1375

S. Hrg. 99-647

MANAGING THE DEBT PROBLEM

HEARING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC GOALS AND INTERGOVERNMENTAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-NINTH CONGRESS

SECOND SESSION

JANUARY 23, 1986

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

60-668 O WASHINGTON : 1986

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

JOINT ECONOMIC COMMITTEE

[Created pursuant to sec. 5(a) of Public Law 304, 79th Congress]

HOUSE OF REPRESENTATIVES

DAVID R. OBEY, Wisconsin, *Chairman*
LEE H. HAMILTON, Indiana
PARREN J. MITCHELL, Maryland
AUGUSTUS F. HAWKINS, California
JAMES H. SCHEUER, New York
FORTNEY H. (PETE) STARK, California
CHALMERS P. WYLIE, Ohio
DANIEL E. LUNGREN, California
OLYMPIA J. SNOWE, Maine
BOBBI FIEDLER, California

SENATE

JAMES ABDNOR, South Dakota, *Vice Chairman*
WILLIAM V. ROTH, JR., Delaware
STEVEN D. SYMMS, Idaho
MACK MATTINGLY, Georgia
ALFONSE M. D'AMATO, New York
PETE WILSON, California
LLOYD BENTSEN, Texas
WILLIAM PROXMIRE, Wisconsin
EDWARD M. KENNEDY, Massachusetts
PAUL S. SARBANES, Maryland

SCOTT LILLY, *Executive Director*
ROBERT J. TOSTERUD, *Deputy Director*

SUBCOMMITTEE ON ECONOMIC GOALS AND INTERGOVERNMENTAL POLICY

HOUSE OF REPRESENTATIVES

LEE H. HAMILTON, Indiana, *Chairman*
AUGUSTUS F. HAWKINS, California
OLYMPIA J. SNOWE, Maine

SENATE

LLOYD BENTSEN, Texas, *Vice Chairman*
ALFONSE M. D'AMATO, New York
PETE WILSON, California

CONTENTS

WITNESSES AND STATEMENTS

THURSDAY, JANUARY 23, 1986

SUBMISSIONS FOR THE RECORD

THURSDAY, JANUARY 23, 1986

MANAGING THE DEBT PROBLEM

THURSDAY, JANUARY 23, 1986

CONGRESS OF THE UNITED STATES, SUBCOMMITTEE ON ECONOMIC GOALS AND INTERGOVERNMENTAL POLICY OF THE JOINT ECONOMIC COMMITTEE,

Washington, DC.

The subcommittee met, pursuant to notice, at 10:03 a.m., in room 2212, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the subcommittee) presiding.

Present: Representatives Hamilton, Scheuer, and Snowe; and Senator D'Amato.

Also present: Sandy Masur, John Starrels, and Don Terry, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The meeting of the subcommittee will come to order.

Today, the Subcommittee on Economic Goals and Intergovernmental Policy of the Joint Economic Committee will examine the implementation of the administration's international debt initiative unveiled by Secretary Baker last October in Seoul.

The international debt problem continues to be a major source of uncertainty and instability for the global economy and international financial system. The U.S. economic recovery masked for a time the fact that this problem is far from solved.

Now with growth substantially reduced in this country, it has become clear that new strategies are needed to help these countries resume adequate growth, while maintaining international financial stability.

The initiatives announced by Secretary Baker in Seoul last October constitute an important departure in policy for the administration in terms of managing the debt problem.

I'd like today to examine the progress toward implementation of this new strategy, as well as to assess its adequacy.

Our two witnesses are David C. Mulford, Assistant Secretary of the Treasury for International Affairs, and Stanley Fischer, professor of economics at MIT.

Gentlemen, both of you have prepared statements. Those prepared statements will be entered into the record in full. I'd appreciate it very much if you would summarize your prepared statements fairly briefly so we can get to questions promptly.

Mr. Mulford, would you begin, please?

STATEMENT OF DAVID C. MULFORD, ASSISTANT SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS

Mr. MULFORD. Thank you, Mr. Chairman.

It's a pleasure to be here this morning to discuss with you the U.S. proposals for improving the international debt situation.

I'd like to begin by pointing out that last fall, there were two important initiatives taken that were related. One was the group of five initiatives of September 22, which, as you know, is designed to improve the international economic situation in general, and to provide a strong foundation for renewed growth in the developing world.

At about the same time, Secretary Baker announced his program for sustained growth for the debtor nations in Seoul, Korea, at the World Bank meeting. This plan was aimed at attempting to reverse some of the adverse aspects which had developed in the international debt situation over the previous year, of which there were several. One was the decline in net new lending by the banks, which, over the past 12 months, had fallen from a reasonable level in the previous years to nearly a zero level. Also, substantial capital flight problems and some fatigue among the debtor nations in their adjustment efforts.

There was also a politization of the issue which we felt needed to be addressed. Secretary Baker responded to these problems by proposing a three-point program which builds on the current case-by-case debt strategy and involves mutually reinforcing actions by the debtor nations, the international financial institutions, and the commercial banks, to improve the debtors' prospects for growth.

First and foremost, it is essential that the debtor nations adopt comprehensive macroeconomic and structural policies to promote growth and balance of payments adjustments, and to reduce inflation. Such programs should include increased reliance on the private sector, more supply-side actions to mobilize domestic savings and foster efficient investment, and greater emphasis on market-opening measures to encourage foreign direct and portfolio investment, capital inflows, and trade.

Second, our proposal recognizes that the International Monetary Fund has played a central role in the implementation of the international debt strategy and emphasizes that this role should continue.

At the same time, it is important for the World Bank and other multilateral development banks to play a stronger role to supplement that of the IMF.

In particular, we have called for increased and more effective structural and sectoral adjustment lending by the MDB's. We envisage a 50-percent increase over current World Bank and Inter-American Development Bank disbursements to the principal debtor nations to $9 billion annually for 1986 through 1988, or a total of $27 billion for the full period.

This would be equivalent to an increase of 20 percent a year in overall exposure after scheduled repayments, or $20 billion in net new lending over the 3 years.

Third, we estimate a need for $20 billion in net new lending by the commercial banks in support of growth-oriented policies by the debtor nations over the next 3 years. This is equivalent to a 2½- to 3-percent annual increase in current bank exposure.

If each of the participants does its part and the demand for quality lending by the World Bank increases, we indicated that we would also be prepared to look seriously at the timing and scope of a general capital increase for the World Bank.

Implementation of the debt strategy will be a long and complex process. It will not involve a single event marking the beginning of operations. Indeed, the process is already well underway. Nor does the U.S. debt initiative provide a rigid plan or blueprint for action which can be applied in full to each of the principal debtor nations.

Implementation will be on a case-by-case basis with the initiative providing a framework for cooperative action to support the debtor nations' own efforts to improve their growth prospects. This will depend upon the individual situation in each debtor country and each country's decision to implement the additional growth-oriented measures which are needed to supplement adjustment efforts already underway.

It is, therefore, inappropriate to look for test cases of adherence to the Baker plan as an example of what we would expect all of the debtor countries to undertake. No single model will fit the diverse situations of these countries. Some are already performing well. Others have undertaken some adjustment measures, but have made only limited progress overall, or have recently experienced major setbacks. Still, other countries are just beginning to make the necessary reforms.

Within these three broad categories, it is clear that a few countries will need to draw on all of the elements of the new initiative. I would include Argentina and Mexico in this group. Mexico is now in the process of negotiating a new program with the support of the IMF, while Argentina continues to work closely with the IMF under its existing program.

In both cases, we believe it is important that structural measures be given increased attention in the context of IMF programs. These countries will also be developing structural policy measures in the context of sector loans with the World Bank. Both will also need major commercial bank financing packages in 1986. Completion of these complex negotiations will take a while and should not be expected overnight.

This is particularly the case for those countries that need to use all of the elements involved in the initiative. These negotiations will have to sort out the relationship between the IMF and World Bank programs.

Representative HAMILTON. Mr. Mulford, I've just been informed that you have to leave at 11. I didn't know that until just moments ago. I'd like to request that you just submit your prepared statement for the record so that we may turn immediately to questions to you prior to your departure. The Chair will begin with a few questions. Then we'll turn after you leave to Mr. Fischer and take his testimony and questions for him at a subsequent time.

First, let me ask you about the impact of the oil price change, particularly with regard to Mexico.

What is your analysis of the impact of the drop in oil prices on the Mexican capability to repay its debt?

Mr. MULFORD. May I say, sir, that I think there's been some confusion. I'm not aware of the fact that I need to leave at 11 and, therefore [laughter], I don't wish to put you under any pressure, as you, indeed, are now putting me under. I'd be happy to complete my statement and answer questions for as long as it takes this morning.

Representative HAMILTON. Well, may I ask, did a member of your staff inform Sandy here——

Mr. MULFORD. Well, there must have been some confusion, but I'm not aware of any need to leave at 11. But I'm happy to answer your question on Mexico and to forgo the reading of the testimony, if you wish.

The testimony was designed, however, to try to preanswer a number of questions you might have. But I'd be happy to deal with the question you just asked, if that's how you——

Representative HAMILTON. Well, I don't want to interrupt your testimony, Mr. Mulford. I think your staff informed us that you had to leave at 11. Your staff is nodding affirmatively to that effect. Ordinarily, I don't like to interrupt a witness' testimony, but if that had been the case, then we only had 45 minutes to go.

So please continue with your statement and then I'll pick up with my question immediately, and try to finish your statement in a reasonably short time.

Mr. MULFORD. Third, we estimate a need for $20 billion in net new lending by the commercial banks in support of growth-oriented policies by the debtor nations over the next 3 years. This is equivalent to 2½- to 3-percent annual increase in current bank exposure.

If each of the participants does its part and the demand for quality lending by the World Bank increases, we indicated that we would also be prepared to look seriously at the timing and scope of a general capital increase for the World Bank.

I think I already said that the implementation of the debt strategy would be a long process and that it would depend upon each group doing their part. I think I also already read that the Baker plan, as it's now being called around Latin America, is not a detailed plan or blueprint, each aspect of which must be met by each debtor country, but, instead, it is a framework for cooperative action in mutually reinforcing areas.

