon in the Ford Administration hailed the role of the private banks in recycling the financial surpluses of the oil producers to the oil importing debtor coun-

46. *Id.*

47. *Id.*

48. *Id.* at 28 (statement of Jacob Javits, Senator from New York).

49. *Id.* at 38-39 (statement of Frank Church, Senator from Idaho).

50. *Id.* at 38 (statement of Paul Sarbanes, Senator from Maryland).

tries through commercial loans.<sup>51</sup> The private banks assured the Multinational Corporations Subcommittee that they were prudent lenders.<sup>52</sup> The officials of the Federal Reserve System and the Comptroller of the Currency were satisfied with the recycling process.<sup>53</sup> Mexico, Brazil, and South Korea appeared to have as much leverage with the banks in negotiating terms as the banks had with them. They could rely less on the multilateral development banks and more on private commercial markets to finance their development needs.

An alternative policy would have been to try to capture some substantial part of the petrodollar surpluses of the oil exporting countries to be re-lent to the oil importing developing countries by the IMF, World Bank, and regional development banks. The funds could then have been placed with the borrowing countries on terms which were more in line with their payment and development prospects. The use of the funds for productive investments would have been more clearly assured.

That this was not wholly unrealistic, in retrospect, is evidenced by the comments of Johannes Witteveen, Managing Director of the IMF in 1973 and Denis Healey, the British Chancellor of the Exchequer at the time.

[M]any oil exporting countries would have been willing to lend a much larger part of their surpluses to the fund . . . . The Iranians and the Saudis were the most supportive . . . . It was interesting that they gave that support to the IMF and didn't make difficulties about the fact that Israel could draw on the Facility.<sup>54</sup>

Witteveen further observed:

[I]f the main countries would have given more support to the [IMF] oil facility at that point, the present debt problem would have been less serious. The influence of the fund on these [debtor] countries would have been better adjustments, and the role of the banks would not have been so large.<sup>55</sup>

Witteveen noted, however, that the position of the industrial countries, "[m]ainly the United States, has been . . . that these deficits should as far as possible be financed through the markets, and only in cases

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51. *Simon Testimony, supra* note 8, at 237 (commenting that the private financial system did a "remarkable job" in handling such large operations).

52. *Multinat'ls and United States, supra* note 39, at 45-56 (statement of William Ogden, Chase National Bank).

53. *Id.* at 60.

54. Witteveen, "We couldn't tell a country, 'You shouldn't spend so much money for buying airplanes; spend more for something else,'" INSTITUTIONAL INVESTOR, June 1987, at 27, 33 (Int'l Ed.).

55. *Id.*

where they couldn't be completely financed through the market was there a role for the fund."<sup>56</sup>

Denis Healey described his efforts:

I tried very hard, my early months as chancellor, to persuade my colleagues to organize some sort of international, official scheme for recycling the OPEC surpluses. But the Americans, particularly, were very hostile to this idea. Basically, they didn't believe in government mucking around in what they thought should be the role of the private sector. They would leave it all to the bankers who were licking their lips at the thought of what they would get out of it.<sup>57</sup>

An even more radical strategy was explored in the Congress, where Senator Javits proposed not financing the oil import needs of the poorer countries.<sup>58</sup> In the same hearing, Senator Church observed that the United States was filling the role of the "fall guy."<sup>59</sup> In words that in retrospect appear prescient, Senator Sarbanes asked what happens if the debtor countries decide not to pay back the loans they contracted.<sup>60</sup>

56. *Id.*

57. Healey, "I thought, if I let the pound slide, then went to the IMF meeting, we could be facing a very serious crisis," INSTITUTIONAL INVESTOR, June 1987, at 66, 66-67 (Int'l Ed.).

58. *American Foreign Economic Policy*, *supra* note 16, at 23 (testimony of William Rogers, Former Under Secretary of State for Economic Affairs, and Hon. Edwin Yeo, Former Under Secretary of the Treasury). Senator Javits observed:

If it is a fact that we expect the current account deficit, because of oil imbalance, of about a quarter of a trillion dollars in the next five or six years, and this money is going to be loaned to us short, that is, on seven days or thereabout on deposit, and then is being loaned out long, as our banks now have \$50 to \$70 billion of credit extended, which we estimate about \$50 billion of which is extended to the LDC's, shall we simply turn around to the LDC's and say look, we did not cause this, it is caused by your friends in the Asian-African bloc, so you go and borrow from them? Why should we be the brokers through which this very risky enterprise is conducted? After all, if there is a demand for a moratorium and if there are major defaults, the banks, as you and I both know, expect that they are going to be bailed out by the IMF or the Federal Reserve. They don't expect that the depositors will pay it, and they should not, as far as we are concerned. The whole stability of this country leans on it.

*Id.* (statement of Senator Javits of New York).

59. *Id.* at 25 (statement of Senator Church of Idaho).

Senator Church stated:

What we are doing is making ourselves the fall guy. We are holding the bag. We are extending the loans. As the pressure of these accumulating loans begins to have its regressive effect on these economies, they will begin talking, indeed as they are already talking, about restructuring the loans. They are dealing with us; we are the creditor, and they are the debtor. I have never known very many debtors who love their creditors.

Meanwhile, the OPEC countries over here who have created the whole problem are in Paris arm-in-arm with the lesser developed countries condemning the Western World . . . .

*Id.*

60. *Id.* at 34 (statement of Paul Sarbanes, Senator from Maryland). The Senator posited:

Healey and Witteveen place the blame for a failed policy primarily on United States policy makers.<sup>61</sup> The recycling strategy, however, had advantages for everyone: the oil producers with surplus funds placed those funds with the strongest financial institutions (and government) in the industrialized world; those institutions expanded and made large profits; the oil importing, borrowing countries received funds with very few conditions attached to them; the United States government financed a significant part of its deficit with funds of the oil producers. The responsibility for reliance upon the recycling strategy may have originated with Secretary Simon and the American Administration, but it was a responsibility shared by the other major actors in the debt drama—the oil producers, the oil importing debtor countries, and the multinational banks.

In August 1982, the Mexican Finance Minister visited Washington to inform United States Treasury officials that Mexico could not meet its debt service obligations to commercial banks.<sup>62</sup> Mexico, however, was not alone in its difficulties. "By the end of the year," observed a Congressional Joint Economic Committee Report, "it became clear that Mexico was only one of nearly a dozen Latin American nations that had borrowed considerably more from U.S., European, and Japanese banks than their sluggish economies were capable of repaying on time." Latin American debtor nations had a total external debt of more than \$318 billion, with yearly interest payments totalling \$38.5 billion. Their trade surplus, at the time, was \$8.5 billion, or \$30 billion less than they needed merely to pay interest. The three largest Latin American debtors—Argentina, Brazil, and Mexico—suffered a particularly dramatic deterioration in their debt servicing capacity. Brazilian debt service (interest on short-term and long-term debt) as a percentage of exports rose from thirty-six percent in 1973-1974 to eighty-seven percent in 1982. The increase in the same time frame for Mexico was from twenty-five to fifty-eight percent, and for Argentina, the deterioration was even more marked. In 1973-1974, the ratio of debt service

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Suppose someone comes along at some point and says well, we are not going to pay them back. We just do not think it was imposed upon us reasonably, and your rules are that you incur these obligations, and then over time we'll return them all—well, we are not going to incur the cost within our society that that implies, and we are just blowing the whistle on this whole system. Then where are we? Is that an altogether implausible prospect?

*Id.*

61. Healey, *supra* note 57, at 66-7; Witteveen, *supra* note 54, at 33.

62. See *supra* note 38 and accompanying text (discussing the Mexican Debt Crisis of August 1982). Probably the best account of events immediately following the Mexican default is to be found in J. KRAFT, *THE MEXICAN RESCUE* (1984).

to exports was twenty-one percent, and in 1982 it was 103 percent.<sup>63</sup>

United States commercial banks were particularly at risk, as Senators Church, Javits, and Sarbanes had foreseen five years earlier. A United States General Accounting Office Report summed up the vulnerability of the United States banks:

In June 1982, U.S. banks held LDC debt equal to 211 percent of U.S. bank capital and LDC debt owed to the largest nine U.S. banks was 323 percent of their capital. Debt owed by Argentina, Brazil, and Mexico to all U.S. banks equalled 82 percent of the U.S. banks capital; debt owed by these three countries to the largest nine U.S. banks equalled 116 percent of their capital.<sup>64</sup>

The Mexican default in August 1982, demolished the optimistic assessment of the effects of the recycling scheme as a means of managing the financial imbalances that had arisen in the aftermath of the oil price rises of 1973 and 1979.

#### PHASE II: 1982-1985

The full dimensions of the crisis, however, were not at first fully appreciated. There were two distinguishing characteristics of this period: first, there was widespread belief in credible circles that the financial crisis resulting from the Mexican default was short-term in nature and was likely to be resolved within an approximate eighteen month time frame; and second, there was the conviction, particularly in United States government circles, that the crisis afforded an opportunity to bring the major debtor countries, especially of Latin America, back into the fold of sound financial and economic management under the aegis of the International Monetary Fund.<sup>65</sup> The World Bank and the regional development banks were accorded a lesser role.<sup>66</sup>

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63. Cline, *Int'l Debt and the Stability of the World, Policy Analyses in Int'l Economics*, INST. FOR INT'L ECON. 17 (No. 4, Sept. 1983).

64. GAO REPORT, *supra* note 2, at 14.

65. See, e.g., *Foreign Assistance and Related Programs Appropriations for 1984: Hearings Before the Subcomm. on Foreign Assistance and Related Programs Senate Comm. on Appropriations*, 98th Cong., 1st Sess., 15 (1983) [hereinafter *1983 Hearings of Foreign Assistance*] (statement of the Hon. George P. Schultz, Sec. of State) (emphasizing the importance of the IMF). "The IMF is a critical part of the adjustment process. The IMF helps affected countries develop sound policies of economic stabilization. Such stabilization policies in turn encourage new commercial lending." *Id.*

66. See Neikirk, *The World Bank: Can It Overcome Barber Conable's Debacle?*, INT'L ECON., 28 (Oct./Nov. 1987) (criticizing president Barber Conable and the World Bank's perceived passivity over the debt crisis). The author writes, "during the first few years of the debt crisis, Mr. Conable's predecessor, A.W. (Tom) Clausen, stayed on the sidelines and permitted the International Monetary Fund to take the leadership role." *Id.* at 30. This judgement may have been unfair to both Clausen and Conable. In the early years of the debt crisis, 1982 to October 1985, the IMF was



The Mexican crisis of August 1982 was resolved with an emergency loan from the United States and American advance purchases of Mexican oil for the American Strategic Petroleum Reserve. But United States authorities who negotiated the rescue package also required Mexico to agree with the IMF on an economic adjustment program that would better balance its external accounts. Before concluding such an agreement with Mexico, however, the then-Managing Director of the Fund, Jacques de Larossiere, insisted that the private bank creditors of Mexico agree to continued financing of Mexico's development.<sup>67</sup> An "involuntary" lending package was assembled to meet Mr. de Larossiere's condition.<sup>68</sup> The pattern was established for dealing with the other major debtor countries: first, an immediate United States rescue operation including a short-term credit (six months); second, a commitment to seek an agreement with the Fund; and finally, involuntary continued lending by the private bank creditors linked to an agreement between the debtor country and the Fund.<sup>69</sup>

The economic adjustments advocated by the Fund differed in detail for each country. The emphasis, however, was the same—to shift resources from the domestic sector into activities which increased foreign exchange earnings. This strategy meant production for export, a reduction in domestic expenditures and economic activity, and a devaluation of the currency to spur exports. The reduction in domestic public expenditures, in practice, translated into a decline in investment.<sup>70</sup>

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encouraged to take the leadership, "but all that changed when the Treasury Secretary James Baker unveiled his widely heralded Third World debt plan at the bank-fund meeting in Seoul two years ago. The Baker Plan stressed economic growth over austerity, and virtually invited the World Bank to take center-stage." *Id.*; see also Ipsen, *The Great \$75 Billion Giveaway?*, INSTITUTIONAL INVESTOR, Sept. 1988, at 318, 324 (noting the belief of one Latin American investor that the World Bank is "best suited" to deal with the debt problem); *Integration of U.S. Policies on Trade, Exchange Rates, and the Accumulated Debts of Less-Developed Countries: Hearings Before the Int'l Trade Subcomm. of the Senate Fin. Comm.* 99th Cong. 2d Sess. 70 (1986) (statement of Prof. Jeffery D. Sachs, Dep't of Econ. Harvard Univ.) (stating "the strategy to date has put the IMF in the front line of the debt crisis"). *But see id.* at 70 (statement of Hon. James A. Baker III, Sec. of the Treasury) (giving equal billing to the World Bank) *Id.*

67. *Bad Debtor's Charter*, THE ECON. Feb. 19, 1983, at 85. [hereinafter *Bad Debtor's Charter*]; Bogdanowicz-Bindert, *World Debt: The United States Reconsiders*, 64 FOREIGN AFF. 259, 263 (Winter 1985/86); see *supra* note 38 and accompanying text (describing the Mexican debt crisis of 1982).

