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THE PROMISES AND PITFALLS OF BAKER'S THIRD WORLD DEBT PLAN

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INTRODUCTION

At the October 1985 meeting of the World Bank and the International Monetary Fund in Seoul, U.S. Treasury Secretary James A. Baker, III unveiled a plan for dealing with the continuing Third World debt problem. His plan involves an additional $20 billion loan to the Third World countries by private banks and increased lending by multilateral development banks (MDBs) as well, in return for the recipients' adoption of market-oriented economic policies. Baker's proposals for Third World governments include:

- o Increased reliance on the private sector, and less reliance on government, to increase employment, production, and efficiency.

- o Supply-side actions to mobilize domestic savings and facilitate efficient domestic and foreign investment by means of tax reform, labor market reform, and development of financial markets.

- o Market-opening measures, including the reduction of export subsidies, to encourage foreign direct investment and capital inflows, as well as to liberalize trade.[1]

The theory is that, if Third World nations were to dismantle state enterprises, abandon regulatory interference with the market, cut taxes and government spending, and in general, establish free markets, growth and exports would be stimulated, generating the cash to repay not only the new loans but the old ones as well.

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1. "Statement of the Honorable James A. Baker, III, Secretary of the Treasury of the United States, before the Joint Annual Meeting of the International Monetary Fund and the World Bank, October 8, 1985, Seoul, Korea," Treasury News, October 8, 1985, p. 5.

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In theory this is a good plan. Initiatives providing long-term solutions to the debt problem are badly needed. Third World nations, moreover, must do something to increase the growth that will not ensue from the interventionist policies that have characterized their economic policies for more than a generation. They must adopt free market policies and cut back government interference with the economy. Offering Third World nations the "carrot" of additional aid in return for adopting better economic policies makes sense.

PITFALLS OF THE BAKER PLAN

The trouble with the Baker Initiative is that there has been insufficient consideration at the Treasury Department of how to execute this strategy and how to avoid its potential pitfalls. Indeed, it appears that Treasury officials strongly resisted promoting market-oriented policies in the Third World. Treasury apparently relented only when Republicans on the House Appropriations Committee threatened to block MDB contributions unless U.S. representatives to these institutions were instructed to demand more market-oriented policies. Only after Congressman David Obey (D-WI), chairman of the House Appropriations Subcommittee on Foreign Operations, refused to support the Administration's budget requests for the MDBs without the backing of House Republicans did Treasury instruct its representatives at the IMF and the World Bank to insist that new aid be dependent on the adoption of free market policies by recipient countries.

Treasury Assistant Secretary David Mulford outlined the following objectives in an April 1985 memorandum to the U.S. executive directors of the World Bank and International Monetary Fund:

1) Use tax policies to encourage savings and investment in support of growth and economic stability. Such policies could encompass overall reductions in income taxes, reductions in marginal tax rates, adjustment of tax systems in light of inflation, the impact of taxation on the misallocation of resources, changes in the structure of commodity or excise taxes, and changes in tax expenditures (deductions or credits).

2) Liberalize foreign trade to facilitate exports and to remove import restrictions. These measures could include reduction or elimination of export taxes, development of nontraditional exports, creation of free trade zones, and deregulation of foreign exchange controls to encourage productive activity in which the country has a clear comparative advantage.

3) Promote pricing policies reflecting market forces to foster efficient allocation of resources. Such steps could include decontrol

of agriculture prices, termination of price controls on industrial products, and lifting ceilings on interest rates.

4) Facilitate appropriate foreign investment. This could include simplification and liberalization of laws regarding foreign investment, active promotion of joint venture activities, and extending the same treatment to foreign investors.

5) Support private sector-oriented growth, encourage privatization, and discourage, where appropriate, direct government activity in the economy.

The strategy outlined in Mulford's memorandum is welcome, but long overdue. Yet Treasury must take care that it does not make the Third World debt situation worse than it now is. There is a danger, for instance, that new loans by private banks to Third World countries will simply expose banks further to the dangers of default. The new private bank loans, moreover, if made in response to Secretary Baker's initiative, might carry an implicit U.S. government guarantee. Although such a guarantee would not exist legally, it might well exist in a political sense, requiring a U.S. bailout in the event of default.