I also indicated that we do not believe that it is appropriate to look for test cases or for events that mark the beginning, because that strategy is already being implemented and there are already some results and there will be more showing over the next few months.

I do want to point out that there are different groupings of debtor countries, Mexico and Argentina, for example, which I think will need the full treatment because they need new bank money in 1986. They have an IMF program to negotiate or to renegotiate. They need to enhance their relationship with the MDB's.

Other countries, some smaller countries, such as Equador, Colombia, Uruguay, Ivory Coast, for example, do not need to take advantage of all elements of the debt strategy at this time because they already have IMF programs. They have recently completed bank packages and reschedulings and they are primarily engaged at this time in enhancing their borrowing relationships with the World Bank.

Equador, in particular, has been very successful in implementing policy changes that have produced already improved results in Equador. They have an IMF program. They plan to have another one when that one expires in March of this year. They have conducted a bank renegotiation and borrowed new money from the banks during the course of last year. They presently are improving their World Bank relationship. They signed a new loan about a week ago and they have another major loan under discussion.

So in Equador's case, one could say the results are very good so far and that they have in many ways already implemented substantial parts of the plan as called for under Secretary Baker's initiatives.

Brazil faces yet a different situation. It is currently enjoying high growth and a strong external position. It will, however, take time to place other measures in place in Brazil to improve their long-term inflation prospects. For the time being Brazil has indicated that it sees no need to negotiate the formal IMF program.

This poses problems for any rescheduling of official credits within the Paris Club, which requires adherence to an IMF stand-by program.

While this issue is being sorted out, any additional voluntary financing by the commercial banks will depend upon their assessment of Brazil's overall creditworthiness based in part on the soundness of its own economic program.

Finally, Peru has chosen quite a different route for the time being, unilaterally imposing a limit on its debt service payments as a percentage share of its total export earnings. Unless Peru adopts a more constructive approach, its unilateral actions will be counterproductive.

More recently, Nigeria has charted a similar course. The end result in each case, unless a more constructive approach is adopted, is likely to be a reduction in their access to badly needed external finance in the period ahead.

I mention these examples to demonstrate the wide divergence of economic situations and attitudes among the debtor nations. Most are already participating in the cooperative approach we have outlined and the question is now how effective they will be in exploiting these opportunities and adjusting their economies.

For these countries, it isn't a matter of formally embracing the Baker plan in order for it to be implemented, but of undertaking the necessary domestic reforms to unlock the maximum potential of their economies.

The response to our proposal by the international financial institutions and commercial banking community has been very positive and encouraging. We have received broad statements of support from the managing director of the International Monetary Fund, the President of the World Bank, the President of the Inter-American Development Bank.

U.S. banks, accounting for 95 percent of U.S. commercial bank exposure in the principal debtor countries, have pledged their support, as have national banking groups and key individual banks in all the major creditor countries. The question, therefore, is what happens next?

To fulfill their part in this cooperative strategy, it will be important for the international financial institutions to enact reforms in their own procedures to increase the emphasis on structural adjustment measures and to phase disbursement under agreed programs so that they can monitor performance in the debtor countries to assure that the changes are being implemented.

We expect to see a growing stream of policy-based structural and sectoral adjustment loans from the World Bank and a strengthened emphasis on privatization, open markets, and increased savings and investment.

The development of capital and equity markets in developing countries which the World Bank, IFC, and the Inter-American Development Bank are already discussing with the banking community will be important, as will the potential for debt equity swaps as part of the privatization process.

Public enterprises have been a major drain on public finances and a significant contributor to the budget deficits in recent years. It is important to reverse this drain on national resources and to facilitate a strong and growing private sector as one element of the necessary structural reforms.

Stronger and more open domestic financial markets, tax reform, and improvement of the environment for investment can also enhance domestic savings and investment as a stimulus to growth.

Trade liberalization and the rationalization of import regimes would also benefit both the export sector and the economy as a whole.

As a practical matter, it is unrealistic to call upon the support of voluntary lending from abroad, whether public or private, when domestic funds are moving in the other direction. Capital flight must be reversed if there is to be any real prospect of additional funding, whether debt or equity.

These are the kinds of reforms that the World Bank and the IMF need to encourage within their lending programs. We will also be working closely with the IDB to encourage necessary procedural and policy reforms to support the U.S. initiative.

Finally, the commercial banking community will need to devise its own mechanisms for implementing its commitment to increased net lending in support of growth-oriented economic programs in the debtor nations. A number of ideas are now under discussion. For our part, however, we have no intention of providing government guarantees for this purpose. We firmly believe that this approach provides a means for improving the quality of outstanding commercial bank loans and is, therefore, strongly in the banks' own interests in those countries that are undertaking sound, growth-oriented adjustment.

Are the amounts that we have proposed for the MDB and commercial bank lending sufficient for those willing to adopt the necessary domestic reforms in light of the recent deterioration in the Mexican situation?

We believe so. Recent global economic developments have not significantly changed the assumptions upon which our estimate for the 15 major debtors were based. These included an average OECD growth rate of approximately 3 percent and the attainment of a 5-percent growth rate during this period for the participating debtor nations.

Interest rates, in fact, have declined, reducing annual debt service requirements for these countries by as much as $7 billion since the beginning of 1985. Declining oil prices, on the other hand, have somewhat improved the financial picture of some of the countries, while worsening it for others.

On balance, the overall situation has improved since last summer.

Looking ahead, a significant decline in oil prices would clearly be beneficial for the developing countries as a whole. However, a precipitous decline would cause obvious adjustment difficulties to those countries dependent on oil exports.

We will need to follow this situation very closely. The program for sustained growth is flexible and adaptable, designed to deal with distributional problems of this kind. However, it is clear already that countries such as Mexico and Nigeria will face increased financing requirements in the near future.

While our proposal includes substantial sums of new money to assist the debtor nations in making the transition to sustained growth, no amount of financing will be adequate unless these countries implement the economic measures which are essential to establish the foundation for growth.

Inflation, which robs economies of the real benefits of growth, must be brought under control. Steps must be taken to help mobilize domestic savings and investment, to reduce the burden of government expenditures, to enhance competitiveness and efficiency, and to tap the potential benefits of foreign investment and trade.

These alone can provide the strong domestic economic foundation essential for improved growth.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Mulford follows:]

PREPARED STATEMENT OF DAVID C. MULFORD

Mr. Chairman, Members of the Subcommittee:

I welcome this opportunity to discuss U.S. proposals for improving the international debt situation. Last fall, as you know, the United States undertook two major initiatives. The first led to the announcement on September 22 by the Group of Five industrial nations of a number of key macroeconomic policy measures designed to improve the prospects for sustained growth in the industrial nations, and hence to provide a stronger foundation for renewed growth in the developing world, as well.

The second initiative was the U.S. proposal for a "Program for Sustained Growth" for the debtor nations, which Secretary Baker outlined in October during the annual meetings of the IMF and the World Bank. Although the debtor nations have made major strides since 1982 in reducing their external imbalances, we were convinced that more still needs to be done to address domestic imbalances, to reverse capital flight, and to establish the essential domestic underpinnings for stronger growth. The sharp decline in net new lending by the commercial banks since 1982 also needed to be addressed, and a positive response developed to the heightened rhetoric and politicization of the debt issue by a number of debtor countries.

To respond to these problems, Secretary Baker proposed a three-point program which builds on the current case-by-case debt strategy and involves mutually reinforcing actions by the debtor nations, the international financial institutions and the commercial banks to improve the debtors' prospects for growth.

First and foremost, it is essential that the debtor nations adopt comprehensive macroeconomic and structural policies to promote growth and balance of payments adjustment, and to reduce inflation. Such programs should include:

-- increased reliance on the private sector;

-- more supply-side actions to mobilize domestic savings and foster efficient investment; and

-- greater emphasis on market-opening measures to encourage foreign direct and portfolio investment, capital inflows, and trade.

Second, our proposal recognizes that the International Monetary Fund has played a central role in the implementation of the international debt strategy and emphasizes that this should continue. At the same time, it is also important for the World Bank and other multilateral development banks (MDBs) to play a stronger role to supplement that of the IMF.

In particular, we have called for increased and more effective structural and sector adjustment lending by the MDBs. We envisage a 50 percent increase over current World Bank and Inter-American Development Bank (IDB) disbursements to the principal debtor nations, to $9 billion annually for 1986 through 1988, or a total of $27 billion for the full period. This would be equivalent to an increase of 20 percent a year in overall exposure, after scheduled repayments, or $20 billion in net new lending over the three years.

Third, we estimate a need for $20 billion in net new lending by the commercial banks in support of growth-oriented policies by the debtor nations over the next three years. This is equivalent to a 2.5 to 3 percent annual increase in current bank exposure.

If each of the participants does its part, and the demand for quality lending by the World Bank increases, we indicated that we would also be prepared to look seriously at the timing and scope of a general capital increase for the World Bank.

Implementation

Implementation of the debt strategy will be a long and complex process. It will not involve a single event marking the beginning of operations. Indeed, the process is already well underway. Nor does the U.S. debt intitiative provide a rigid "plan" or "blueprint" for action which can be applied in full to each of the principal debtor nations. Implementation will be on a case-by-case basis with the initiative providing a framework for cooperative action to support the debtor nations' own efforts to improve their growth prospects. This will depend on the individual situation in each debtor country, and each country's decision to implement the additional growth-oriented measures which are needed to supplement adjustment efforts already underway.

It is, therefore, inappropriate to look for "test cases" of adherence to the "Baker plan", as an example of what we would expect all of the debtor countries to undertake. No single model will fit the diverse situations of these countries. Some are already performing well; others have undertaken some adjustment measures but have made only limited progress overall or have recently experienced major setbacks; and still other countries are just beginning to undertake the necessary reforms.

Within these three broad groupings, it is clear that a few countries will need to draw on all of the elements of the new initiative. I would include Argentina and Mexico in this group. Mexico is now in the process of negotiating a new program with the support of the IMF, while Argentina continues to work closely with the IMF under its existing program. In both cases, we believe it is important that structural measures be given increased attention in the context of IMF programs. These countries will also be developing structural policy measures in the context of sector loans with the World Bank. Both will also need major commercial bank financing packages in 1986. Completion of these complex negotiations will take a while and should not be expected overnight.