68. Kuczynski, *The Outlook for Latin American Debt*, 66 FOREIGN AFF. 129, 131 (Fall 1987).

69. See *Bad Debtor's Charter*, *supra* note 67 at 286 (stating that the United States agreed to rescheduling and/or increasing the loans); Kuczynski, *supra* note 68, at 131 (noting that to avoid defaults, commercial banks were forced to lend additional money).

70. INTER-AMERICAN DEVELOPMENT BANK, ECON. AND SOC. PROGRESS IN LATIN

The more advanced developing countries such as Brazil, South Korea, Taiwan, and Mexico were relatively well positioned to execute the IMF strategy for emphasizing export growth. The development strategy of the past two decades had expanded industrial capacity, making it more sophisticated.<sup>71</sup> The increased availability of credit for this purpose in the 1960s and the virtually unlimited funds to which the NICs had access in the 1970s enabled them to expand their industrial base without restraints from potential competitors in the industrialized world.

Moreover, as the industrialized countries adjusted to the oil shock of 1973-1974 by deflating their economies, multinational corporations looked with increasing interest on investments in the NICs, particularly Brazil, Chile, Taiwan, and South Korea.<sup>72</sup> Low wages, disciplined labor, and financial incentives for foreign investors were attractive inducements for new investments, particularly because the products manufactured could be exported to markets in the industrialized world at more competitive prices than domestic production in those markets.<sup>73</sup> Companies increased exports from Latin America to take advantage of low cost production and to use capacity idled by economically depressed local markets.<sup>74</sup>

These advantages were further maximized by the United States domestic economic policy. The large tax cuts enacted by Congress in 1981, coupled with the increase in expenditures for the military budget, far outweighed decreases in domestic nonmilitary spending.<sup>75</sup> The result was a fiscal stimulus that propelled the American economy into significant expansion in 1983 and 1984, far greater than that of Europe

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AMERICA: EXTERNAL DEBT CRISIS AND ADJUSTMENT REP. 33-50 (1985). The Report examines the process of macroeconomic adjustment of the seven largest Latin American economies to the abrupt curtailment of external lending in the post-1982 period—Argentina, Brazil, Chile, Columbia, Mexico, Peru, and Venezuela. *Id.* Those countries produced almost 90 percent of the total output of goods and services of all Latin America and Caribbean countries and owed a similar proportion of the total external debt. *Id.* The Report concluded that there was a "decline in national savings and a dramatic fall in the aggregate investment ratio for the seven countries from an average of 24.1% of GNP in 1980-82 to 18.1% in 1983-84." *Id.* at 9; see also Fishlow, *The State of Latin American Economics, Economic and Social Progress in Latin America* 133-37 (1985) (discussing critically the IMF model); Montagnon, *IMF Criticized for "Short-Term" Policies in Debtor Countries*, *Fin. Times*, Sept. 16, 1985, at 1 (displaying a view more sympathetic to the IMF).

71. IMF ANNUAL REPORT, *supra* note 32, at 21.

72. COUNTERING WORLD DEFLATION, *supra* note 33, at 9.

73. *Id.*

74. *Id.*

75. IMF ANNUAL REPORT, *supra* note 32, at 2, 6.

and Japan.<sup>76</sup> Interest rates in the United States remained high in historical terms relative to inflation. These "real" interest rates attracted huge capital flows from abroad, an attraction enhanced by the image of the United States as the last best bastion of capitalism in the Western world. The dollar, relative to other currencies, increased in value.<sup>77</sup> This increase made imports cheaper in the United States, restraining price increases by domestic United States producers. Imports increasingly supplanted domestic production.<sup>78</sup>

According to the IMF:

The U.S. recovery was of fundamental importance to countries seeking export-led adjustment. U.S. imports from Asia and European developing countries increased by some 80 percent between 1980 and 1984, with the growth being concentrated in 1983-84 . . . Exporters of manufactures achieved remarkable success, as U.S. imports from them doubled between 1980 and 1984.<sup>79</sup>

In contrast, other industrial countries' imports from these regions were flat.<sup>80</sup> Virtually the entire increase in exports from Latin America between the first quarter of 1983 and the first quarter of 1985 went to the United States.<sup>81</sup>

But the "strong" dollar also made it more difficult for American exporters to sell their goods in foreign markets. In the NICs, these markets were already constrained by the economic austerity programs, although these programs were fitfully implemented in many of the NICs. Hence, the relative balance that had prevailed in the 1970s between United States exports and imports to and from the NICs collapsed; draconian austerity programs in the debtor countries, combined with devalued currencies and reduced bank loans to those countries, triggered a sharp decline in debtor country imports.<sup>82</sup> United States exports to the Latin American region fell to \$23 billion in 1983 from \$39 billion in 1981, the year before the Mexican debt announcement.<sup>83</sup> In 1981, Latin American farm product imports totalled \$6.9 billion or fifteen percent of all United States farm exports. Between 1982 and 1986, however, United States agricultural exports to Latin America declined by one third, to \$4.5 billion. As a result of the reduction in consumption by the debtor countries, an estimated one million jobs have

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76. *Id.*

77. *Id.* at 19.

78. COUNTERING WORLD DEFLATION, *supra* note 33, at 9.

79. IMF ANNUAL REPORT, *supra* note 32, at 21.

80. *Id.*

81. *Id.* at 19.

82. See COUNTERING WORLD DEFLATION, *supra* note 33, at 9.

83. MORGAN GUARANTY TRUST CO., WORLD FIN. MARKETS, LDC DEBT: DEBT RELIEF OR MARKET SOLUTION? 10 (Sept. 1986).

been lost in the United States.

With United States exports to the NICs (and more generally to the developing world) falling, and imports from them soaring, the United States merchandise trade deficit with the NICs grew precipitately. The trade deficit with the East Asian NICs, such as South Korea, Taiwan, Singapore, and Hong Kong increased from \$4 billion in 1980 to \$30 billion in 1986.<sup>84</sup> In Latin America, the trade balance was substantially improved by slashing imports and investment.<sup>85</sup>

The developing countries as a whole succeeded in substantially reducing their combined current account deficit from approximately \$100 billion in 1982 to \$44 billion in 1984. The aggregate deficit of the developing countries other than the Middle Eastern oil producers, including the NICs, declined from \$91 billion in 1981, equivalent to twenty-three percent of exports of goods and services, to only \$38 billion in 1984, nine percent of exports of goods and services.<sup>86</sup> In effect, the IMF-sponsored strategy had significant success in bringing about a reduction in the debtor countries' imbalances in their external accounts.

At the same time, however, there was a steep decline in private bank financing of the debtor countries. As the IMF explained:

The decline in the developing countries' net borrowing from market sources was the most dramatic financial development in 1981-84 . . . the supply of new commitments to borrowing countries from commercial sources virtually dried up. Countries that relied predominantly on market sources for financing their external position (the market borrowers) borrowed \$125 billion (net) from banks and other private creditors in 1981-82, but only \$25 billion in 1983-84. Indeed, the market borrowers, financing situation was even tighter than these figures suggest. They secured net inflows from private creditors in 1983-84 only as a result of obtaining some \$23-24 billion in concerted lending packages related to debt restructuring.<sup>87</sup>

What this meant was that the debtor countries needed to use their trade surpluses to finance their debt service obligations to the banks. Brazil, for example, which achieved a \$12 billion trade surplus in 1984,

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84. MORGAN GUARANTY TRUST CO., *WORLD FIN. MARKETS, THE ASIAN NICs AND U.S. TRADE* 6 (Jan. 1987).

85. MORGAN GUARANTY TRUST CO., *WORLD FIN. MARKETS, THE BAKER INITIATIVE: THE PERSPECTIVE OF THE BANKS* 2 (Feb. 1986). In Argentina, capital formation fell from an average of 25 percent of GNP in 1979-80, to 16 percent in 1985; in Brazil, investment declined to 17 percent in 1982-85, whereas, it had achieved an average 27 percent in the 1970s; and in Mexico, investment which had grown at an average 28 percent in 1977-81 declined to a low of 22 percent in 1982-83. MORGAN GUARANTY TRUST CO., *WORLD FIN. MARKETS, GROWTH AND FINANCIAL MARKET REFORM IN LATIN AMERICA*, 2 (Apr./May 1986).

86. IMF ANNUAL REPORT, *supra* note 32, at 19.

87. *Id.* at 21-22.

also had an interest bill to the private banks of \$11 billion. The Latin American countries in 1984 had a net transfer of \$30 billion in debt service payments to the private commercial banks; over the four year period 1981-84, the net transfer of debt service payments from the Latin American region to the private commercial banks was estimated to have been approximately \$100 billion.<sup>88</sup>

Yet as Leonard Silk of the New York Times remarked, the banks have remained "remarkably calm," perhaps because they were not in any great danger.<sup>89</sup> Silk observed that the Chairman of the Federal Reserve Board, Paul A. Volcker, "told the American Bankers Association conference in Honolulu . . . 'we have a strong safety net under our own banking system, as do other leading countries.'"<sup>90</sup> He enumerated this safety feature as: (1) deposit insurance, and (2) an understanding that the rules would change to protect the banks.