And there is also the danger, of course, of Third World countries botching their market-oriented strategy. Prodding a nation to reverse decades-old extensive government interference in its economy is by no means easy. Special interests strongly will resist the loss of jobs, income, and privileges. True liberalization and decentralization of economic power threaten a ruling elite far more than do IMF "austerity" measures, which may lead to greater centralization.

POLITICAL OBSTACLES

It may, indeed, be politically impossible for Third World countries to do all that needs to be done. Third World countries, moreover, historically have resisted advice from Western nations and development institutions, dismissing it as paternalism smacking of neocolonialism. And of course, many Third World countries lack government administrators and a business class familiar with the operation of a free market. Mistakes, therefore, inevitably will be made even by the most well-intentioned Third World leaders, thus endangering the success of the overall plan.

The lack of capital in the Third World will be a problem even with the Baker initiative's additional $20 billion. Even if this were not a problem, many Third World states are not capable of absorbing large amounts of capital and using it efficiently. The financial and other institutions necessary to allocate capital efficiently, on projects of genuine economic value, simply do not exist. Thus past

loans have tended to be made through the government. This has caused an enormous waste of resources, as funds have been channeled into projects favored by political interests rather than economic considerations. It also has tended to increase the concentration of government power, which in turn discourages the development of market institutions. If future loans continue to go directly to central governments, foreign direct investment will be discouraged and scarce resources wasted with little benefit to developing nations.[2]

A PERMANENT SOLUTION

Despite these possible pitfalls, the Baker Initiative could offer some hope of unraveling the problems posed by the huge Third World debt. To do so, however, the Treasury must be committed firmly to free market expansion in the Third World and insist on compliance with its conditions.

So far, the Treasury has been unwilling to use its leverage to force the World Bank and other MDBs to insist on a free market strategy. It now has an excellent opportunity to do so, for the U.S. is negotiating a general capital increase for the World Bank and other MDBs. In this, Washington should be pushing the types of measures outlined in a June 28, 1985, letter to Secretary Baker from Congressmen Jack Kemp (R-NY), Mickey Edwards (R-OK), Jerry Lewis (R-CA), and John Porter (R-IL). These include:

1) Reform of concessional lending. Maturities on MDB loans need to be cut to 25 years (from over 50 years, in some cases, now) and interest charges raised to 6 percent, from rates as low as 0.5 percent. "Soft" loans should be gradually phased out and countries forced to borrow on more stringent terms.

2) Increased private sector emphasis. MDB loans need to be directed toward the private sector and away from the public sector.

3) Economic conditionality. MDB lending should be targeted toward those countries that have made free market, pro-growth policy reforms.

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2. There is considerable evidence that many of the loans made in the past did little more than provide the foreign exchange for wealthy elites to get their wealth out of the country. For example, the World Bank estimates that more than 65 percent of Argentina's gross capital inflows from 1979 to 1982 simply financed capital flight. See World Development Report 1985 (New York: Oxford University Press, for World Bank, 1985), p. 64.

In the past, the Treasury has presented the Congress with requests for general capital increases for the MDBs as faits accomplis, saying that the U.S. is obligated to appropriate such funds because they are the product of international negotiations. This year, for the first time, congressional leaders have made their demands prior to the start of negotiations and threatened to block MDB appropriations unless reforms are made. Therefore, there is no excuse for the Administration to fail to make part of its negotiating strategy the reforms outlined in the June 28 letter.

ROLE OF THE PRIVATE BANKS

U.S. banks know that they have made many bad loans to Third World countries, which ultimately will not be repaid, threatening not merely their profits but their very solvency. They understandably thus encourage foreign aid from Western nations and MDBs, which would provide Third World nations with the capital and foreign exchange to continue making loan repayments and prevent the day when these loans must be written off. Predictably, these banks may see the Baker proposal as another opportunity to relieve themselves of their liabilities.