This is particularly the case for those countries that need to use all of the elements involved in the initiative. These negotiations will also have to sort out the relationship between the IMF and World Bank programs and any commercial bank financing, to be worked out on a case-by-case basis, to assure that all three elements are moving together in support of growth-oriented policy reforms within the debtor countries. This will require closer cooperation between the international financial institutions in assessing the debtor countries' economic policies and financial needs and supportive financing by the commercial banks.

A second group of countries may only need to exploit a part of the initiative at this point.

Ecuador, for instance, provides an excellent example of a country that is already adopting the sound economic policies that are fundamental to the approach we have proposed. It has an IMF program in effect which is on target. It has recently negotiated commercial bank financing and debt rescheduling packages. It has already had considerable success in implementing policies which will help to increase the incentives for domestic savings and investment, to open up markets, and to privatize government-owned enterprises in order to improve economic efficiency and the stimulus to growth. The sector adjustment loan which Ecuador signed last week with the World Bank extends this effort further, and additional sector loans are expected to be negotiated in the future, as well. Ecuador clearly aspires in the next phase to return to a voluntary lending status, which would be a marked sign of success.

Other debtor countries are at various stages along this policy/financial support continuum. Some, such as Colombia, are already well advanced in policy implementation. Others, such as the Ivory Coast and Uruguay, similarly have IMF programs and recent bank financing and debt rescheduling packages, and are in the process of negotiating additional structural adjustment measures with the World Bank.

Brazil faces yet a different situation. It is currently enjoying high growth and a strong external position. It will, however, have to take firm measures in order to sustain solid growth and reduce inflation. For the time being, Brazil has indicated that it sees no need to negotiate a formal IMF program. This poses problems for any rescheduling of official credits within the Paris Club, which requires adherence to an IMF standby program. While this issue is being sorted out, any additional voluntary financing by the commercial banks will depend on their assessment of Brazil's overall creditworthiness, based in part on the soundness of its own economic program.

Finally, Peru has chosen quite a different route for the time being -- unilaterally imposing a limit on its debt service payments as a percentage share of its total export earnings. Unless Peru adopts a more constructive approach, its unilateral actions will be counterproductive. More recently, Nigeria has charted a similar course. The end result, in each case, unless a more constructive approach is adopted, is likely to be a reduction in their access to badly needed external finance in the period ahead.

I mention these examples to demonstrate the wide divergence of economic situations and attitudes among the debtor nations. Most are already participating in the cooperative approach we have outlined and the question is how effective they will be in exploiting these new opportunities and adjusting their economies. For these countries, it isn't a matter of formally "embracing" the Baker plan in order for it to be implemented -- but of undertaking the necessary domestic reforms to unlock the maximum potential of their economies.

Role of the Financial Institutions

The response to our proposal by the international financial institutions and the commercial banking community has been very positive and encouraging. We have received broad statements of support from the Managing Director of the International Monetary Fund, the President of the World Bank, and the President of the Inter-American Development Bank.

U.S. banks accounting for 95 percent of U.S. commercial bank exposure in the principal debtor countries have pledged their support, as have national bank groups and key individual banks in all the major creditor countries.

What happens next?

To fulfill their part of this cooperative strategy, it will be important for the international financial institutions to enact reforms in their own procedures to increase the emphasis on structural adjustment measures and to phase disbursement under agreed programs so that they can monitor performance in the debtor countries to assure that the changes are being implemented.

We expect to see a growing stream of policy-based structural and sectoral adjustment loans from the World Bank and a strengthened emphasis on privatization, open markets, and increased savings and investment. The development of capital and equity markets in developing countries, which the World Bank, IFC, and Inter-American Development Bank are already discussing with the banking community, will be important, as will the potential for debt/equity swaps as part of the privatization process.

Public enterprises have been a major drain on public finances and a significant contributor to budget deficits in recent years. It is important to reverse this drain on national resources and to facilitate a strong and growing private sector as one element of the necessary structural reforms.

Stronger and more open domestic financial markets, tax reform, and improvement of the environment for investment can also enhance domestic savings and investment as a stimulus to growth. Trade liberalization and the rationalization of import regimes would also benefit both the export sector and the economy as a whole.

As a practical matter, it is unrealistic to call upon the support of voluntary lending from abroad, whether public or private, when domestic funds are moving in the other direction. Capital flight must be reversed if there is to be any real prospect of additional funding, whether debt or equity.

These are the kinds of reforms that the World Bank and the IMF need to encourage within their lending programs. We will also be working closely with the IDB to encourage necessary procedural and policy reforms to support the U.S. initiative.

Finally, the commercial banking community will need to devise its own mechanisms for implementing its commitment to increase net lending in support of growth-oriented economic programs in the debtor nations. A number of ideas are now under discussion. For our part, however, we have no intention of providing government guarantees for this purpose. We firmly believe that this approach provides a means for improving the quality of outstanding commercial bank loans and is therefore strongly in the banks' own interest in those countries that are undertaking sound, growth-oriented adjustment.

Conclusion

Are the amounts we have proposed for MDB and commercial bank lending sufficient for those willing to adopt the necessary domestic reforms, in light of the recent deterioriation in the Mexican situation? We think so. Recent global economic developments have not significantly changed the assumptions upon which our estimates for the 15 major debtors were based. These included an average OECD growth rate of approximately 3 percent and the attainment of a 5 percent growth rate during this period for the participating debtor nations.

Interest rates, in fact, have declined, reducing annual debt service requirements for these countries by as much as $7 billion since the beginning of 1985. Declining oil prices, on the other hand, have somewhat improved the financial picture of some countries while worsening it for others. On balance, the overall situation has improved since last summer.

Looking ahead, a significant decline in oil prices would clearly be beneficial for the developing countries as a whole. However, a precipitous decline would cause obvious adjustment difficulties for those countries dependent on oil exports. We will need to follow this closely. The "Program for Sustained Growth" is flexible and adaptable, designed to deal with distributional problems of this kind. However, it is clear already that countries such as Mexico and Nigeria will face increased financing requirements in the near future.

While our proposal includes substantial sums of new money to assist the debtor nations in making the transition to sustained growth, no amount of financing will be adequate unless these countries implement the economic measures which are essential to establish the foundation for growth. Inflation, which robs economies of the real benefits of growth, must be brought under control. Steps must be taken to help mobilize domestic savings and investment, to reduce the burden of government expenditures, to enhance competitiveness and efficiency, and to tap the potential benefits of foreign investment and trade. These alone can provide the strong domestic economic foundation essential for improved growth.

Representative HAMILTON. Thank you, Mr. Secretary. My understanding now is that there is no restraint on your time. Is that correct?

Mr. MULFORD. That's correct.

Representative HAMILTON. OK, the Chair, then, would like to turn to Mr. Fischer and have his testimony and then we'll direct questions to both of you.

Mr. Fischer, you may proceed.

STATEMENT OF STANLEY FISCHER, PROFESSOR OF ECONOMICS, MAS ACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MA

Mr. FISCHER. Thank you, Mr. Chairman. I appreciate the opportunity to be here to discuss the Baker plan, which, I should say at the outset, is a constructive first step in attacking the world debt problem, but one that will have to be supplemented and taken further if this problem is to be put behind us.

The debt problem is very largely a Latin American problem. Forty percent of the total $860 billion world debt is that of Latin America. But it's mainly a Latin American problem because that's where the private lending has been. Eighty percent of Latin American debt is owed to commercial banks, whereas in Africa and Asia, most of the debt is from international institutions or from official sources.

So when we're talking about the debt, we're talking about Latin America.

What I want to do in my testimony is to start by reviewing the background of the current problem, putting some numbers on the size of the problem that faces Latin America. Then I discuss how the problem has been dealt with so far and then I will turn to the Baker plan and mention both the features that make it so welcome, and the inadequacies.

Now, if you look, Mr. Chairman, please, at table 1 of my prepared statement, you'll get some idea of the magnitude of the debt problem. We're talking about world debt of $860 billion at the end of 1985. Latin America debt was $360 billion, about three times their exports and about 40 to 50 percent of their total GNP.

How did their debt get to be so big? Well, there are three parties that deserve blame. The first and foremost is mismanagement in the Latin American countries. During the seventies, there was ready access for these countries to foreign loans at very low real interest rates, and they took them. Not only did they borrow; they appreciated their currencies, creating large current account deficits and they ran enormous government budget deficits. For instance, from 1979 to 1982, the three big debtors—Argentina, Brazil, and Mexico—doubled their budget deficits from 7 to 15 percent of GNP.

So that the main part of the blame goes to these countries and very bad economic management, during which, as a result of the overappreciation of their currencies, a large amount of capital that had been borrowed fled the countries, resulting in large holdings, untraceable or, at least, untouchable, of foreign currency abroad by the residents of these countries.

Now the second party responsible for this problem is the banks that did the lending. If you look at table 1 on the debt statistics, you'll realize that between 1980 and 1982, there was total lending of $97 billion to Latin America, most of that, something like $95 billion, by the commercial banks.

So that in 2 years, from 1980 to 1982, the commercial banks increased their exposure at a time when these countries were clearly mismanaging their affairs and when there was no basis for the lending. There cannot be any doubt that the only reason the commercial banks were doing this was they knew that if they got into trouble, they'd be rescued by the Federal Reserve System, by the IMF, and by others.

Those were irresponsible loans, irresponsibly made, and it seems to me that in solving this problem, the institutions that made them, will have to bear some of the burden of the adjustment that takes place.

The third part of the blame for this problem goes to the real interest rate. At the time the debt was incurred, up to 1980, real interest rates were low, close to zero, in fact, sometimes negative. Table 2 of my prepared statement will give you some idea of what happened between 1977, what people at that time thought of as normal when the real interest rate was zero or even negative. Even in 1980, the real interest rate was still less than 1 percent. Then between 1980 and 1982, the U.S. interest rates went up very sharply, the inflation rate dropped, and the real interest rate rose from 1 percent to 6 percent.

Now, what difference does that make? It makes an incredible difference to a heavily indebted country. In 1980, these countries had to make real interest payments abroad of 0.3 percent of the GNP. Three years later, they had to make interest payments abroad of 3.3 percent of their GNP.