But there was no safety net under the factory worker displaced by the loss of work resulting from the decline in export markets and the competition from foreign imports. Not surprisingly, political pressures grew within the United States for the protection of American jobs. The December 1985 Morgan Guarantee World Financial Markets Report aptly summed up the policy and its consequences: "[A]verage real wage gains have been negligible in this recovery, maintaining their stagnation of the last ten or more years."<sup>91</sup> Foreign competition, it noted, "has been the key factor."<sup>92</sup> The report added:

[T]his is not attributable solely to the higher dollar. The long run shift of comparative advantage in manufacturing to the NICs helped them penetrate the U.S. domestic market even before the dollar's rise. U.S. manufacturers are keenly aware of the cost savings attainable through contracting for production in low wage areas abroad.<sup>93</sup>

The 1982-85 debt strategy not only had a high cost for the American

88. Declaration of Montevideo, Dec. 18, 1985, at 3.

89. Silk, *Economic Scene; Good Reasons To Lend More*, N.Y. Times, Nov. 4, 1983, at D1. Silk noted:

The financial markets in the United States and other Western countries have been remarkably calm in the face of the international debt crisis. This may be because the major banks, despite their heavy exposure in the debt-ridden developing countries, are not really in great jeopardy: they are protected by deposit insurance, by the recognition of regulators that, if necessary, accounting rules would be changed to protect them and by the expectation that their national central banks would rescue major banks to protect the system.

*Id.*

90. *Id.* (quoting Paul A. Volcker, Chairman of the Federal Reserve Board).

91. COUNTERING WORLD DEFLATION, *supra* note 33, at 9.

92. *Id.*

93. *Id.*

factory worker, but for the debtor countries as well, particularly in Latin America. The December 1985 Montevideo Declaration of the Foreign Ministers of the Latin American Group of countries that had originally met in Cartagena, Colombia to discuss the debt crisis, observed that, "in the last five years Latin America has regressed a decade."<sup>94</sup> Malnutrition and infant mortality indices also increased. Investment in infrastructure and new production facilities dramatically declined. Projects financed by the World Bank and the regional development banks slowed to a halt as the debtor countries were unable to put up their share of the funding.

When Alan Garcia was elected President of Peru in July 1985, he announced that Peru would limit its payments to creditors to ten percent of its export earnings. The other Latin American debtor countries did not follow Peru's lead, but by the fall of 1985, it was becoming evident that debt fatigue was taking hold in all of the debtor countries. The private sector was not investing in new production facilities; the public sector could not lead the way, both because it was too inefficient and because it was constrained by agreements with the IMF and the creditor countries. The combination of debt fatigue in the major debtor countries and mounting political resistance in the United States to a flood of imports from debtor countries desperate to earn the income to pay the interest on their foreign indebtedness, created a sense of crisis in Washington. Something vital had to be done. The result was the Baker Initiative.

### PHASE III: THE BAKER INITIATIVE

At the October 1985 annual meeting of the World Bank and the IMF in Seoul, South Korea, Secretary of the Treasury James A. Baker III proposed a new initiative for dealing with the economic malaise of the major debtor countries in the developing world. The Secretary explicitly embraced the concept that economic growth was the best means to overcome the depressing effects of the debt crisis in the debtor countries.<sup>95</sup> If not abandoning the austerity emphasis of the 1982-85 period, he at least relegated it to a lesser priority. Baker proposed that additional resources be made available to those debtor countries that undertook major economic policy reforms, with special emphasis on reducing

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94. Declaration of Montevideo, Dec. 18, 1985, at 1.

95. Statement by the Hon. James A. Baker III, Secretary of the Treasury of the United States before the Joint Annual Meeting of the Int'l Monetary Fund and the World Bank, Oct. 8, 1985, Seoul, South Korea, *reprinted in*, UNITED STATES DEPARTMENT OF TREASURY, TREASURY NEWS at 4-5 (Oct. 8, 1985) [hereinafter Baker Statement].

the role of the public sector in the economy and liberalizing restrictions on imports and foreign direct investment.<sup>96</sup>

Under the plan, private commercial creditor banks would lend \$20 billion of net additional resources (in excess of repayments of principal and interest received from the debtor countries) over a three year period to the countries undertaking such reforms.<sup>97</sup> The World Bank and regional development banks would increase their disbursements to such countries by fifty percent over existing levels.<sup>98</sup> With respect to Latin America, the Secretary observed that if the Inter-American Development Bank was to participate in such a program, it would need to make major internal changes.<sup>99</sup>

There was, however, no detailed explanation as to how private bank lending was to be related to that of the multilateral development banks (MDBs) (the World Bank and the regional development banks, the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank). The explanation left many unanswered questions. Was there to be, as the private banks demanded, joint disbursements, sharing of repayments, or mandatory cross defaults between the private and development bank loans so that a default against one became a default against the other? Who was to make the judgment whether the commitments of the debtor countries to policy reforms were sufficient to justify eligibility for Baker's Initiative lending plan? Who was to monitor whether the commitments were being fulfilled? How did the Baker Initiative lending differ from the "involuntary" private bank IMF lending packages? Did it substitute for them, or was it additional? Was all MDB lending to be related to

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96. *Id.* The initiative Baker proposed included:

- 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;
- market-opening measures to encourage foreign direct investment and capital inflows, as well as to liberalize trade, including the reduction of export subsidies
- . . .
- market-oriented exchange rates, interest rates, 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 freeing up resources for the private sector.

*Id.* at 5-6.

97. *Id.* at 9.

98. MORGAN GUARANTY TRUST CO., WORLD FIN. MARKETS, LDC DEBT REDUCTION: A CRITICAL APPRAISAL 3-5 (Dec. 30, 1988) [hereinafter LDC DEBT REDUCTION].

99. Baker Statement, *supra* note 95, at 9.

the Baker Initiative? If a debtor country was ineligible for Baker Initiative lending, was it still eligible for MDB loans? What was the "premium" attributable to the Baker Initiative (the lending by these institutions that would not have occurred if there had been no Baker Plan)? There were no answers to these questions.

Even if there had been a plan, a basic problem would have remained. The motive behind the Baker Initiative had been political: the backlash building in the United States against the 1982-85 strategy and the fear that in the debtor countries, the moderates who wanted to work within the system were in danger of being overrun by more radical forces, who wanted a break with the existing international financial order.<sup>100</sup> This concern argued for a rapid infusion of funding to alleviate the debt service obligation of the debtor countries and to act as a stimulus to economic growth.<sup>101</sup> Such a stimulus, it was believed, would draw the poison from the critique of the radicals.

This sense of political urgency, however, conflicted with the conviction on the part of the Treasury staff that the debt crisis afforded an unparalleled opportunity to achieve, in the debtor countries, the structural reforms favored by the Reagan Administration. The core of these reforms was a commitment, on the part of the debtor countries, to reduce the role of the public sector as a vehicle for economic and social development and rely more on market forces and private enterprise, both domestic and foreign.<sup>102</sup>

At the same time, Secretary Baker's call for increased net new lending to the debtor countries by the private commercial banks, loans in excess of debtor country interest and principal repayments to the banks, conflicted with the private banks' strategy of reducing their exposure in the debtor countries. The resulting ambivalence of the banks made their response to the Baker Initiative less than enthusiastic. The Baker Plan did not result in the debtor countries "growing out" of the debt crisis. During 1985-87, the seventeen most highly indebted countries that were to be the primary beneficiaries of the Baker Plan paid \$74 billion more than they received from private commercial banks and multinational lending institutions.<sup>103</sup> Between September 1985 and

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100. See Broad, *How About a Real Solution to Third World Debt?*, N.Y. Times, Sept. 28, 1987, at A25 (noting that the new coalitions organized to demand drastic reductions in debt service received wide support from the Philippines to Argentina).

101. See *id.* (stating that the Baker Plan proposed significant new lending to the fifteen most indebted countries).

102. See Baker Press Release, *supra* note 95, at 5 (calling for decreased reliance on the public sector and increased use of the private sector).

103. See THE WORLD BANK, *supra* note 1, at xiv, x-xix (listing the 17 highly indebted countries: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ivory



September 1987, American banks cut their overall loans to fifteen countries, which were the original object of the Baker Plan, by twelve percent from \$91 to \$80 billion.<sup>104</sup> Per capita income in these countries has declined practically every year since 1980.<sup>105</sup>

An impasse between the United States and the major Latin American member countries of the Inter-American Development Bank (IDB), the largest and oldest regional development bank, prevented the bank from playing a major role in the region's development. The Agreement Establishing the Inter-American Development Bank (IDB Charter) had been signed by the United States and nineteen Latin American states as a part of the Alliance for Progress program initiated by President John F. Kennedy.<sup>106</sup>

The impasse concerned the demands by the United States, in part supported by Canada and the nonregional member countries of the IDB, for a more effective role in decision making in the Bank. Unlike other multilateral institutions, the borrowing member countries of the IDB own a majority of the voting shares.<sup>107</sup> Decisions, unless specifically stated otherwise, are made by a majority of the total voting power.<sup>108</sup> By voting as a block, the borrowing member countries could

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Coast, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia). Jamaica and Ecuador were later added to the original Baker 15. *Id.*

104. *Id.* at xxi.

105. *See id.* at xiii (listing economic indicators from 1980-87).

106. *Discurso pronunciado por el Presidente de los Estados Unidos, John Fitzgerald Kennedy*, en Sesión Protocolar del Consejo de la Organización de los Estados Americanos, el 14 de abril de 1961, para celebrar el Día de las Américas.

Interestingly, an agreement to establish such an institution had been reached by the Eisenhower Administration. It thus represented a bipartisan initiative in the United States. Cuba was the only one of the Latin American states that did not sign the Charter. Later, several English speaking Caribbean countries that gained their independence became members of the Bank. In the 1970s, a number of Western European countries and Japan also became members of the IDB; *see* J. LEVINSON AND J. DE ONIS, *THE ALLIANCE THAT LOST ITS WAY, A TWENTIETH CENTURY FUND STUDY* 36-45 (1970) (discussing the background to the promotion of the Inter-American Development Bank); *INTER-AMERICAN DEVELOPMENT BANK, GENERAL RULES GOVERNING ADMISSION OF NONREGIONAL COUNTRIES TO MEMBERSHIP IN THE BANK* (1976) (listing the nonregional member countries of the IDB: Austria, Belgium, Denmark, Germany, Israel, Italy, Japan, Netherlands, Portugal, Spain, Switzerland, United Kingdom, and Yugoslavia).

107. *See* Agreement Establishing the Inter-American Development Bank, Inter-American Development Bank, December 30, 1959, art. viii, § 4(a), 10 U.S.T. 3029, 3054, T.I.A.S. No. 4397, at 14, 389 U.N.T.S. 69, iii (stating that regional developing member countries under the Charter are entitled to 53.5% of the voting shares; the United States holds 34.5% of the shares of the Bank; Canada is entitled to 4% and the remainder is held by the nonregional member countries).

108. *See id.* art. viii, § 4(c)(iii), at 3090. Amendments to the Charter required a majority of the total number of governors, including two thirds of the governors of

theoretically approve individual loans and technical assistance. There were, however, limits to this power. For example, a quorum is necessary for all meetings of the Board of Executive Directors requiring an absolute majority of the total number of Directors, including an absolute majority of directors of regional members, representing not less than two-thirds of the total voting power of the members.<sup>109</sup> As the United States represented 34.5 percent of the voting power, the absence of the United States Director could effectively prevent the passage of any proposal by preventing a quorum.

This power was rarely used, however. Decisions in the Board of Executive Directors were by and large achieved by consensus. Nevertheless, the United States Treasury Department, which has responsibility for participation of the United States in the multilateral institutions, sought to exercise greater influence over the design of loan and technical assistance proposals.<sup>110</sup> It sought to amend the Rules of the Board of Executive Directors to permit two directors to delay a loan or technical assistance proposal for an extended period of time.

Borrowing member countries perceived this proposal as constituting a de facto North American veto because they assumed that Canada would almost invariably vote with the United States.<sup>111</sup> The negotia-

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regional member countries of the Bank representing not less than three fourths of the total voting power of the member countries; see also *id.* art. xii (a), at 3090.