If their goal were to unload their foreign debts, why, then, would they even consider lending another $20 billion as Secretary Baker advocates? There appear to be three reasons. The first is the hope that the federal government would implicitly guarantee such loans. Second is a desire to expand the number of banks with Third World exposure to increase the political pressure for an ultimate bailout. And lastly there is an understanding that there will be a major capital increase for the World Bank over the next few years--perhaps as much as $80 billion, of which the U.S. would kick in $20 billion. In effect, this increased capital could be used to repay private bank loans. Indeed, there is even evidence that important government officials, such as Federal Reserve chairman Paul Volcker, endorse this strategy, feeling that a shift of Third World default risk from private banks to MDBs is necessary and desirable.[3]

WRITE-DOWN BAD LOANS

As such, a successful Baker Initiative must devise a mechanism allowing the U.S. banks to write down their bad loans. This cannot be

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3. Volcker hinted at this during testimony before the Subcommittee on International Development Institutions and Finance of the House Committee on Banking, Finance and Urban Affairs on July 30, 1985.

done all at once because it would literally wipe out--on paper anyway--the capital reserves of many large banks, plunging them into technical insolvency and bankruptcy. At that point, their deposits would all become government liabilities through the Federal Deposit Insurance Corporation. Such a policy, therefore, would make no sense.

A better solution would be the development of a secondary market for Third World loans, which would allow the banks to recover some of their principal. This would assume a willingness on the part of debtor countries to trade equity in their productive assets for loan forgiveness. For example, many Third World governments own business enterprises or shares in such enterprises that could be applied to outstanding debts. The benefit to debtor countries would be settlement of their debts on better terms--say 50 cents on the dollar. It would, in short, operate much like an ordinary bankruptcy proceeding, where debtors are relieved of their debts in return for liquidation of their assets.[4]

Barriers to this could be U.S. government regulations, such as the Glass-Steagall Act, which prevents banks from owning equity, and accounting conventions, which may force banks into technical insolvency, even though their actual financial position may be improving, by removing from their books loans that never would be repaid. Bank stock prices probably already incorporate the knowledge that many Third World loans will have to be written off eventually and discount future earnings accordingly. Indeed, to the extent that banks are able to settle on such loans at more than the market currently thinks possible, the result would be an increase in bank stock prices.

CONCLUSION

The problems can be overcome, however, by a Reagan Administration commitment to deal with the Third World debt problem permanently. This would entail removing the governmental barriers to growth in Third World countries and instituting procedures for an orderly write-down of bad loans, rather than putting off the problem with more loans and running the risk of an ultimate bailout of the private

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4. See Allan H. Meltzer, "A Way to Defuse the World Debt Bomb," Fortune, November 28, 1983, pp. 137-139; Carol Loomis, "Why Baker's Debt Plan Won't Work," Fortune, December 23, 1985, pp. 98-102; Robert E. Weintraub, International Debt: Crisis and Challenge (Fairfax, Virginia: Department of Economics, George Mason University, April 1983); idem, International Lending by U.S. Banks: Practices, Problems, and Policies (Fairfax, Virginia: Department of Economics, George Mason University, August 1983); and James Barth and Joseph Peltzman, International Debt: Conflict and Resolution (Fairfax, Virginia, Department of Economics, George Mason University, January 1984).

banks. Unfortunately, despite the initiative proposed by Baker, his Treasury Department seems inadequate to the task, while the State Department appears oblivious.[5]

This makes the appointment of the new World Bank president, when A. W. Clausen steps down next year, extremely important. A strong, knowledgeable World Bank president could provide the leadership to deal with the debt problem permanently. President Reagan is scheduled to make a decision on this important appointment shortly after the first of the year. Two candidates with superb qualifications are former Treasury Secretary William Simon and European Community Ambassador J. William Middendorf.

The Administration is to be commended for recognizing the seriousness of the Third World debt problem and offering a substantive proposal for dealing with it that relies on free markets and economic growth, rather than bailouts. However, there seems to be too little emphasis on important details and an apparent overemphasis on the interests of the MDBs and the private banks, with the danger that this proposal could become a bailout, or at least be ineffective. The long-term solution ultimately requires an orderly write-down of bad loans. A strong World Bank president like Simon or Middendorf could lead the way to a permanent, lasting solution to this serious problem.

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5. As evidence of this, the State Department seems wholly unaware of the extent to which the Treasury Department, working with Congressman David Obey, chairman of the House Appropriations Subcommittee on Foreign Operations, has gutted appropriations for security assistance just to save appropriations to the MDBs. Treasury seems to view this as "protecting its turf" without realizing how seriously the U.S. security assistance program is being undermined. This situation will be even worse if, as it appears, MDB funding will, in effect, be exempt from the provisions of Gramm-Rudman, thus requiring all mandated cuts in foreign assistance to come out of bilateral aid.