The interest rate swing cost those countries 3 percent of GNP. Now that is enormous. That's the size roughly of the reduction we're planning to have in our budget deficit over the next 3 or 4 years, and you know how hard that is. Well, that's the change in the foreign payments that they had to make as a result of the change in the interest rate.

Those are the three sources of this problem which arose between 1980 and 1982 and became manifest when Mexico ran into trouble in 1982.

The real interest rate payable on the debt has continued to rise as old debt gets folded in at new interest rates.

Once the problem arose, it was handled on a piecemeal basis, which is probably the only way to handle it. We've had lots of scares and alarms about moratoriums on debt, debtors' cartels, and various other things. We've had countries like Peru and Nigeria saying they're not going to pay and the small countries are somewhat in arrears. But the system is creaking along. It's in nobody's interest to let it collapse. The banks have a lot at stake. The countries have a lot at stake in having continued access to lending. Nobody wants to create a collapse of the system. Nonetheless, in the process, real bank lending to the Latin countries is way down.

The banks have not emerged scot-free in the process of adjustment since 1982. They've had a very hard time, the money center banks, keeping the syndicates together. The little banks are always trying to jump out and always being forced back in. That has been a problem.

They've had to reduce their markup over LIBOR, London interbank rate. Their profit has fallen a bit. But they're still marking up over the cost of borrowing.

In a few cases, they've written down the value of loans on their balance sheets, but very little.

Now the stock market knows that the banks have not got a great claim, and calculations suggest that the stock market treats the foreign debt worth about 85 cents on the dollar in the balance sheets of the banks.

So the stock market has given them a writedown. But none of the benefit of that has accrued to the borrowing countries because they're still trying to make the full payments. We're in a situation where you could say that the banks have been damaged because their equity value is down, but the people who are the cause of the damage to the banks are still trying to make the payments, are still bearing the burden and have not gotten relief as a result of the effective writedown that has happened to the banks.

The Latin American countries have dealt with this problem pretty decisively and pretty impressively on the trade side. Table 3 of my prepared statement shows that the Latin Americans have met the burden of paying the increased interest payments almost entirely by a reduction in imports.

We were very proud in 1984 of the fact that Brazil increased its exports to the United States very markedly and, indeed, between 1983 and 1984, there was a large increase in Latin American exports to the United States.

But between 1981 and 1985, there has been a decline in exports from Latin America. It's imports that have done the adjusting and they've adjusted so much, that on trade account, on goods that they sell abroad versus importing, the Latin Americans have made a transition that almost enables them to pay the interest that they have to pay.

Now, how do they get that? They've got that by running extraordinarily restrictive domestic policies. They've had austerity, IMF-based austerity, on a remarkable scale. Table 4 of my prepared statement has the data on that. What you'll see is that all of the countries—these are the five biggest Latin American debtors, the five leaders on the Baker plan list in Latin America—all of them have had a fall in per capita GDP between 1980 and 1985. The country which we think of as the model for others, Argentina, has had a decline in GDP of 18 percent in the last 5 years and showed no increase in 1985 over 1984.

The only country from which you could say there's a ray of hope is Brazil in the last year, which has started to grow.

Making all this worse is the fact that the domestic demand restriction has been largely on investment. If you look at the data there, you'll see that in every one of these countries, there's been a very sharp fall in investment as a share of GDP.

So that this restriction, this dealing with the debt crisis that we've had, has been one which involves cutting back on demand, damaging longrun growth prospects by cutting back investment. It's not a solution that can continue for very long.

Mexico this year ran into the problem of trying to expand, being hit by the oil shock, but also being hit by the fact that it could not get access to more imports. Every country that is going to deal with its recession is going to try to expand out of this problem, and they have to try to expand out of this problem. They're going to have an import problem. They're going to have an import financing problem.

Now I don't have anything much to add to Mr. Mulford's exposition of the Baker plan. Just to repeat the three main clauses. The debtor countries will pledge themselves to growth-oriented reform. The commercial banks will kick in with about $20 billion over the next 3 years. I'm not sure of the exact figures—there seems to be some difference between what the World Bank thinks and other figures—but roughly an increase for multilateral development banks of about $4 billion a year over the next 3 years.

The total Latin American debt is $360 billion. The total Latin American interest is $40 billion. The numbers that we're talking about for the increase in lending is something of the order of about a half of that per annum.

We're talking about large numbers, indeed, in terms of lending. But those numbers are small relative to the interest burden that is being borne by the Latin countries.

Along with the plan, the administration published a list of 15 countries that were the leading candidates for aid under the new plan. The list was an honorable one to be on despite its being a list of countries with problems. Other countries asked to be put on the list afterwards, indicating the favorable reception the plan has.

If you look at the top six countries, which, aside from the Philippines, are all Latin American, you will see that their interest bills as a percentage of GDP range from a low of 5.8 percent to a high in the Chilean case of 13.

They're making payments abroad of about 6 percent of GDP in interest alone at present, and that's an enormous burden that they have to deal with, and that is the primary obstacle to their restarting growth.

The plan has had a lot of support, and it should have had a lot of support.

The question is, Will it work?

It goes in the right direction on each of its three features. The most important change is its shift away from the IMF programs, which emphasize import reduction through contracting the domestic economy, to longrun growth. That's crucial. Second, by keeping the banks in, it recognizes that the banks have to play a part in solving this problem that they helped to create. Third, by involving the international institutions so heavily, it recognizes, and Mr. Mulford's testimony recognized that as well, that it would not be sensible for the United States to insist on particular plans for all countries. It would be much better to use the expertise that's available in the international institutions, particularly the World Bank.

I emphasize the World Bank because one of the difficulties in this whole plan is that there is no way of forcing power away from the IMF, which has got a very shortrun, restrictive mentality, toward the World Bank. But that is going to be important in leading to the success of this plan.

I wrote a set of four questions that I'll go through, but Mr. Mulford answered some of them in his testimony.

The first is how serious the part 1 conditionality, the freeing of markets, is in the Baker plan. I gathered from what was said that we are not going to insist, the United States, that a country, say that decides it does not want to sell its electricity company, will be cut off from the plan.

There are grave difficulties in opening up very quickly. Let me take the leading one.

Capital flight is a very serious problem in these countries. If you open up those countries, anybody sensible in Argentina or Brazil or Mexico is going to try and hold some money abroad. It doesn't make sense, just as a pure financial matter, for anybody to concentrate their portfolio entirely in one country. If you open up access to the world capital markets, rational people, people like you and me, will say, I don't want to be 100 percent Mexican. I'd like to be 20 percent American, in dollars.

If you do that, you're going to have capital flight on an enormous scale. It's not going to be easy to open up your capital accounts and prevent capital flight at the same time. Those things come slowly, as confidence is regained in those countries.

Similarly, we are in favor, and we should be in favor, of selling off public companies. Selling off all the public companies in these countries is going to require an enormous amount of preparatory work. They don't have capital markets, for one thing. Just calculating how to sell the electricity company or the railways or the telephone company is a very time-consuming effort that requires a lot of expertise.

They don't have a lot of expertise. They're probably much better off raising the prices in these companies, telling them, don't run deficits, firing people and maintaining state control, then starting the plan by trying to get rid of all the companies.

Over a course of years, in a well worked out adjustment plan, they can plan to sell off those companies, and they should because otherwise, we'll get back into the same problem.

But those things take time and it's just as well that we're not insisting that it all gets done right up front.

To make the point differently, whatever it is that we do, we need substantial support, or the World Bank needs substantial support, in this adjustment from the receiving countries. Unless we get plans that are agreed to by the recipient countries, in which they're enthusiastic about this thing, it isn't going to work.

We're asking for enormous changes. They know they have to be done. I think there's actually a benefit for these countries in having external pressure. If you talk to the policymakers in those countries, in Argentina or Mexico, they'll tell you how politically difficult it is to do various things and how outside pressure helps.

To that extent, it's a good thing.

But they really, underneath it, will have to agree to the plans if they're going to be a success and we should conceive of this plan as instituting a set of negotiations between those countries and the World Bank and IMF that will lead over a long, but not a short, period to substantial changes in the structure of their economies.

The third question that the plan raises and that I think is unresolved is how the banks are going to be kept in. The plan calls for the banks to increase lending by 3 percent in aggregate. Well, if you have an aggregate total, they're going to increase exposure by 3 percent. When it comes to a Mexico, they're entirely free to say that 3 percent applies on average, but you're certainly not average. How about zero in your case?

It's not clear what power the plan envisages or what ability the plan has to produce this lending. It's not made explicit. Maybe it's not made explicit because it shouldn't be. In fact, there is enormous power to produce that lending and the enormous power is that this plan and the role of the IMF and the World Bank is what guarantees the loans of those banks.

Without the IMF and World Bank, the banks would long ago have faced default. It's because the institutions have kept the countries alive and have stitched together these plans that the banks are still in there making their 100 percent claims. And the power, I think, that is implicitly being used, and that should be used, is the one that says, if you don't like it, you can lump it, and that's a reasonable way of keeping the banks in.

Now I'll come to what I think is really the key difficulty, and that is that the Baker plan is a long-term plan. It addresses fundamental structural issues. There is an immediate problem for these countries of growing in the next few years. During that period of restructuring, we're not going to get any increased supply of any great amount out of the elements introduced by the plan.

What they need is more resources now. Now where are they going to get them? You could say we should have an interest moratorium that would enable them to be rid of the burden of interest payments in the next few years while they grow. I think that would be better than nothing, but I don't think it's ideal because they don't really want to accumulate debt at a rapid rate.

The single best thing that could happen to the developing countries is taking place now, is a reduction in the United States' real interest rate.

Here, I think Gramm-Rudman may be doing a power of good, whatever people think about it in the domestic economy. If interest rates come down by another 2 or 3 percent, we're going to make a large difference in the problem of the developing countries. And there is something which is not in the Baker plan which may be the crucial ingredient to its success.

That brings me to the last component, which is the role of the commercial banks. And here I think is where we need to ask for a greater contribution. The commercial banks have basically been rescued from a series of foolish loans by the actions of the international institutions. They are continuing to make loans to the developing countries at rates well above the rate at which they borrow. They're continuing to make profits on these loans.