109. *Id.* art. viii, § 3(f), at 3090.

110. Fidler, *IADB Seeking a New Role After the Lost Years*, *Fin. Times*, Mar. 16, 1989, at 6. "The essence of the dispute was the dissatisfaction of the Reagan Administration with the bank's operations and lending policies." *Id.*

111. Fidler, *IADB Capital Increase Smooths Way on Loans*, *Fin. Times*, Mar. 17, 1989, at 6. The article describes the compromise formula on voting which led to a break in the deadlock:

The IADB has a 12-strong board. The agreed formula gives the right to delay loans to one director for two months; two directors, five months; and three directors, 12 months. The U.S. and Canada have one director each; the European countries two directors; and Latin American states eight. The Bank's president would have power to vote some loans not subject to delay.

*Id.* The article noted that, "the way has been cleared for a Dollars 22.5b capital increase for the Inter-American Development Bank. Clearance follows resolution of a three-year-long, often acrimonious dispute between the U.S. and Latin American shareholders." *Id.*; see also *Inter-American Bank Could Win Big Role in New LDC Debt Plan*, *J. Com.*, Mar. 16, 1989, at 7A. The agreement in principle at the Amsterdam meeting needed to be ratified through a formal vote of Government authorities in favor of the resolutions authorizing the increase in resources. Funding in the form of capital increases and direct appropriations for the Fund for Special Operations of the Bank, which makes loans on highly concessional terms to borrowers, required parliamentary and congressional approval. Hence, the resources increase and the increased lending program was not expected to be effective before calendar year 1990. Fidler makes a common error in reporting the \$22.5b as the capital increase. In fact, the \$22.5b figure refers to the projected *lending* program for the four year period 1990-94, which required a capital increase of \$26.5 billion. The difference is accounted for by

tions over an increase of resources deadlocked for four years.<sup>112</sup> Not until the Annual Meeting of the Board of Governors of the IDB in March 1989, was the impasse resolved. The Governors reached a compromise agreement on an increase in resources that would permit a lending program of \$22.5 billion over the four year period 1990-1994. Additionally, the Governors agreed upon a procedure in which the Board of Executive Directors of the IDB would amend the rules of procedure of that body to permit a substantial delay for a maximum period of one year, in discussion on an agenda item if the requisite number of Executive Directors objected to the consideration of the item. The United States Acting Governor at the meeting further proposed that the IDB engage in sector lending, a form of quick disbursing lending conditioned on changes in policy by the debtor country, only in conjunction with the World Bank. The Governors agreed that at the end of two years, they would review the situation to determine whether the IDB should engage in such lending without the need to do so jointly with the World Bank. In 1988, the IDB loan authorizations declined to the lowest level in five years.<sup>113</sup> Instead of contributing to the Baker Initiative, the region's development bank could not play a significant role.

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the fact that the lending program is partially financed by repayments of previous loans, estimated cancellations and a balance carried over from the previous (Sixth) Replenishment, all of which totalled (for the capital resources of the Bank) an estimated \$8.1 billion. The balance was then obtained by the \$26.5 billion capital increase. Only 2.5 percent of the capital increase (\$661 million) is paid-in, the remainder is callable or a form of guarantee by the member countries to make such capital available if necessary to meet the obligations of the Bank to creditors (after drawing upon Bank reserves). However, not all of the callable capital is recognized in the capital markets as a basis for Bank borrowing in such markets. Only the callable capital subscriptions of the Bank's nonborrowing member countries are recognized in the financial markets as a basis for the Bank borrowings in those markets. The borrowed funds are then used to fund disbursements of the loans extended by the Bank to borrowing member countries to import goods and services for development purposes. Hence, of a total capital subscription of \$26.5 billion, \$12.5 billion or approximately 48 percent is "usable."

112. See *Foreign Assistance and Related Programs Appropriations for Fiscal Year 1988: Hearings on H.R. 3186 Before the Subcomm. on Foreign Operations of the Senate Comm. on Appropriations*, 100th Cong., 1st Sess. 69 (1987) [hereinafter *1987 Hearings on H.R. 3186*] (statement of James W. Conrow, Deputy Assistant Secretary for Developing Nations, Dep't of Treasury); see also *Future Role of the Inter-American Development Bank: Hearing Before the Subcomm. on Int'l Dev. Institutions and Fin. of the Comm. on Banking, Fin. and Urban Aff., House of Representatives, on the Future Role of the Inter-Am. Dev. Bank*, 100th Cong., 2d Sess. 23-25 (1988) [hereinafter *1988 Hearings on Int'l Dev.*] (statements of R. Sternfeld, Former Excc. Vice-President of the Inter-American Development Bank); *Making Foreign Aid Work*, Wash. Post, Mar. 27, 1987, at A26 (discussing foreign aid and giving a critical comment on the position of the Treasury in the IDB negotiations); *Mistake at Treasury*, J. Com., Apr. 27, 1987, at 16A.

113. INTER-AMERICAN DEVELOPMENT BANK, ANNUAL REPORT 1988 at V.

The Baker Seoul speech succeeded in its primary objective: the Baker Plan became the agenda for overcoming the debt crisis. Whatever its original motivation, the Baker Plan can be understood as a rather eclectic attempt to synthesize the development experience of the past three decades. The Plan took the development priorities of the 1950s—emphasis upon the role of the private sector, and foreign direct investment—repackaged them, and presented them as a new departure. It adapted the 1960s Alliance for Progress concept of country programming and policy reform, substituting for the social reform content of the Alliance period the classic American conservative themes of increasing efficiency and reliance on market forces. The Plan built upon the development financing role of the private credit markets that evolved in the 1970s by more directly linking that financing to the lending of the IMF and the MDBs. Above all, by tying the debtor country access to capital for development purposes to fidelity to a single economic development model that enhanced the role of market forces and private enterprise, Secretary Baker created the impression that what he sought was a return to the conditions that had prevailed three decades earlier in the 1950s when access to capital for development purposes depended upon adherence to IMF and World Bank guidelines.

#### PHASE IV: NEW INITIATIVES

Three and a half years later, there is new interest in more comprehensive approaches to the debt problem. Indeed, the first such suggested approach was articulated by United States Senator Bill Bradley. In a June 1986 speech, Bradley suggested that some part of the debt would need to be gradually written off, but that this should be done only for those countries that agreed to satisfactory economic and social reform programs.<sup>114</sup> Bradley's statement that private commercial banks would have to forgive part of the debt was considered a radical proposal. In other respects, however, Bradley's approach was quite conventional and consistent with the Baker Plan's emphasis upon the case-by-case approach. It explicitly embraced the concept of conditioning debt relief upon commitments by the debtor country to policy reform, although Bradley gave greater importance than did Secretary Baker to social equity as a part of the necessary reforms. The details of Senator Bradley's plan were less important than the fact that he enlarged the agenda for discussion of possible alternatives to dealing with the debt

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114. Address by Senator Bill Bradley, *A Proposal for Third World Debt Management* (June 29, 1986).

crisis beyond the Baker Plan. Bradley could do this because he was respected as an expert on economic issues both in the press and in Congress.

Initially, Bradley was an isolated voice. More recently, however, there has emerged a plethora of proposals for more comprehensive debt relief. Three factors appear to have led to this development. First, the May 1987 announcement by John Reed, Chief Executive Officer of Citicorp, that Citicorp was adding \$3 billion to its loan loss reserves as a contingency against third world debt risks, and The Bank of Boston's action later in the same year to actually take losses on specific loans to debtor countries, amounted to an open admission by creditor banks that some part of the debt was not repayable.<sup>115</sup> With most of the major banks in some degree following Citicorp's lead, although stopping short of the Bank of Boston's actions, the concept of debt forgiveness appeared to have gained a degree of legitimacy in political circles in Washington.<sup>116</sup>

The second factor that led to a search for alternatives to the Baker plan was the failure of the debtor countries to achieve sustained economic growth under the aegis of the Baker Plan, and the continued reluctance of the private commercial banks to lend new money aside from that associated with restructuring designed to assure the continued flow of interest payments. Moeen A. Quereshi, Senior Vice President of the World Bank, summed up the economic problem: "[i]nstead of growing at four to five percent per year—which was the average rate of growth we had expected was necessary—the countries overall have grown at less than one half that rate."<sup>117</sup> The Inter-American Development Bank observed that the region's 1987 economic performance was disappointing: "[e]conomic growth reached 2.6 percent, only marginally higher than the population increase of 2.2 percent . . . . In nearly all the countries, per capita GDP in 1987 was lower than in 1980." One year later, J.P. Morgan, generally sympathetic to the Baker Plan, summed up the balance for the debtor countries:

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115. See Truell, *Citicorp's Reed Takes Firm Stance on Third World Debt*, Wall St. J., Feb. 4, 1987, at 6 (stating that John Reed, Chairman of Citicorp, decided to halt the trend in making more concessions to debt-burdened nations).

116. See Pine, *U.S. Policymakers Fear Citicorp Stance on Debtor Nations Imperils Global Plan*, Wall St. J., Feb. 13, 1987, at 5 (noting that U.S. policy makers expressed concern that Citicorp's hard line stance may threaten global debt strategy); Bartlett, *Big Banks Shift From Third World*, N.Y. Times, July 27, 1988, at D1 (stating that thirteen of the largest U.S. banks reduced their portfolio of troubled loans to third world countries).

117. Rowan, *Third World Debt has Nations Looking for Creative Answers*, Wash. Post, Mar. 20, 1988, at H4.

Despite repeated attempts to bring down inflation, most of the debtors have had little enduring success. Nor are the debtors growing out of their problems: by and large, their economic growth has remained quite inadequate for basic needs. Financial support from foreign private and official creditors has not measured up to the goals of the Baker initiative. Confidence has yet to return and, on balance, flight capital has not been repatriated.<sup>118</sup>

Finally, there has appeared to be a growing realization that a resolution of the United States trade deficit may be linked to the economic recovery of the debtor nations, particularly in Latin America.<sup>119</sup> A recent report of the Overseas Development Council observes that, "the economic welfare of the United States is inextricably linked to developments in the global economy and in the developing countries."<sup>120</sup> Fueled by these developments, a lively debate has broken out in Washington. Secretary Baker, supported by Paul Volcker, former Chairman of the Federal Reserve Board, contends that there is no alternative to the Baker Plan.<sup>121</sup> Others, including members of the United States Congress, contend that there must be an alternative to the Baker Plan.

The most comprehensive legislative initiative on Third World debt is the Omnibus Trade and Competitiveness Act of 1988.<sup>122</sup> The two bills later merged into the Act were House Bill 3, titled "Trade and International Economic Policy Reform Act of 1987"<sup>123</sup> and Senate Bill 1420,

118. LDC DEBT REDUCTION, *supra* note 98, at 1.

119. See Address by J. Robinson III, Chairman and Chief Executive Officer of American Express Co., *A Comprehensive Agenda for LDC Debt and World Trade Growth*, before the Overseas Development Council at 1, 7 (Feb. 29, 1988) (listing effect of LDC debt on the United States trade deficit); OVERSEAS DEVELOPMENT COUNCIL, U.S. POLICY AND THE DEVELOPING COUNTRIES: AGENDA 1988, GROWTH, EXPORTS, AND JOBS IN A CHANGING WORLD ECONOMY, at 6, 10 [hereinafter AGENDA 1988].