As far as I can see, their contribution to the Baker plan is very little, indeed. The Baker plan rescues them from potential difficulty. The IMF and the World Bank rescue them because they'll be increasing their lending to those countries.

Commercial banks are not paying. I think the logical way of getting a substantial contribution from the commercial banks is to require that their lending be at rates well below the rates they've been lending now at something like the London interbank rate, which would be between 1½ to 2 percent less than the rate at which they're lending at present.

Now why should they do it?

They should do it because they're a part of the problem. They caused it and they're being helped out of it by this plan.

What difficulties would that create? It creates the difficulty that they'll be expecting lower payments, lower profits over the future.

The way to handle that is to require them to begin writing off this debt at a slow rate over the next 5 or 6 years, to a point where they'll be at the value that the market now places on it, which is about 85 percent of the value that they carry it on their books.

Can they take that? Well, they can take it. It will make a difference to their profits. But it's not clear at all why they should not make a contribution which would come to something quite substantial for Latin America, something like $3 billion a year, to solving this problem.

Thank you.

[The prepared statement of Mr. Fischer follows:]

PREPARED STATEMENT OF STANLEY FISCHER

Even since Mexico temporarily suspended debt service payments in 1982, the threat of a major debt repayment crisis has hung over the international economy and the United States banking system. Rapid United States growth and booming exports from the debtor nations in 1984 gave hope even to the optimists. But new strains on the basic muddling-through strategy in 1985 led to the announcement in October of the Baker Plan for a comprehensive attack on the problem.

The debt problem is largely Latin American. Forty percent or $360 billion of the total developing country debt is Latin American. Debt to export ratios for Latin America are double those of other debtors. And most of the Latin American debt is market-interest rate debt owed to non-official creditors, whereas African and Asian countries owe more than half their debt to international institutions.

In my testimony I will first set the background by describing the origins of the debt crisis and the policies adopted to deal with it so far. Then I outline and discuss the Baker Plan.

The Baker Plan is a constructive first step, which does not go far enough. The commercial banks will have to make a more serious contribution if the debtor countries are to achieve sustainable growth. Throughout I concentrate on Latin America, and within Latin America on the big three ABM countries, Argentina, Brazil, and Mexico.

I. The Background.

The distant origins of the debt crisis lie in the oil price increase of 1973 and the subsequent accumulation of wealth by OPEC countries. OPEC needed to invest its funds, and the international banks found the outlet in the newly industrializing countries. Nominal interest rates were low, the inflation rate was rising, and real interest rates for the borrowers were low and even negative. The debtors grew fast and the strategy of developing through private borrowing looked like a total success.

The blame or responsibility for the debt crisis has to be shared three ways. Fiscal and exchange rate mismanagement by the borrowers deserves the largest share. With ready access to foreign exchange at low real interest rates, governments in the debtor countries increased spending, and appreciated their currencies allowing large current account deficits to develop. From 1979 to 1982 public sector deficits in the three ABM countries more than doubled, from an average of 7% to more than 15% of GDP.

The second responsible party is the lenders. Table 1 shows relevant debt statistics for the period 1977 to 1985. The most striking period is during the second oil price shock between 1980 and 1982 when Latin American debt from private sources increased by $100 billion, or over 10 % of a year's GNP in Latin America. It takes two to make a loan, and in making those loans the banks can only have believed that their loans would not be allowed by the international

Table 1: DEBT STATISTICS. (Capital Importing Developing Countries)

	1977	1980	1981	1982	1983	1984	1985
Total debt ($b.)	334	567	662	749	797	830	865
Latin America:							
Total debt ($b.)	125	229	286	326	340	351	359
Debt/Exports (%)	193	182	208	267	288	272	283
% owed to official creditors	17	14	12	12	15	16	18

Source: World Economic Outlook, October 1985. ($b.) means billions of dollars.

monetary system to fail so long as they exposed themselves deeply enough.

The third share of the blame goes to the real interest rate. At the same time as the banks were expanding loans to the debtor countries, the real interest rate in the United States increased to historically unprecedented levels. Table 2 shows the average interest rate paid on Latin American debt, the U.S. inflation rate, and the real interest rate paid by Latin America. Debt which had been available at essentially a zero real interest rate in the seventies became more expensive in the eighties than it had ever been before.

The change in the debt burden caused by the rise in the real interest rate is crushing. In 1980 Latin America had to make real interest payments abroad equal to 0.3% of GDP. By 1983 the real interest burden was 3.3% of GDP. If the real interest rate had stayed constant, the burden in 1983 would have been 0.5% of GDP.

Table 2: INTEREST RATES ON LATIN AMERICAN DEBT.

	1977	1980	1981	1982	1983	1984	1985
Nominal interest rate	5.3	10.0	11.7	12.0	10.6	11.3	10.8
U.S. inflation (GNP deflator)	5.8	9.2	9.6	6.0	3.8	3.7	3.2
Real interest rate	-0.5	0.8	2.1	6.0	6.8	7.6	7.6

Sources: Economic Outlook, October 1985, and Economic Report of the President.

II. Dealing with the Debt, 1982-1985.

After the Mexican suspension in 1982, the debt was handled on a piecemeal basis. The developing countries had to meet the enormous debt burden. Heavy borrowing to meet the payments would not have made a great deal of sense with the real interest rate at 6-7% .

Although the debtors have occasionally talked about joint action to declare a moratorium on the debt, or to default, there has been no debtors' cartel. Some countries have not met payments at times, some like Peru continue not to do so, but the system creaks along. The large debtors have continued to make payments on their debts, and have reduced their debt to export ratios. The banks have increased their nominal exposure by continuing lending, usually working out terms with the intervention of the international institutions. But real bank lending in the last two years is down as the banks increased lending by less than the inflation rate.

In earlier times the debtors would have gone into default, as they (except for Argentina) did in Latin America in the 1930's . This time the IMF and the Fed have cooperated to keep the banks lending. There has in effect been a lenders' cartel, organized jointly by the major money center banks in their industry and wittingly or not helped by the IMF.

The banks have not emerged scot-free in the process. Holding the syndicates together has been difficult. As time has passed, the banks have been forced to take lower mark-ups over LIBOR. Some small write-downs have been taken on their balance sheets. Reflecting uncertainty about the value of their third-world debt, the heavily exposed banks have suffered reductions in stock market value. Some calculations suggest the stock market values foreign debt at about 85 cents on the dollar. It may be said then that the banks have already taken a write-down on their debt. However, none of the benefit of the reduced value of these assets accrues to the borrowers. We then have the worst of both worlds, the lenders have taken a loss, but the borrowers show no gain, and are still bearing the burder of trying to repay in full.

To meet their interest payments, debtor countries have turned their trade accounts around, running large trade surpluses. The data for Latin America in Table 3 are extraordinary. Countries have found

Table 3: THE TRADE ACCOUNT IN LATIN AMERICA.

	1977	1980	1981	1982	1983	1984	1985.
Exports ($b.)	50.6	94.2	100.7	91.2	91.7	101.3	97.9
Imports ($b.)	51.1	96.3	103.9	83.9	62.7	64.0	64.0
Trade surplus/ GDP (%)	-0.1	-0.3	-0.4	1.0	4.1	5.0	4.4

the resources to pay the interest bill mainly by cutting back on imports. Despite the much-trumpeted increases in exports in 1984 especially from Brazil, 1985 exports from Latin America measured in dollars are lower than they were in 1981.

The change in the trade surplus of 5% of GNP exceeds even the increase in the real interest bill. The entire current account balance for 1985 was just $8 billion or 2% of the value of their debt. To get some perspective on what they have been forced to accomplish, note that as a percentage of GNP the improvement in the Latin American current account in the 1981-1985 period far exceeds the worsening of the U.S. current account.

The improvement in the trade and debt picture was achieved almost entirely through domestic demand restriction. Latin America has during the last five years suffered a decline in its standard of living, visible both in the data and on the streets. Table 4

Table 4: GROWTH AND INVESTMENT.

Country.	Change in Per Capita GDP, (%). 1980-85	1984-85.	Investment/GDP (%) 1980	1984*
Brazil	-3.0	4.8	22.5	15.7
Mexico	-3.6	0.7	24.8	18.5
Argentina	-17.7	-4.5	22.4	16.6
Venezuela	-20.8	-2.7	25.2	14.3
Chile	-9.1	0.2	16.6	12.0

Source: CEPAL, IFS. *Data in this column for Mexico, Argentina and Chile are for 1983.

contains data on the five largest Latin debtors. Per capita GDP is lower in 1985 than it was five years before in every case in the table, and is an extraordinary 18% lower in Argentina--the country which is thought of as a model. Except in Brazil, economic growth in 1985 provided little encouragement that the austerity of the previous years was about to end.

More serious yet, investment has been cut drastically. Long run growth prospects are being sacrificed to deal with the debt crisis through the old-time medicine. Restrictive demand policies, enforced with the help of the international institutions, have cut import demand. Exports have not changed anywhere near as much as imports. And when exports to the United States have increased fast, protectionism has raised its head.

The debtors cannot continue running such restrictive policies. Soon they have to begin growing again. When they try, import demand will rise immediately (this, plus the drop in the price of oil happened to Mexico this year) and they will be back in balance of payments difficulties. Argentina and the other countries on the list will all have the same problem.

III. The Baker Plan.

As 1985 wore on, the private banks were providing less and less new funds for the debtors. The real value of total Latin American debt in 1985 fell. The pace of export expansion decreased. Mexico, the success story of 1983 and 1984, ran into trouble as the price of oil cracked. The political question of how far and how long an austerity program could be imposed, let alone the wisdom of doing so especially in countries showing encouraging signs of returning to democracy, was becoming more urgent.

The Reagan administration had taken a resolutely hands-off attitude to the debt problem, arguing it should be worked out without any fresh infusions of funds from the U.S. or the international institutions. Disturbed at the prospect that major banks could take losses exceeding the value of their capital, the Fed had played a vigorous part in the strategy of managing the crisis by fostering cooperation between the private banks--whose joint interest was to keep lending--and the international institutions. But the administration kept out.

The Baker Plan is a welcome first step by the U.S. administration towards solving the debt crisis. The plan is threefold.

1. Debtor countries pledge themselves to growth-oriented economic reform. Market forces will be given a greater role in the economy. Government companies should be sold off, trade liberalized, excessive regulation reduced, and so forth.

2. The commercial banks will over the next three years increase their exposure in the debtor countries by $20 billion, or 3% per annum.

3. The multilateral development banks will extend their lending, by a total of about $12 billion over the next three years. The World Bank in particular will play a larger role, in fostering the growth-oriented policies that appear to be a pre-requisite for receiving help under the Baker Plan. The $12 billion is over and above current lending efforts, which are at the rate of about $11 billion per year.

These numbers should be compared with the outstanding total debt of $865 billion, or the Latin American debt of $360 billion. In Latin America alone annual interest amounts to nearly $40 billion, apparently more than the amounts slated to be lent under the Baker Plan.

Along with the Plan a list of 15 heavily indebted candidate countries was published. Table 5 contains the top six, together with relevant economic variables.

Table 5: THE TOP SIX BAKER CANDIDATES.

Country	Foreign debt ($b.)	1985 Interest ($b.)	(% of GNP).	Debt owed to U.S.banks ($b.)
Brazil	103.5	11.8	5.8	24
Mexico	97.7	10.8	6.3	26
Argentina	50.8	5.1	7.9	8
Venezuela	32.6	4.1	8.1	11
Philippines	27.4	2.1	6.2	6
Chile	21.9	2.1	12.9	7

Source: Fortune, 12.23.85.
Note: Remaining nine countries are Yugoslavia, Nigeria, Morocco, Peru, Colombia, Ecuador, Ivory Coast, Uruguay, Bolivia. Their total debt is $103.5 billion, total interest is $8.5 billion, and total debt owed U.S. banks is $13.4 billion.

The IMF, the World Bank and debtor governments welcomed the plan. Some time later money center banks holding 95% of the debts expressed their support. It is reasonable to believe that in return for their support the banks would try to get the Treasury to guarantee any further lending that they undertake. The Treasury rightly will not do this. The banks have nowhere else to go to protect their existing investments than to continue lending.

IV. Will the Plan Work?

The Baker Plan goes in the right direction on each of its three features. Most crucial, it shifts the emphasis away from IMF program import reduction through contraction of the domestic economy back to long run growth. Second, by keeping the banks in, it recognizes not only their interest in avoiding debt default but also their responsibility for the Latin debt problem. And third, by heavily involving the international institutions it recognizes both that the United States would be ill advised to try to force politically sensitive structural economic change on the debtor nations and that technical expertise is available, particularly in the World Bank.

There are though major questions about the Baker Plan, which is more a set of intentions than a detailed plan. First, is the question of how serious the part 1 conditionality is and how it will be implemented. Are the international institutions supposed to refuse to help countries that will not sell their public companies, preferring rather to devote their efforts to running the companies more efficiently? Presumably not.

The Baker Plan does not spell out the nature of the structural adjustment plan. That is all to the good. So what is the meaning of the Baker conditionality? It must be that the IMF and the World Bank will agree with the debtor country on a long-term plan involving structural reform that will lead to growth. A key element in the plan will have to be a restoration of investment. This can be achieved by lending to governments on condition they lend on to the private sector.

Beyond the most general guidelines, the plan should not dragoon the recipient into accepting particular United States preoccupations about the ingredients for growth. To take a simple example, there is probably no short-run payoff to selling electricity companies in the developing countries to the private sector. The key concern is to get their prices and investment decisions right, and conditionality on that can be made part of the World Bank agreement.

Whatever the nature of the adjustment plan, it will have to be willingly agreed to by the recipient country. There is no question that policy-makers in many countries know that the right way is to liberalize, and that they want to do that. But each country has its own political culture. Putting ideologically-based restrictions on Baker Plan agreements is a sure way of both making the agreement a political issue in the recipient country and producing reluctant and half-hearted cooperation by the recipient--and thus likely failure.

The second question is how the Baker Plan will shift power in the international system away from the IMF. The IMF is used to short-run agreements--devalue, cut the government budget deficit, and call us in the morning type management. Growth is a much slower process, and entirely new methods of conditionality will have to be worked out.

The third question is how the banks are going to be kept to the terms of an agreement with any particular country. The banks have agreed to increase lending by 3% in aggregate, but are free to tell any particular country that it gets less. Presumably the key here is for the international institutions to work out arrangements that are mutually agreeable with the countries and then inform the banks of the conditions under which they will continue to be paid, if they come in with the promised 3%.

The key question though is whether the Baker Plan is enough. The answer is that it cannot be in the short run. Structural adjustment takes time. Countries that expand demand can grow fast immediately. Countries that implement supply side changes will show better performance over the long run. Baker's cures are long run cures.

In the short run the countries face the dilemma that to grow fast they need imports. They are already heavily in debt, and further borrowing jeopardizes long-run success. They need more net resources, or a reduction in their current interest burden. An interest moratorium would give them breathing space, but still leaves them with more debt further down the road and is not the best choice.

The best thing that could happen is a reduction in the United States real interest rate back to 2-3%. This would be equivalent to an increase in resources equal to 2-3% of GNP for the recipients. Here Gramm-Rudman-Hollings will do real good by reducing the U.S. budget deficit and real interest rates.

But there is another important component. The banks stand only to gain from the Baker Plan, yet they contribute very little to it, beyond asking for guarantees of their loans. In 1984/5 banks were lending to the Latin American debtors at an average of 130 basis points above LIBOR, plus commissions in some cases. There is simply no reason for them to have those margins. They should be required in any future agreements that are worked out with the international institutions and debtor countries to lend at LIBOR.

In brief, the debtor countries need to turn their attention to growth. The Baker Plan does that. They need structural reform. Provided the Baker Plan is implemented without excessive ideological baggage, they will be encouraged to do that. The countries need relief from their current debt and real interest burden, without going further into debt. The Baker Plan does not do that. Here the banks have to play a more constructive role by substantially reducing their interest rates. That way they get more assured payment, and they contribute to solving a problem they helped create.

Representative HAMILTON. Thank you very much, Mr. Fischer. We appreciate the testimony of both you gentlemen.

Now, Mr. Mulford, we'll go back to my question on the oil matter, and Mexico, particularly.

The drop in oil prices, according to press reports this morning, may create some great difficulty, additional difficulty for Mexico and I'd like to get your assessment of that.

Mr. MULFORD. Well, in my testimony, I indicated that declining oil prices would impact negatively on some of the large debtors which are oil exporters, and it impacts particularly severely on Mexico, which has a rather narrowly based economy and depends very heavily on the revenue side for earnings from export of oil.

I would say, by the way of introduction, that in the oil markets, and the reports that we're reading in the press, we should be aware of the fact that the numbers being quoted in the press, the very sharp declines in oil prices, are the sort of financial oil prices or the traded part of the market, and these drops, although they've been very sharp, do not necessarily represent the values or prices at which product is changing hands, or will change hands in the market.

You may remember that during the period of oil price rises, the financial part of the market ran well ahead of the listed prices in the Middle East, for example, and that may be happening to some extent on the downside.

So I would just introduce a note of caution there to say that when we pick up the paper and we see a price drop of $25 down to $20 in the market, it doesn't mean that the whole oil market, every trade transaction, et cetera, has shifted by that magnitude.

It is, however, a disturbing feature and, obviously, a downward move of that type is followed by adjustments in the real market all the way down the line.

In the case of Mexico, it has had some substantial deterioration in its situation during the second half of 1985. It had an inflation rate of about 65 percent against a hoped-for target of around 58 to 59 percent, and an earlier target that year of something like 40 to 50 percent. So, clearly, the situation internally deteriorated.

It also failed to reduce its budget deficit as a percentage of GDP by the target it had in mind, which was something around 5 percent, and it missed that substantially and ended up with something in the neighborhood of a 10-percent budget deficit ratio to GDP.

The oil price situation, therefore, has already, as markets began to soften in 1985, become something of a problem for Mexico. And the sharp decline that we've seen in recent times clearly spells a further need by them to assess the situation and attempt to adjust their economy.

I think it's a little early to tell exactly how they might go about this, but, for example, just to give you some general guidance, we have projected for 1986, on the basis of a $20-oil price, that Mexico's current account deficit would be in the neighborhood of about $4 billion. We reached that conclusion after making the assumption that they will respond to that situation by reducing imports, to some extent, and perhaps increasing liftings by 150,000 or 200,000 barrels a day in order to attempt to enhance their revenues with higher export sales.

That being the case, that is not all that different than the projection before these changes took place where there was a $3½ to $4 billion current account deficit or financing gap to be managed. And I think you will have seen numbers to the effect that Mexico was interested during the course of 1986 in financing of approximately $4 billion, of which something like $2½ billion would be obtained from the banks and the balance would be obtained from the international financial institutions.

Now if there is a price decline sharply below $20—in other words, if the movement were to continue and it were to be precipitous as it has been in the recent past—and I would point out, by the way, that none of us yet know what price Mexico will set for its various grades of oil for the month of January because they preannounced that they would set their prices at the end of January retroactive to the first of January.

So that is a figure that we don't yet have.

But assuming that there's deterioration from their previous level, clearly, the situation for the moment would appear to be containable. But if prices continue to go down, it is going to be a much more difficult situation and the amount that they would need to finance themselves in 1986 would rise sharply. And it's entirely within the realm of possibility that it could move from $4 billion to $6 or $6½ billion relatively quickly.

Representative HAMILTON. When you talk about the present situation as containable, as I understood you, said containable in the context of a price of oil of about $20. Does that mean that they will still have to get additional new loans in order to contain it?

Mr. MULFORD. Yes. Yes. What I meant is by containable, if Mexico were to adjust to whatever new price of oil it sets, which I think will be somewhere above $20 for the time being, and it were to cut imports, which we think can be done to some extent without severe damage, if it were to raise liftings in the near future to attempt to make up some of that revenue loss, it would still face a financing problem at this moment approximately similar to what was anticipated as we entered this period—approximately $4 billion.

Now that does mean that they have to raise external finance of about $2½ billion or $2.8 billion from the banks and the balance of the $4 billion from international financial institutions.

They have under negotiation substantial loans at the moment with the World Bank, sectoral loans of one type or another, and I believe the estimate for the World Bank is that they expect to conclude loans during the course of 1986 with Mexico of approximately $1 billion.