120. AGENDA 1988, *supra* note 119, at 4. More specifically, notes the report: The negative impact of the economic downturn in the developing countries on the U.S. economy was direct and measurable: U.S. exports to all developing countries dropped from \$88 billion in 1980 to \$77 billion in 1985. If exports had grown in the first half of this decade at the same rate as in the 1970s, they would have totalled about \$150 billion in current dollars. The impact on employment also was dramatic. The actual and potential employment loss (if exports had grown as they did in the 1970s) amounted to 1.7 million jobs—or nearly 21% of total official unemployment in 1986.

*Id.* at 10.

121. See Rauch, *Why Hill's Debt Hawks Are So Ruffled*, Nat'l J., Mar. 12, 1988, at 683 (noting Volcker's support of the Administration's plan—that to push the banks would be counterproductive).

122. See Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, 102 Stat. 1107; Bruce A. Morrison, Member of Congress, Third World Debt Legislative Report: Int'l Debt Management Authority at 1 (June 6, 1988) (noting the bill's importance).

123. H.R. 3, 100th Cong., 1st Sess. (1988).

titled the "Omnibus Trade and Competitiveness Act of 1987."<sup>124</sup> This initiative had its antecedents in proposals made as far back as 1986.<sup>125</sup> As approved in May 1988 by the House Banking Committee, the key provision of the Act is the establishment of an international debt adjustment facility that would: (a) purchase sovereign loans at a discount, passing along the benefits of such discount to the corresponding debtor country, (b) encourage developed countries with capital surpluses to invest these in debtor countries, and (c) assist creditor banks in voluntarily disposing of sovereign loans in the private sector.<sup>126</sup> One of the goals of the Act is a genuine reduction in the debt servicing burden stifling growth in the developing world.<sup>127</sup> Debtor countries would ask the facility to purchase some of its debt and present a plan for "future economic management of the country." Once a debt discount and amount to be purchased were established, the facility would make offers to the debt holders and would purchase any loans tendered by using funds which it had raised itself in private credit markets. Any borrowing by the facility would be backed either by the commitments of developed nations or the IMF's gold reserve. The facility, in its new role as creditor, would then further seek to reduce the debtor's burden on the discounted debt, by engaging in debt restructuring such as debt for equity swaps, debt buy-backs by the debtor at the discounted price paid by the facility, or long-term securitization of debt with a contingent claim on some key debtor export at a specified price. As a result of the Act, capital surplus countries such as Japan and Germany are encouraged to provide more support for the facility than other participating countries.

The initiative further calls for the analysis of existing regulatory impediments to negotiated reductions in sovereign debt obligations<sup>128</sup> and to the sale of such debt at a discount in secondary markets, as well as possible changes to current reserve requirements.<sup>129</sup> Significantly, there

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124. S. 1420, 100th Cong., 1st Sess. (1988).

125. Congressmen John J. LaFalce and Bruce A. Morrison most clearly articulated the proposal in H.R. 1423, and H.R. 1453, respectively. H.R. 1423, 100th Cong., 1st Sess. (1988); H.R. 1453, 100th Cong., 1st Sess. (1988); see News from Congressman John J. LaFalce, *LaFalce Unveils Major Legislative Initiative to Confront Third World Debt Crisis* (Mar. 5, 1987); News from Congressman John J. LaFalce, *Action Needed on Third World Debt* (Mar. 16, 1987); Bruce A. Morrison, Member of Congress, *Third World Debt Legislative Report: Int'l Debt Management Authority* (Sept. 25, 1987).

126. Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 3111(a)(3)(A)-(C), 102 Stat. 1107, 1377 (to be codified at 22 U.S.C. § 5331).

127. *Id.* § 3103(2), at 1376 (to be codified at 22 U.S.C. § 5323).

128. *Id.* § 3122(a)-(b), at 1380-81 (to be codified at 12 U.S.C. § 3912).

129. *Id.* § 3122(b), at 1380-81.

is also a statement of Congressional intent that bank regulators should provide "maximum flexibility" to encourage negotiated reductions in principal and interest obligations. The legislation also tackles the problem of capital flight, by requesting further studies on possible solutions, for example, how countries which serve as "resting places" for such capital might help debtor countries to identify its sources. There are also requests for various additional studies on such subjects as the impact of past IMF austerity policies on debtor nations and how to mobilize greater private capital for developing nations.

The Omnibus Trade Bill was voted out of the Conference Committee.<sup>130</sup> The Senate trade bill was generally compatible with the House bill although the compromises were closer to the Senate bill.<sup>131</sup> The proposals regarding the facility were essentially the same, calling upon the Secretary of the Treasury to explore negotiations with other developed countries for its creation.<sup>132</sup> The Senate version, however, provided that the Secretary could decline to enter such negotiations if he should make a finding that to do so would: "(A) result in a material increase in the discount at which sovereign debt is sold, (B) materially increase the probability of default on such debt, or (C) materially enhance the likelihood of debt service failure or disruption."<sup>133</sup> A provision from the Conference bill that became part of the Act requires the Treasury to submit a progress report six months and twelve months from the date the Act became law.<sup>134</sup> The most restrictive part of the Senate bill incorporated into the Conference proposal, and finally the Act itself is a provision that prohibits such a facility from requiring any financial backing from the United States Government.<sup>135</sup>

Another comprehensive approach to the problem was unveiled by American Express Company Chairman and CEO James D. Robinson, III at a speech before the Overseas Development Council.<sup>136</sup> Similar to

130. Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, 102 Stat. 1107 (to be codified in scattered titles and sections of U.S.C.).

131. See generally H.R. CONF. REP. No. 576, 100 Cong. 2d Sess., reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 1547 (paralleling the provisions of the House bill with the Senate Amendments to it).

132. Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 3111(a)(2), 102 Stat. 1107, 1376 (to be codified at 22 U.S.C. § 5331).

133. *Id.* § 3111(a)(2)(A)-(C), at 1376.

134. *Id.* § 3111(c), at 1377-78. In light of the Treasury's opposition to such a facility, it is unlikely that such report will be encouraging.

135. *Id.* § 3112(a), at 1376-77. The Congress, however, can expressly vote to contribute to the IDMA. *Id.*

136. Speech by James D. Robinson, III, Chairman and Chief Executive Officer, American Express Company, *A Comprehensive Agenda for LDC debt and World Trade Growth*, before the Overseas Development Council (Feb. 28, 1988) [hereinafter Robinson Speech]; see also Robinson, "Radical Relief," Wash. Post, Mar. 15, 1988, at



the legislative initiative described above, the proposal, in Robinson's words, would serve as a "comprehensive approach to deal with the major imbalances and present realities."<sup>137</sup> Robinson proposed the creation of a new international agency that would purchase sovereign debt of debtor countries at a negotiated discount,<sup>138</sup> conditioned on adherence to an agreed economic adjustment program. In exchange, Robinson's so-called Institute of International Debt and Development (I2D2) would issue interest-bearing, long-term bonds and participating preferred stock to the banks.<sup>139</sup> The governments of major developed countries would sponsor the Institute, which would constitute a joint venture of the World Bank and the Fund.<sup>140</sup> The sponsoring governments would provide the initial capital of the Institute, either directly by call or through other unspecified arrangements. The World Bank and the IMF must agree to any other arrangements.<sup>141</sup> Robinson expects its obligations to receive the highest credit ratings as a result of the "contingent commitments of the sponsoring country governments," i.e., the major developed countries.<sup>142</sup> The Institute would subordinate debt it purchased to all new debt in the future,<sup>143</sup> as long as the economic adjustment program agreed to with the debtor country remains in place.<sup>144</sup> This would presumably encourage new lending, as any new loans would have a prior claim on debtor country resources over debt that the Institute purchased and owned.

As expected, the proposal came under severe criticism from those who advocate a continuation of the "muddle through" approach existing so far. Secretary Baker has complained that the scheme "puts the solution squarely on the backs of the taxpayers in the creditor countries." Clearly, the proposal would create unknown costs for major developed countries that serve as sponsoring governments. Critics further point out that, (a) banks would be taking losses on their investments, and (b) it is difficult to understand why a debtor country that politically cannot deal with creditor banks or with policies imposed upon it by IMF would find it easier to deal with a behemoth Institute such as the one envisioned by Robinson. On the other hand, as Robinson points out, under the comprehensive approach of the proposal, ev-

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A23 (outlining his proposal for addressing world debt).

137. Robinson Speech, *supra* note 136, at 12.

138. *Id.* at 15, point 5.

139. *Id.* at 15, point 5.

140. *Id.* at 14, point 1.

141. *Id.* at 14, point 3.

142. *Id.* at 15, point 5.

143. *Id.* at 15, point 7.

144. *Id.* at 16, point 8.

everyone shares the burden and everyone reaps the benefits.<sup>145</sup> The participating countries receive debt relief, if they agree to and continue to implement sound economic policies. The banks get high grade paper in exchange for their low grade loans. Lastly, Robinson emphasizes that developed countries contribute to the soundness of the global economy and financial system and the opening of markets that have been closed in recent years.<sup>146</sup>

Like the Baker and Bradley Plans, both the LaFalce/Morrison and Robinson schemes emphasize the need for agreed economic policy reforms in the debtor countries. Whatever the differences among them, there appears to be a broad consensus linking additional lending (Baker) or debt relief (Bradley, LaFalce/Morrison, Robinson) to policy reform within the debtor countries. An interesting variation of this theme has been proposed by Congressman Donald Pease. He would introduce a two-tier concept of conditionality, the first tier being balance of payments targets. Only if these targets were not met for two consecutive years, would more detailed policy conditions enter into discussion. Congressman Pease would locate a proposed debt purchase facility in the IMF rather than the World Bank as proposed by Robinson and LaFalce/Morrison.

Moeen A. Quereshi, Senior Vice President of Operations at the World Bank, expressed skepticism as to the political willingness of the industrialized countries to support a debt facility such as the one recommended by Robinson and Congressional critics of the Baker Plan. Instead, Quereshi outlined a six-point agenda for further development of the international debt strategy: "an emphasis on investment [in debtor countries], explicit medium term financing plans, an expanded role for official lenders in financing new investment, greater differentiation among countries, broadened efforts to reduce debt, and greater regulatory flexibility . . . ."<sup>147</sup>

The Institute of International Finance, spokesman for the major banks engaged in international lending, argued the case against mandatory debt reduction by the major commercial banks, noting that "[m]andatory debt forgiveness deals with the symptoms, not the

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145. *Id.* at 3.

146. *Id.* at 8.

147. Remarks by Moeen A. Quereshi, Sr. Vice President of Operations at the World Bank, *Six Principles for a Revitalized Debt Strategy* 11-19 (prepared for delivery to All Party Parliamentary Group on Overseas Development Conference on "Growing Out of Debt—The European Contribution") (London, Dec. 6, 1988) [hereinafter Quereshi Remarks].

causes."<sup>148</sup>

Other commentators, however, view generalized debt reduction by the commercial banks as desirable and inevitable. Hobart Rowan, economics editor of the *Washington Post* observed:

Slowly but surely, seven long years after the crisis broke out in 1982, the richer world is moving toward the reduction of the huge debt that is hanging over and crippling many nations in the poorer Third World. . . . There is an unspoken acknowledgement that much of the \$250 billion owed by major Latin debtor countries to the commercial banks is never going to be paid off.<sup>149</sup>

In hearings before the House Banking Committee on International Economic Conditions, William Seidman, Chairman of the Federal Deposit Insurance Corporation (FDIC) testified that, "it is the FDIC's conclusion that the LDC debt situation poses no immediate discernible threat to the FDIC. The FDIC fund is affected only if insured banks fail. At this time, although this is a serious problem and may affect bank profits, failures due to LDC debt are not likely."<sup>150</sup> The money

148. THE INST. OF INT'L FIN., *THE WAY FORWARD FOR MIDDLE INCOME COUNTRIES* 19 (Jan. 1989). The Institute continued:

Banks do not believe that mandatory debt forgiveness would be in the interests of the Baker Plan countries. It would be self-defeating since it would choke off the future capital flows from private sources which are absolutely crucial to growth and development in the middle income countries. There is a moral hazard because bad performance would be rewarded. Mandatory debt forgiveness deals with the symptoms, not the causes. It might well result in a relaxation of financial discipline, which could only delay the needed policy changes. And without changes in policy, debtor countries soon will be unable to service any future obligations that they might hope to attract. Thus, no lasting solution can be achieved through debt forgiveness; indeed, debt forgiveness seems likely to ensure that middle-income countries will become the wards of taxpayers in the industrial countries, dependent upon them for foreign aid and competing with the poorest countries for the meager amounts of aid that are available.

*Id.*; see also Quereshi Remarks, *supra* note 147, at 11-19 (discussing the six points in depth).

149. Rowan, *Richer Nations Moving Toward Cutting Debt*, *Wash. Post*, Feb. 12, 1989, at H1.

150. *International Economic Conditions, U.S. Financial System Exposure to LDC Debt Crisis (panel 2): Hearings Before the House Banking Comm.*, 101 Cong., 1st Sess. (1989) (testimony of W. Seidman, Chairman Fed. Deposit Insur. Corp.) reprinted in (NEXIS, Fed. News Serv. at 5). Seidman observed:

With respect to the exposure of U.S. banks to the LDC debt, it is concentrated in the nine money center banks. . . . Since 1982, when this problem gained general attention, the nine money center banks have been successful in building their primary capital to a level which allowed them to withstand any likely events in the LDC areas. In December 1983, these nine banks had aggregate exposure to the 31 LDC countries of \$61 billion. This was an amount nearly twice their aggregate primary capital of \$32 billion. As of June 30, 1988, however, the same nine banks had increased their combined primary capital to \$65 billion. And thus at this point, their LDC debt exposure of roughly \$55 billion total less than 85 percent of their aggregate capital.

center banks, then, were in a position to participate in a debt reduction program without severe detrimental financial consequences to themselves. At the same time, they were in a stronger position to negotiate with the debtor countries than they had been in the early years of the debt crisis. As Alan Riding of the *New York Times* put it, "debtor nations have been outmaneuvered."<sup>151</sup> Henry Kissinger summed up the financial result in stark terms: "Since the end of 1982 Latin America has paid around \$235 billion in interest, but its indebtedness has increased by \$50 billion. Latin America, an underdeveloped region, has become a net exporter of capital."<sup>152</sup>

The tentative nature of the debate surrounding the debt issue is reflected in the regulatory, accounting, and tax thicket. Loans to developing countries can be quite profitable for the banks, creating an incentive for the Banks to stay in the lending game to the debtor countries. The degree of profitability, however, may depend upon the tax status of the individual bank. For example, where a debtor country uses a gross-up method for computing the income tax theoretically withheld on interest income earned by the Bank in the debtor country, the Bank is allowed a foreign tax credit under the United States Internal Revenue Code, although the full amount of the tax may not have been actually paid in the debtor country.<sup>153</sup> But the value of the foreign tax credit depends upon whether the Bank has sufficient foreign source income against which it can use the foreign tax credit earned in the debtor country.<sup>154</sup> For those banks that do not have such foreign source income, interest received on outstanding loans from debtor countries is

*Id.* at 5-6.

151. Riding, *It's the Decade of Unsupportable Debt*, N.Y. Times, Mar. 6, 1988, at 2. He continued:

When the crisis was at its height, they were encouraged to be "responsible". If they kept up interest payments and accepted austerity imposed by the International Monetary Fund, their "cash flow" problems would soon ease and capital markets would reopen to them . . . . So year after year, in the name of rebuilding their credit rating, countries that "imported" capital to grow paid out more in interest than they received in fresh credit. Conversely, while having to accept constant rescheduling of principal payments, commercial banks continued to earn good interest on their loans. By the time this arrangement was challenged last year, big debtors had lost their chance to change the rules, and the informal cartel of banks, Western governments and international financing institutions had seized the initiative.

*Id.*

152. Kissinger, *First a Breakthrough with Mexico*, Wash. Post, Jan. 11, 1989, at A21.

153. See *Int'l Debt*, *supra* note 13, at 21 (statement of Sen. Frank Church) (noting that Brazil is the example most cited for the arithmetical details of how this worked for the private commercial banks).

154. *Id.* at 19-21.

increasingly being used to pay down the loans—and, thus, get out of the business of lending further money to the debtor countries.<sup>155</sup>

The tax status of an individual bank may be a determining factor as to whether it stays in the game. In 1986, however, Congress manifested its belief that the foreign tax credit regime had resulted in significant inequities, even abuses, by the Banks.<sup>156</sup> Congress, therefore, provided for a phase out of the provisions as they had previously existed.<sup>157</sup> It ameliorated the severity of this decision by exempting for a limited time thirty-four of the debtor countries. This allowed the banks to claim foreign tax credits for income taxes paid in those countries, although such credits could only offset foreign source income of the banks.

The situation is further complicated by new capital adequacy rules designed to achieve a common standard for measuring banks' capital adequacy on the basis of the degree of risk assigned to its asset base. The proposal establishes a framework that: (1) makes regulatory capital requirements more sensitive to differences in risk profiles among banking organizations; (2) takes off-balance sheet exposures into explicit account in assessing capital adequacy; and (3) minimizes disincentives to holding liquid, low-risk assets. The critical recommendation of both proposals is to relate capital adequacy to risk-weighted assets held by the Banks. The target proposed is that by 1992 the standard ratio of capital to weighted risk assets should be eight percent. Of that,

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155. See LDC DEBT REDUCTION, *supra* note 98, at 2 (noting “[a]fter six years of involuntary lending and no assurance of eventual repayment at full value, few commercial banks are interested in further increasing their exposure to troubled debtors”); see also REPORT OF THE THIRD WORLD DEBT PANEL OF THE ECONOMIC POLICY COUNCIL OF UNA-USA, THIRD WORLD DEBT: A REEXAMINATION OF LONG-TERM MANAGEMENT 22 (Sept. 7, 1988).

156. See *Int'l Debt*, *supra* note 13, at 19-21. The Senate Report noted:

For example, let us suppose that Citibank's branch in London has shown a profit of \$1 million in 1977; the same year, its branch in the Bahamas has also shown a \$1 million profit. Citibank would have to pay a 52 percent tax or \$520,000 on its London income to the U.K. Treasury; it would have to pay zero tax to the Bahamas government on its Nassau branch earnings because the Bahamas have no corporate income tax. Since Citibank is a U.S. corporation, it would also owe a nominal 48 percent tax on its consolidated foreign earnings, to the U.S. Treasury, i.e., \$960,000 of \$2 million in earnings. However, because of the foreign tax credit, it can offset dollar for dollar all the taxes it paid to the U.K. government, up to 48 percent on its London branch earnings, and credit the remaining four percent, paid to the U.K. Treasury against the U.S. taxes owed on its Bahamas income, on which it had in fact paid no foreign income tax. It thus gets an additional \$40,000 credit against U.S. taxes. The result is that Citicorp in fact owes the U.S. Treasury only \$440,000 on its \$2,000,000 in overseas earnings.

*Id.* at 19.

157. See 26 U.S.C.A. § 904, Historical and Statutory Notes at 423-34 (West 1986).

the core capital elements—equity and retained earnings—should be at least four percent.<sup>158</sup>

Loan loss reserves, however, will no longer be eligible for inclusion as part of a Bank's primary or core capital for purposes of the capital adequacy test. Moreover, the Internal Revenue Service (IRS) will no longer allow Banks to anticipate loan loss reserves as deductions in the year in which they are established, thus reducing net income for that year. The deduction, according to the IRS proposed regulations, would only be taken in the year in which the specific loan is actually written down. On the other hand, the Securities and Exchange Commission allows such anticipated losses to be shown as part of the financial statements of the enterprise.

A similar ambiguity is reflected in the regulatory scheme that governs debt-for-equity swaps. The debt-for-equity swap idea has been around for some time. Prior to 1987, Chile and Mexico were actively sponsoring this scheme. Some additional countries used the idea to originate proposals to swap debt for conservation and ecological commitments and programs. Beginning in mid-1987, however, other countries and banks further developed the debt for equity swap idea and by the beginning of 1988, Brazil (November 1987), Argentina (October 1987) and Venezuela (April 1987) had programs in place.

*Euromoney*, which ran a supplement to its January 1988 issue on "Global Debt: The Equity Solution," correctly pointed out that, "[m]any bankers have pinned their hopes on debt/equity swaps. They are seeking to convert their devalued loans into power plants in Chile, textile mills in Brazil, and car plants in Mexico, in short, building industrial empires from the ruins of their LDC debt portfolios."<sup>159</sup> These expectations are probably unrealistic. Nationalism and public image in the countries must be considered when foreign interests attempt to buy control or partial ownership in important industries or business sectors. Other problems arise with the United States regulatory and accounting regulations.

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158. See Minimum Capital Ratios: Issuance of Directives, 12 C.F.R. pt. 3 (1988) (presenting the risk-based capital guideline); Bank Holding Companies and Change in Bank Control, 12 C.F.R. pt. 225, app. B (1988); see also Capital; Risk-based Capital Guidelines, Department of the Treasury, Office of the Comptroller of the Currency, 12 C.F.R. pt. 3 (Docket No. 88-5); Federal Reserve System, 12 C.F.R. pt. 225, app. B (Regulation Y; Docket No. R-0628); Federal Deposit Insurance Corporation, 12 C.F.R. pt. 235, app. A. A useful summary of these proposals can be found in the International Financial Law Review. Spencer & Murray-Jones, *Capital adequacy: towards a level playing field*, INT'L FIN. L. REV., Mar. 1988, at 19.

159. *Global Debt: The Equity Solution*, EUROMONEY, Jan. 1988, at 3 (Supp).

Regulation K of the Bank Holding Company Act<sup>160</sup> limits bank investments overseas to activities of a banking or financial nature or related incidental activities.<sup>161</sup> Depending on the amount of the investment, an overseas targeted company must have a minimum specified percentage of its assets involved in authorized activities. The Federal Reserve Bank liberalized Regulation K in August 1987 and again in April 1989 to deal specifically with investments made through debt-for-equity conversions in the countries that, since 1980, have restructured their sovereign debt held by foreign creditors.<sup>162</sup> Pursuant to the amended Regulation K, banks are allowed to purchase up to the entire stock of a nonfinancial company in the heavily indebted countries referred to above, if it is purchased from the government: that is, if it forms part of a privatization program, and up to forty percent of the shares of a foreign company if it is part of the private sector.<sup>163</sup>

There are limits to the amount of the investment and to any subsequent lending to the company specified in the Regulation.<sup>164</sup> The disposition period has been expanded to within two years of the date on which the bank is permitted to repatriate the investment in full, but in any event, within fifteen years of the date of acquisition.<sup>165</sup> For previously acquired shares or other ownership interest purchased to prevent a loss upon debts held, the disposition period is a mere two years, although the Federal Reserve Board of Governors can extend the period.<sup>166</sup>

On the accounting side, one problem related to swap asset valuation has been resolved.<sup>167</sup> The "fair value" of the debt and the "fair value" of the acquired equity are both to be considered in calculating the fair value of the swap.<sup>168</sup> A further problem, however, involves the accounting treatment of those loans which are to be traded. To avoid the "contamination" of other loans to the same country, the accountants seek to have the banks divide their loans into investment and trading portfolios.<sup>169</sup> In this way, any concerns that arise on collectibility or marketa-

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160. Regulation K, Bank Holding Company Act of 1956, 53 Fed. Reg. 5358 (1988) (to be codified at 12 C.F.R. § 211).