The banks are being looked to for $2½ to $2.8 billion and Mexico is negotiating a new IMF program which will provide something in the neighborhood of $900 million.

So, the resources that are required are visible. The key, as I think we have both stated here this morning, is whether the countries, and in this case, Mexico, will be willing to undertake the kind of substantial economic reforms in their economies to create the credibility that is required to obtain funds from private lenders who are the major sources of funds in this case, that is, commercial banks, and to convince the commercial banks that they will follow a collection of policies that will restore a basis for growth, will contain capital flight, and so on.

If they don't do that, it's already been made clear by commercial banks in general that they're going to be looking for very significant signs of change in Mexico before they lend.

So there is a negotiation ongoing which has to be brought to a successful conclusion before Mexico can finance itself and, obviously, with oil prices declining, this complicates that process very substantially.

Representative HAMILTON. Before turning to Senator D'Amato, Mr. Fischer, do you want to comment on this Mexican oil problem?

Mr. FISCHER. No. Just to add that Mexico last year planned to have a budget deficit of 5 percent of GDP and had one of about 10. They're planning to do this year what they said they'd do last year. But they seem to be very serious about it.

I think that they can contain the situation if they follow through on the policies they've set out. That's the sense in which the Baker plan is very useful. It provides the encouragement to go through. I think it should be making a little more resources available to them by encouraging lower cost financing.

Representative HAMILTON. I want to get to that in a few minutes. Senator D'Amato.

Senator D'AMATO. Mr. Chairman, let me commend you for holding this timely hearing. And I thank my colleague, Congressman Scheuer, for yielding his time at this time. I have to get back to the Senate.

You know, Mr. Mulford, you have the obligation of attempting to deal with this incredible problem that has built up over the years. I look at some of the debt that's placed before us in Latin American countries, and it would appear that the share of the U.S. banks are in for, just the U.S. banks, is about $80 billion.

The chairman raised the question with respect to Mexico and the problem it will have in terms of the falling oil prices and what that does to its projection. We haven't even begun to look at some of the other critical areas. Nigeria, Venezuela, Indonesia—we're not just talking about Mexico here—in terms of that nation with respect to what happens with its declining oil revenues.

I have to say that I am rather skeptical of a program that will pour $20 billion, a substantial portion of which coming directly from the United States, certainly being guaranteed by ourselves and IMF and others, after bad money. This is good money after bad.

Now that's almost treason and heresy to say that kind of thing. But, when are we going to wake up? Do you really think that Colombia is going to pay back the debt to this Nation?

No way. They have a problem in terms of keeping their very structure together. They can't even control the drug traffickers who have at times certainly more money—if we want to do something, we should help them get the money from the drug traffickers over there.

Peru? Equador? Argentina? Why, I just think that what we're doing is failing to face up to some of the facts.

Mr. Fischer, in his presentation, touches on them. We've had banks that were greedy for years. When I came into office in 1980, they made these great presentations as to how much money they were making on their foreign loans. Absolutely incredible.

And where was the Treasury and where was the Federal Reserve in saying, this is a mockery? They were discounting bad debts one after another, making new loans, discounting the next loan, and showing huge profits.

It's absolutely incredible what they gotten away with.

Now we have to consider the American taxpayer here because we're going to be held accountable. The banks are going to say, you told us to make these loans. You told us to make these loans.

I see this policy that you're advocating, which is being discussed, as nothing more than a continuation of this situation. In the final analysis, you're going to have to write off these debts. We're going to have to come out with a plan to give them a long period of time in which to do this so the whole financial deck of cards doesn't come tumbling down.

I'm not suggesting that we're not going to have to do something. But, I just think that this is more good money after bad, and we're failing to own up to it.

They're never going to pay back this money. This is a game. We're digging ourselves in deeper and deeper and deeper. To give John $10 so that he can give you back $9, so that you can say that I'm current on the interest that is paid, is nonsense.

We watched it year after year after year, and we're doing it again. Why?

That's the question.

Mr. MULFORD. I didn't get the focus of that question. [Laughter.]

Senator D'AMATO. Well, do you want me to be a little more explicit?

Mr. MULFORD. Well, if you could just ask one question at a time.

Senator D'AMATO. I think it's a darn foolish plan to say that we're going to give somebody $1 who can't pay us back, that we're now going to increase it, giving him more money, and now, at the end of this, you're going to have to pay me back $1.50.

There's no hope here. Take a look at it. Why don't we recognize it? Why don't we begin to look at this in an enlightened, businesslike manner?

This shoveling more and more money out there and putting off the day of reckoning is just simply exacerbating the problem.

Representative SCHEUER. Will my colleague yield for a focused question?

Senator D'AMATO. Certainly.

Representative SCHEUER. I would like to ask on behalf of my colleague, Senator D'Amato, what each of you gentleman, what value each of you gentleman would place on those Latin American loans if you were a Federal bank examiner examining the books of the commercial banks that hold those loans right now?

You said, Mr. Fischer, somebody values them at 85 percent. Would you value them at 85 percent? Would you, Mr. Mulford? And if not, what figure would you put on them?

Mr. FISCHER. The person who values them at 85 percent is the stock market, from what you can dig out of the data on value of banks, according to their exposure in the Latin countries.

The value that you place on them is not independent of whether these plans are adopted. I would think that a reasonable plan writing down the debts by reducing the interest rates on them to about 85 percent is one that is sensible.

If there is an end to lending to Latin America, that debt will be worth a lot less than 85 cents on the dollar.

So the question that's being asked is, given the most sensible plan, what are those debts worth? And I'd say about 85 cents.

Mr. MULFORD. Let me try to address the Senator's question in a fairly general way, because I think it is important to try to understand how we look at the general problem. Obviously, you raised many good points.

But as to the debt itself in these countries, the long-term objective of the strategy is to attempt to allow a situation to occur where there could be a sufficient recovery and growth in these economies at a higher rate than their accumulation of external debt, so that over a period of time, their economies are better able to carry the debt burden.

On the banking side, the hope is that the increase in exposure on the part of the banks, that is, net new lending, takes place at a slower rate than their growth of capital. And therefore, as is already the case, their exposure to these countries in relation to their total banking picture declines and becomes more manageable.

Now this is a proposition that takes time and it requires very careful management and it requires that there be no major accident along the way that unhinges the system, that is, one which would cause confrontation between the debtors who might unilaterally decide not to pay or reduce interest, or whatever, or unilateral action by the banks, which might have the effect of seriously undermining confidence in the banking system.

So, obviously, we all have a stake in attempting to see if this process can be moved forward with the constructive end result that I have summarized, because I don't think any of us seriously expect all the debt to be repaid. We don't expect corporations to repay all their debt.

What we expect is corporations to manage the debt that they use in their business in such a way that they carry it without undue risk to the corporate enterprise. And the same is true in the case of governments. Governments incur debt. They maintain debt. They repay debt. But they do not pay debt down to zero.

And I don't think that anybody is looking for a situation where countries in Latin America would be required, in order to be called a success, to reduce their debt to zero.

The aim here is to bring their debt burden back into line with the capacity of their economies to carry that debt.

At that point, those countries would become voluntary borrowers once again; that is to say, they would be able to command resources in the financial markets on a voluntary basis, as they were doing before, and the system would return to a more normal functioning.

So, that is the aim of the debt strategy and I think it should be seen in that context.

You cannot really look for, in my opinion, an approach to the debt strategy which takes the entire global problem of debt, which has been summarized this morning by Mr. Fischer for us, and simply look at that and say, how do I solve this total global problem?

You have to attack it on the basis of a country-by-country approach, hoping as you go along that you make significant progress in some countries, knowing that you will not make total progress everywhere across that broad front, but that gradually you reduce the problem by running a strategy which helps some countries escape from this problem.

Now as I said in my testimony, Equador has made good progress. There is a very good chance if Equador can continue this progress that it will return to the ranks of voluntary lenders, borrowers from the banking system, and that it will not need, as indeed it does not at this time, large amounts of new money.

If they can continue their performance, their situation will improve and their debt, and their debt ratios and the burden in general of the debt in their economy, will decline.

Now, obviously, other countries have greater problems. But I think we need to keep in focus here on the fact that it's a country-by-country situation. The across-the-board type of solutions where, for example, we asked banks to write off all the debt or to reduce interest rates for everybody, or to allow the capitalization of interest, those solutions all have a common disadvantage, and that is they treat everybody the same—performing nations and nonperforming nations alike.

And, in the end, in my opinion, they will cost a great deal more by way of a solution than to continue the present approach.

I would like to say one thing more about the debt strategy to correct what I think is a misconception, that there was nothing in it with regard to the banks, asking them to share a greater burden.

There was a request on our part that the banks should reduce their spreads, reduce or eliminate their fees, and that the expenses that are incurred in renegotiating the loans and doing the documentation should not be collected by the banks and billed to the countries, but should be absorbed by the banks.

Now those were suggestions that would make a difference and we made those to the banks in good faith, hoping that they would take that into account.

We in government cannot insert ourselves in the banking business and make the decisions for them. But we did make that suggestion and hope they would follow through on it as a means of reducing at the margin somewhat the burden that is being carried.

I hope that gives you some answer to your question, Senator.

Senator D'Amato. Mr. Mulford, let me ask you something. When do you think the banks will return to their voluntary participation?

Mr. Mulford. Well, I think it will be at different times for different countries.

As I've said, in the case of Equador, if I were to hazard a guess, I would say that perhaps Equador will become a voluntary borrower of short-term moneys again over the next year or two if they can continue to perform.

In the case of Argentina, which is a country rich in natural resources, self-sufficient in food and energy, there has always been a view that the turnaround in Argentina, if it could be begun, could be quite dramatic.

So that if Argentina continues to perform, comes up with further adjustments, lays the basis for a resumption of growth in its economy, and it is going to be a beneficiary of falling oil prices, Argentina has some prospects, in my opinion, of returning to those ranks over a period of some years.

Other countries, it will be difficult, unless they adopt very significant reforms for their economies. In the case of Mexico, I believe they need to open their economy to foreign investment. I believe they need to privatize these large government enterprises which are a drain on their budget deficit. They need to adopt a new trade regime. They need to adopt more effective tax systems, and so on.