161. *Id.* § 211.5(a).

162. *Id.* § 211.5(f)(2).

163. *Id.* § 211.5(f)(2)(i), (ii).

164. *Id.* § 211.5(f)(4)(i).

165. *Id.*

166. *Id.* § 211.5(e).

167. See Evans, *Bankers Proceed Cautiously With Debt/Equity Strategy*, EUROMONEY, Jan. 1988, at 5 (Supp.) (noting that banks are now utilizing debt for equity swaps).

168. *Id.*

169. *Id.*

bility of loans held in the trading portfolios for swaps would not affect the high-grade loans held on the investment side, and, thus, leave intact the banks' overall portfolio.

A study on Accounting and Regulatory Policies Affecting Debt Restructuring (the Study) concluded "that [c]urrent regulatory and accounting policies have not prevented banks, that were otherwise inclined to do so, from participating in a wide range of negotiated debt reduction transactions with borrowing countries."<sup>170</sup> The statement, as far as it goes, is true. The more pertinent question, however, is whether the three agencies are facilitating such restructuring as much as they might if a consensus existed in the Executive Branch and the Congress that such a restructuring was desirable.

The issue is perhaps most acutely presented in connection with recognition of loan losses. The Study notes that under Generally Accepted Accounting Principles (GAAP) and regulatory rules, management has the responsibility for estimating likely future losses. "Any estimated probable losses must be recognized by a provision charged against current income to create an allowance (reserve) for those future losses."<sup>171</sup> The Study further notes that "[a]s losses are realized through the sale of a bank's loans at a discount, the exchange of its loans for an equity investment, or other means, they are charged against the loan loss reserve account."<sup>172</sup> If the Bank has adequately estimated these losses through the reserve account, current earnings will not be affected.

The Study observes that "[a]lthough FASB has not issued standards which directly address developing country debt transactions, accounting guidance issued by the AICPA [the American Institute of Certified Public Accountants] makes it clear that losses on such items as swaps, sales, and debt exchanges generally should be charged against the loan loss reserve."<sup>173</sup> If the generalized debt relief scheme were agreed to among the parties, presumably loan loss reserves constructed in the absence of such a scheme would not suffice. The loan loss reserve would have to be replenished by a charge against current income. If the loss, however, were amortized over a number of years, the reserve could be replenished more gradually, thus, reducing the immediate negative im-

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170. OFFICE OF THE COMPTROLLER OF THE CURRENCY, THE BOARD OF GOVERNORS OF THE FED. RESERVE SYSTEM, AND THE FED. DEPOSIT INS. CORP. STUDY ON ACCOUNTING AND REGULATORY POLICIES AFFECTING DEBT RESTRUCTURING I (unpublished manuscript) [hereinafter STUDY ON ACCOUNTING]. The study was prepared pursuant to a Congressional directive.

171. *Id.* at 6.

172. *Id.* at 7.

173. *Id.*



pact on any one year's current income. According to the Study, however, neither GAAP or current regulatory practice permits such amortization.<sup>174</sup>

The regulatory and tax schemes above reflect the absence at present of a completely coherent approach among the different agencies in Washington that have responsibility in the debt area.<sup>175</sup> This ambiguity, in turn, reflects the tensions among sometimes conflicting objectives. On the one hand, the regulators have a responsibility to maintain the solvency of the institutions for which they have oversight responsibility; they desire to avoid congressional criticism that they are not doing an effective job of regulation. As is the case with the foreign tax credit scheme, regulators are also increasingly sensitive to possible

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174. *Rules for Determining the Allocation of Bank Loan Losses Under Section 865 of the Internal Revenue Code as Added by the Tax Reform Act of 1986*, I.R.S. Notice 89-57, 1989-21 I.R.B. 23 (May 22, 1989). Any reduction in principal balances or interest rates on outstanding loans is likely to be accomplished through a buy-back of the debt by the debtor country, an exchange of debt instruments, or through a sufficiently material modification of the existing debt agreement to cause the modification to be treated as an exchange. Consequently, it is probable that voluntary debt reduction will result in losses on the sale or exchange of a debt instrument rather than be treated as losses resulting from bad debt.

The IRS has resolved the question of allocating the source of such losses. The Tax Reform Act of 1986 provided clear guidance for determining the source of gain on the sale or exchange of personal property. Under the Tax Code, the gain is sourced to the seller. Consequently, when a U.S. bank sells a foreign loan for a gain, the governing rule is clear: the gain is to be considered U.S. source income. But the rule found in the Tax Code only addresses the source of gains; it does not address the source of losses, which was left to the Secretary of the Treasury to prescribe by regulation.

A U.S. international bank asked the IRS for guidance on the source of losses arising from the sale or exchange of LDC debt. On Friday, April 28, 1989, the IRS determined that such losses should be allocated between domestic and foreign sources on the basis of the ratio between the tax book value in the loan portfolio between loans generating domestic source income and loans generating foreign source income, an outcome less favorable to the banks than one which would have allowed such losses to fully offset domestic income. *Id.*

There is, however, also an issue as to what constitutes a loss for disclosure purposes. Under the *Financial Accounting Standards No. 15 (FAS 15), Accounting Debtors and Creditors for Troubled Debt Restructuring*, issued by the Financial Accounting Standards Board in June 1977, where a debt instrument is exchanged for another instrument with a lower interest rate and reduced principal, so long as the stream of payments (both interest and principal) exceeds the book balance of the loan, the restructured debt is not considered "troubled" debt and no loss has been incurred. FASB 15 interpretations are likely to be significant in any debt reduction scheme.

175. *Compare UNITED STATES GENERAL ACCOUNTING OFFICE, REPORT TO CONGRESSIONAL REQUESTORS, INTERNATIONAL BANKING, SUPERVISION OF OVERSEAS LENDING IS INADEQUATE* (May 1988) (recommending "stricter reserve requirements to more accurately reflect the high risk of IDC loans . . .") with *STUDY ON ACCOUNTING*, *supra* note 170, at 1 (stating that the three principal bank regulatory authorities sought to demonstrate that "[c]urrent regulatory and accounting policies have not prevented banks, that were otherwise inclined to do so, from participating in a wide range of negotiated debt reduction transactions with borrowing countries.").

abuses in the system.

On the other hand, regulators do not wish to be responsible for imposing disincentives which can be blamed for creating a liquidity crisis by giving the banks an excuse to still further reduce their exposure in the debtor countries. The conflict among these objectives leads to an appearance of incoherence in the regulatory and tax regimes as they impact on the continued willingness of the private banks to maintain and increase their lending to the debtor countries. This appearance of incoherence, however, is symptomatic of a broader lack of consensus in Washington between the Administration and important parts of the Congress as to how best to approach the debt issue.

The tentative approach of the parties to the debt issue is perhaps best illustrated by the experience with the Mexican/Morgan Guaranty swap scheme.<sup>176</sup> Under this proposal, Mexico offered banks an opportunity to swap government loans at a discount for new high-yield bonds whose principal would be backed by a special issue of zero-coupon United States Treasury securities issued only to the Mexican government. The Mexican proposal could have resulted in a significant move toward debt forgiveness because participating banks would forgive the amount of the discount to face value of their loans in tendering them. Only 139 out of more than 500 creditor banks, however, made any offers and only 95 of them proposed discounts acceptable to Mexico. Accordingly, Mexico's debt was reduced by only \$1.1 billion, far below the \$10 billion it had set as a target. Mexico's Director of Public Credit, Angel Gurria, has been quoted as saying that Mexico will continue its efforts to reduce its debts and will probably try "a number of variations on this scheme. . . ."<sup>177</sup>

The Mexican bond issue reflected the frustration of the debtor countries in not being able to capture a part of the discount on their debt in the private secondary market for their own benefit. That market itself might be misleading as a true indicator of the value of that debt, as it is a relatively thin market. On the other hand, absent another indicator, it is the only market signal that presently exists. Although the result of the Mexican bond issue was generally considered to be disap-

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176. See Orme, *Mexico Prepares New Proposals As Debt Bond Offer Disappoints*, J. Com., Mar. 7, 1988, at 7A (analyzing the Morgan Guarantee Trust supported Mexican debt swap). See generally K. Telljohann and R. Buckholz, *The Mexican Bond Exchange Offer: An Analytical Framework*, Salomon Brothers, Inc. (Jan. 1988).

177. Pine, *Pressure to Revamp Third World Debt Strategy Mounting*, L.A. Times, Mar. 11, 1988, IV, at 1; see also, *Mexico's Plan to Reduce Debt is Short of Goal*, Wall St. J., Mar. 4, 1988, at 4 (noting that Mexico's plan to reduce the nation's foreign bank debt has fallen short of expectations).

pointing, in my opinion, it did mark an evolution in official thinking regarding the debt issue. For the first time, the United States Treasury participated in a scheme that had as its explicit purpose a voluntary "forgiveness" by the private banks of a part of the principal amount of the outstanding debt.<sup>178</sup>

Moreover, the Mexican scheme led to a further definition of the "common law" governing the prevailing accounting and regulatory rules. The bank regulators and accountants accepted that exchanging a given amount of existing indebtedness for new issues in a lesser face amount would not contaminate the remainder of the debt retained by the Banks.<sup>179</sup> Hence, the remaining indebtedness would not need to be written down to the level of the discounted debt that had been exchanged. In other words, the regulatory and accounting authorities implicitly accepted that debt forgiveness may actually enhance the value of the outstanding indebtedness.<sup>180</sup>

### REFLECTIONS

In light of the foregoing, what we are witnessing in Washington is a period of experimentation. Ideas are percolating. They are tested, discarded, modified, sent back for retooling, or abandoned altogether. There is as yet no consensus between the Administration and Congress as to how to approach the debt and development issue. With this in mind, let me suggest six items that should be considered in the evolution of any new consensus.

First, the debt crisis is not the result only of mistaken policies in the debtor countries. It represents a shared responsibility among debtor countries, creditor banks, and creditor countries. Each one of the parties in the period 1974-82 had a part in ignoring the clear warning signs of an impending storm. Judgments as to the relative responsibilities of the major parties to the debt crisis—mistaken policies of the debtor countries, short-sighted lending policies of the private banks, the failure of public officials to appreciate the gravity of the problem, and excessive reliance on a market solution to the problem—are therefore inappropriate. No one party should disproportionately bear the burden of the economic adjustments that are the consequence of the recycling strategy of the 1974-82 period.

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178. See SECURITIES AND EXCHANGE COMMISSION, STAFF ACCOUNTING BULLETIN No. 75, 17 C.F.R. PT. 211, at 4-5 (Jan. 4, 1988) (expressing the staff's views regarding certain accounting and disclosure issues relevant to a proposed Mexican Debt Exchange Transaction).

179. *Id.*

180. *Id.*

Second, it became evident in 1974 and thereafter that a group of highly indebted, newly industrializing countries had achieved world class status in the international economy. In 1974, the industrialized countries generally adjusted to the domestic oil price rises of 1973-74 by adopting deflationary economic policies. The continued borrowing and economic expansion of the NICs, however, provided a growing market for industrialized country exports, particularly capital goods, that eased the domestic economic contraction in those industrialized countries. Whether this was a wise policy on the part of the NICs is not here at issue. The significant point is that the economies of the NICs as a group were of such a size that they made a significant difference (by virtue of their continued imports) in mitigating the recessive effects of the economic adjustment effort in the industrialized countries. The NICs cannot be relegated to bystander status on the major decisions as to the future shape of the international economy. They are demanding a significant voice in decision making in the institutions that are at the center of the international economy. This is reflected in the impasse that unfortunately existed for nearly four years in the negotiations concerning the increase in resources for the IDB.

Third, the emergence of the NICs into the international economy as world class players means that they, too, have had to accept limitations on their own economic autonomy. Brazil's unilateral moratorium on debt service payments had to be abandoned in large part because the Sao Paulo industrial entrepreneurs have become such an integral part of the international economy that they cannot afford to be isolated from conventional financial and economic relationships. Unilateral action to limit debt service is therefore perceived as more harmful than useful by a politically powerful part of Brazil's economic leadership. Conversely, as the recent report of the Overseas Development Council observes, it is likely that the United States will find it more difficult to resolve its trade imbalances without renewed sustained economic growth in the NICs, particularly in Latin America.<sup>181</sup> It is in the economic self interest of both the United States and the debtor countries for these countries to resume their role as net importers rather than exporters of capital.

Fourth, a debt strategy that places disproportionate emphasis upon the highly indebted countries running huge trade surpluses with the United States as a means of paying the debt service on outstanding loans is likely to create a political backlash in the United States. To the

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181. See AGENDA 1988, *supra* note 119, at 42. The report states that the "U.S. prosperity is inextricably linked to the achievement of global development." *Id.*

extent that trade surplus is achieved by compressing imports as well as an aggressive export drive to the United States market, the perception in the United States will grow of an unfair trade imbalance that prejudices the interests of American factory workers. That is essentially what happened as a consequence of the strategy that was followed in the period 1982-85.<sup>182</sup>

It may be that, in fact, the exports of the highly indebted countries are, relatively, not that great a factor in the United States trade deficit compared to the trade surpluses of Japan and the European Economic Community. To the extent that the perception exists that the imbalance is unfair, however, it will lead to increased demands within the United States for greater industrial protection and more aggressive measures to open foreign markets to American goods. The devaluation of the dollar as a means of coping with this problem has limits, both as to its feasibility in an open international trading system and, domestically, in the United States in cheapening American domestic assets for foreign purchasers. A debt strategy that relies excessively on trade surpluses earned in the United States market by aggressive debtor country exporting and compressing of imports will be self defeating.

This is not to say that there should be less emphasis upon becoming internationally competitive in exports. On the contrary, this is a *sine qua non* in an increasingly competitive international economy. It is to say that a better balance among exporting, importing, and development finance is essential. My own view is that some element of debt relief must be a part of such a balance. The form and amount of such relief, however, are not as yet within reach of a consensus.

Fifth, it is unlikely that a single development model can be imposed upon the diverse conditions that prevail in the debtor countries. The debtor countries vary considerably in the way they have adjusted to the oil price revolution of the 1970s and the changing economic circumstances of the 1980s. But it is a mistake to believe that what worked in South Korea can be easily transposed to the Latin American context. The social and political conditions are too different and are different even among Latin American countries themselves. Furthermore, there will be differences of emphasis in the countries among competing con-

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182. See *supra* note 120 and accompanying text (discussing the impact of the economic downturn of developing countries on the U.S. economy); see also *Integration of U.S. Policies on Trade, Exchange Rates, and the Accumulated Debts of Less-Developed Countries, Hearings Before the Subcomm. on Int'l Trade of the Senate Comm. on Finance, 99th Cong. 2d Sess., 61 (1986)* (statement of Prof. Jeffrey D. Sachs, Harvard School of Economics, Harvard University) (stating that the trade balances shifted after 1982).

siderations of social equity, economic efficiency, and political systems. The result at times is likely to lead to less than optimum economic efficiency. Economic efficiency, however, is not the only criterion that countries will follow in their decision making. The dilemma in Latin America may be most acute in redefining the role of the state in economic and social development, a central tenet of the Baker Plan. It is true that with the advent of the debt crisis in 1982, the economic model of high economic growth achieved by foreign borrowing, largely by the public sector, became discredited.<sup>183</sup> Moreover, the association in Latin America of such public sector expansion with the military governments of the 1960s and 1970s helped to create an internal climate in a number of countries that was propitious for reducing the scope of the public sector in the economy. There are, however, other factors that militate against too radical an attack on the role of the public sector in the economy. Private enterprises in Sao Paulo, Brazil, and Mendoza, Argentina, for example, may have resented the explosive growth of the state-owned autonomous entities, but these private firms themselves are often undercapitalized. They depend upon the national development banks for credit and, often, upon the public sector for orders, although this dependence may now be diminishing as they become internationally competitive.

The Alliance for Progress of the 1960s, with its emphasis upon social reforms, however modest, encouraged an expansion of the educational system in Latin American countries. In the 1970s, the fruits of this expansion became apparent in the increased cadres of University graduates. In Brazil, for example, between 1970 and 1985, the number of University graduates tripled; graduates found employment in many cases in the state-owned enterprises.<sup>184</sup> In effect, the public sector became a vehicle for social mobility and the path to middle class status

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183. See, e.g., Bartlett, *A Vicious Circle Keeps Latin America in Debt*, N.Y. Times, Jan. 15, 1989, at E5 (noting the debt crisis); Carlos Menem, *A Peronist Who May Rule Like A Pragmatist*, BUS. WEEK, July 3, 1989, at 41 (examining a perceived shift towards economic privatization in Latin America). In Brazil, however, the failure to curb spending by the state enterprises and thereby reduce the Government's fiscal deficit led to the resignation of the Finance Minister, Mr. Luiz Carlos Bresser Pereira. The issues which led to the Minister's resignation are discussed in a particularly perceptive article by the New York Times correspondent in Brazil, Alan Riding. Riding, *States Role Key Issue for Brazil*, N.Y. Times, Dec. 21, 1987, at D8.

184. The high social cost of Brazilian education expenditures were analyzed in a Report by the World Bank Staff. WORLD BANK, BRAZIL, PUBLIC SPENDING ON SOCIAL PROGRAMS: ISSUES AND OPTIONS 39-42 (Vol. I, May 27, 1988). The document is designated for official use only, but its basic points were reported in the Brazilian press; see, e.g., *Journal do Brasil*, July 17, 1988, *Economia*. Governo Fracassa nos Programas Sociais, I caderno, at 21.

for significant numbers of Latin Americans. And it was the middle class that was the backbone for the opposition political parties that turned against the military governments and came to power in the middle 1980s.<sup>186</sup>

President Raul Alfonsin of Argentina observed that the basic principle underlying his government's economic program was the need for Argentina to become economically more efficient:

A key element in our program is our belief that a greater insertion of Argentina in world trade flows is a precondition for sustained growth. In the past, and for some time, the Argentine economy was able to expand under the rules of the game of a semi-autarkic model. However, this kind of development was prolonged beyond a reasonable period. The time has come to settle accounts with the shortsightedness which relegated us to stagnation, while the world witnessed an expansion of markets and the technological revolution.<sup>186</sup>

Alfonsin, in words that would have been unthinkable ten years ago, further stated:

Subsidies and regulations have discouraged innovation and competitiveness. Argentineans have no choice: either we begin a growth process more closely associated with private investment, relying less on state enterprises and the granting of fiscal and credit privileges to the private sector or we will quite simply be perpetuating inflation and stagnation.<sup>187</sup>

This observation, in my opinion, is now generally shared, by and large, in most countries in Latin America. But the pace at which this objective can be accomplished is also limited by past development experience.

Hence, there is a fundamental ambivalence about the role of the public sector in Latin America. Understood in this context, major advances have been achieved in trimming and defining a different role for the public sector in economic growth. External pressure, however, that seeks to force the pace beyond the tolerance of domestic political possibilities, could engender a dangerous political backlash in debtor countries.

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185. See, e.g., CRASSWEILLER, JUAN D. PERON AND THE ENIGMAS OF ARGENTINA 55-79 (1988) (analyzing the social roots of Peronism and the contrasting Radical party). In Argentina, the Radical Party of President Raul Alfonsin is generally considered to have its political base in the Argentine middle class, in contrast to the leading opposition party, the Peronistas, which is based upon the Argentine working class. *Id.* In Brazil, the majority party, the Movimento Democratic Brasileiro (MDB) is a more amorphous conglomeration of forces, but basically it has been urban middle class in origin and is being challenged by a political party, the Partido Trabalhista (PT), which arose out of the organized wage sector in Sao Paulo.

186. Remarks by President of the Argentine Republic Raul Alfonsin, Americas Society, New York (May 31, 1988).

187. *Id.*

Finally, any economic adjustment program which is to be sustainable must, in my opinion, deal with the social question. That question, as Hannah Arendt, the noted political scientist has observed in her classic work, *On Revolution*, is "what we may better and more simply call the existence of poverty. Poverty is more than deprivation, it is a state of constant want and acute misery whose ignominy consists in its dehumanizing force."<sup>188</sup> The return to democratic forms of government in much of the Southern Hemisphere is subject to the tensions that derive from this condition for great numbers of people in the debtor countries. As Arendt noted, "the transformation of the Rights of Man into the rights of Sans-Culottes was the turning point not only of the French Revolution but of all revolutions that were to follow."<sup>189</sup> No elected government can ignore the social question, given the abysmal conditions of life that exist among too much of the population in many of the highly indebted countries. Hence, an economic adjustment program that ignores this question is not likely, over time, to be politically and socially sustainable, a fact that is increasingly recognized in the international financial agencies.

On March 10, 1989, Secretary of Treasury, Nicholas F. Brady in a speech to a conference on Third World Debt sponsored by the Bretton Woods Committee and the Brookings Institution explicitly endorsed debt reduction as a necessary part of American Strategy: "The path towards greater credit worthiness and a return to the markets for many debtor countries needs to involve debt reduction." This general declaration by the Secretary was not accompanied by a detailed plan as to how debt reduction should be accomplished. Rather, like the Baker speech in Seoul in October 1985, the Brady speech appeared to be a response to pressures building in Latin America for a change in the then prevailing debt strategy. In 1985, the election of Alan Garcia as President in Peru and his declaration that Peru would henceforth limit its debt service payments to a percentage of exports stimulated the change in policy embodied in Baker's speech towards economic growth rather than austerity. In February 1989, a newly elected President in Venezuela, Carlos Andres Perez, implemented economic austerity measures as part of an agreed program with the IMF. Gasoline and transportation fares were increased while subsidies were reduced. Riots in Caracas ensued; more than 200 people died. The Brady initiative endorsing debt relief was widely perceived as being, in part, a response to the social unrest evidence in the Caracas riots. The Brady speech envisioned a role in

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188. H. ARENDT, *ON REVOLUTION* 54 (1963).

189. *Id.* at 55.



debt reduction for the IMF and the World Bank, but the details were not agreed among the creditor governments, the private commercial banks, and the debtor countries.