Senator D'AMATO. Mr. Mulford——

Mr. MULFORD. So they have major reforms to accomplish.

Senator D'AMATO [continuing]. You heard Mr. Fischer's statement. How realistic do you really believe the kinds of reforms that we talk about can take place? You talk about nations that are holding on by their fingernails.

Let me suggest to you that the reforms that you call for in many of these areas simply are not going to be attained. They're not realistic.

Why talk about bringing in capital into areas that are marginal, at best, where people are doing everything they can to bring capital out of that area, as opposed to bringing it in?

It's a daydream. It's make believe. And that's what I'm saying. There are significant parts of this plan, and you can cite to me the example of Equador and I say, fine, and the example of Argentina, wonderful, but I wish there were more.

With very few exceptions, you can't really outline the prospects, the ones that are hopeful. Do you really think they're hopeful?

Mr. MULFORD. Yes, I have outlined some earlier and I would like to——

Senator D'AMATO. Is Mexico hopeful?

Mr. MULFORD. Well, I didn't say that. I said they had some very serious problems.

But I do think that during the last few years, countries, debtor countries, which have run, as was stated by Mr. Fischer, very inefficient economies—he made that point very clearly and very well, I thought—they have had to come to grips over the past few years with the need to change. And their first efforts to change were largely on the external side. They improved their payments situation, but they did not get at the heart of their internal economic problems.

As time has passed, I have had the feeling that these countries have come more and more to realize that they are going to have to come to grips with this essential problem of reforming their domestic economies. And by that word "reforming," I mean totally reforming, including capital flight, et cetera. They have to accomplish results.

They know that the time is running out and they know that the capital is becoming less available to them.

Therefore, it seems to me that they are becoming more and more inclined to see the writing on the wall, to accept that they're going to have to make major changes. We're seeing, for example, the beginning of announcements for the sale of government enterprises. Mexico has sold government enterprises, for example. They've announced some changes in their trade regime.

It isn't as if they haven't done anything. They have made some progress and they have further progress to make.

But it's a continuing process. These are very difficult political problems in these countries. We know in our own country how long it takes to address the budget deficit problem, for example, and come up with some means of successfully coping with that problem politically.

These countries are no exception. They face difficult political problems to make the kinds of changes in their economies that are required.

In my view, the chances for those changes are improving because the atmosphere in these countries is improving for change. Their ability to carry out the change is in question. I agree with you, it is in question. It is an open question whether the reforms in Mexico can, in effect, be accomplished on a broad enough scale to solve the kinds of problems that they face and to unlock sufficient flows of credit to keep that process of adjustment going.

They will come to see that unless they make the changes, the flows of capital are not there, because the Baker plan has one important assumption, and that is that if the debtor countries do not undertake adjustment, the plan doesn't work. So it's key. It recognizes that. And the debtor countries must accept that challenge or the rest of the plan doesn't go into effect.

Senator D'AMATO. Mr. Mulford, I think sometimes we may concentrate on Mexico a little too much, because, if anything, that should be a country, given its vast wealth in natural resources and oil, in particular—they're much better positioned than some of the other nations—than Peru, than Colombia, than some nations that don't have nearly that kind of wealth and they don't have the infrastructure and the structure to bring about the kinds of changes necessary.

You're talking about some countries that have revolution on their hands. And here, we're talking about them encouraging economic development and growth.

Now, I just think it's pie in the sky. And what we're doing is putting off the inevitable.

And let me say this—I am not suggesting that we walk away from all nations at one time. As you say, we have to address these problems individually, nation by nation. There are some that are making progress, but others that aren't.

We'd better look in to it.

And here, we're talking about some of the areas in South America and Latin America. But there are other nations. For example, I wonder what we're going to be doing in terms of the debt and the debt structures for Poland. How are we going to address this? Aren't we wiser to begin to make plans to write down the structure for those nations where there is little, if any, hope of recapturing that?

And, of course, if they're ostracized from the free market and from the World Bank and from others, then they will make a determined attempt to see to it that at least some interests are repaid over a period of time.

But to say that we're going to spend more dollars in this manner, I believe that we're just putting off the inevitable, and we're really putting everyone together in one large group, and we're saying that we've loaned you so much money that you now control us.

That's part of a strategy. If you owe the bank $50,000, you're in trouble; if you owe them $50 million, they're in trouble.

I think the Third World nations now know that.

Mr. MULFORD. Well, I think there's a couple of points to be made there. One is that I think countries that are not necessarily rich in resources can do very well.

Look at Southeast Asia, where a number of countries that do not compare with Argentina, for example, basic resources. They've run economies with the right policies, open markets, incentives, et cetera, and they are not major debtor countries today and they are lent to voluntarily by the banks.

Take the case of Korea, which has almost as much debt as Argentina. It is not regarded as a debtor problem country because it runs a successful economy that carries that debt.

I come back to the question—the key is the economic policies that are pursued in these countries. Latin American countries have further to go to reform their economies than other countries around the world. And it is there that we must apply our assistance and pressure to help them do the right things in their economies.

Senator D'AMATO. I hope the plan addresses some of these problems. I'm somewhat skeptical, but I hope I'm wrong.

Mr. FISCHER. Excuse me, Senator. Could I just pick up on one point you raised?

I think that what you say about they owe us a lot of money, we're in trouble—that's true. Then the question is what do you do about it? Particularly since what we're beginning to see in Latin America and Argentina and Brazil is serious prospects of return to democracy. Walking away from the problem is not something we want to do in those cases.

The amounts of resources that are being transferred into Latin America under this plan are actually quite small relative to what we would lose if we walked away from it. If they wrote off the debt, the American banks would be worse off if there were big trouble, and so would they.

So we're in this situation. We might as well try and work our way out of it.

In fact, exposure in Latin America in real terms is down in the last 3 years. Latin America has been paying back more to us than they've received from us. I think that's part of the problem. I think that the difficulty that the Baker plan does not address is the question of how you get from here to there.

It's clear that 10 years down the road, if they've made those reforms, they'll be better off, we'll be better off, and everyone will be better off. Those reforms don't give you a payoff within 3 or 4 years. And what the problem is is how do we see them through from now to there, allowing them to grow in the meantime?

They've restricted domestic demand very sharply. They have deep recessions and the plans that Mr. Mulford is talking about are ones which will enable them to increase supply. They have to be able to handle demand for the next few years and they actually need more. They need a reduction in their burden to enable them to reach the stage where the U.S. hoped-for reforms come into effect.

Senator D'AMATO. Mr. Chairman, thank you so very much for giving me the opportunity.

Representative HAMILTON. We're glad to have you with us, Senator.

Mr. Mulford, how do you respond to this basic criticism that Mr. Fischer is making, and that is that the Baker plan is OK in the long run, but not in the short run, as I understand it, capsulated?

How do you respond to that?

Mr. MULFORD. Well, I think one has to start by looking at, in the case of the 15 large debtors, as indeed we did, the size of the financing that we believed was required. We analyzed the major economies. We attempted to assume that there would be a positive growth rate of, say, 4½ to 5 percent, which is less than they used to grow at, but it's positive growth and it's more than they're growing at today.

We then looked at their capacity to generate exports, direct investment flow possibilities. We put all this together and we established what we thought was the financing gap to be financed.

This worked out to the amount that we designated from the banks, an increase in their exposure of 2½ to 3 percent. We believe that number to be adequate.

Factored into that number, of course, is the enhanced flows from the World Bank, the MDB's, which is a very substantial increase in their flows, something in the neighborhood of 50 percent, and represents a further $20 billion of new money over the 3-year period after repayments are taken into account.

So, we believe you're looking at, under the strategy, a very substantial potential flow of resources.

My own view is that the more important question is can the countries come up with the economic reforms necessary to unlock these funds, because to say that there's a potential availability of *X* amount of money doesn't get at the problem if they're not doing the right things. I don't think anybody wants to start by saying, we need ultimate, an endless amount of money, in order to finance these guys as they stand today for as long as they care to carry on like that.

That's not our plan. Our plan is that they should reform their economies and we believe that is a financable proposition with the figures that we have in mind.

Representative HAMILTON. But even if you reform those economies, I think Mr. Fischer's point is it's going to take several years, 3 or 4, for those reforms to begin to have an impact.

In that 3- or 4-year period, you're going to have the necessity to grow and you're going to have the need for imports.

How do you handle that?

Mr. MULFORD. This plan assumes that the financing provided and the kind of economic policy measures adopted would enable them to grow at something like 4½ to 5 percent.

Representative HAMILTON. Beginning very quickly.

Mr. MULFORD. Well, I think that the policy reforms, they do come into effect over time. But some have a longer gestation and some are quite quick.

I mean, I don't think you can generalize on that point.

Representative HAMILTON. I'm not sure how all of these elements of the Baker plan fit together. Of course, I agree with you that it's essential that they make these macroeconomic structural reforms. I think that's basic.

How does all of this thing fit together? Is that a kind of a first step, countries must come forward with a comprehensive macroeconomic structural policy reform? That has to be in place before these additional resources begin to flow from the multilateral institutions and private institutions?

Who approves that plan, anyway? How does this thing fit together?

Mr. MULFORD. I think what will happen on the implementation side and, of course, as I said in my testimony, it will be different for the different kinds of countries. Some need only to use a part of the plan. Some need only to, for the time being, enhance their relationship with the World Bank for certain structural adjustment or sectoral adjustment loans.

This can be accomplished in a relatively short period of time. I gave the example of Equador. The Ivory Coast has loans under negotiation. We'll soon sign them. Colombia does. Uruguay is looking into this possibility. And all those countries have their IMF program, or something like it, in place and they have their bank financing in place, their new money package in place.

You're really, I believe, asking about the sort of classical situation where a country—take Mexico or Argentina, because they're both in a similar situation today—either have an IMF program that's about to run out or they must negotiate one. They face in the next 12 months a substantial need for new money from the banks, and they need to enhance their relationship with the MDB's.

So, in a sense, they need all elements of the plan. And I think your question is aimed at how does that fit together?

I think in those cases we will see these countries negotiate standby programs with the IMF and that will be the first order of the day.

Those programs, we hope, will have a greater element of sensitivity in them concerning structural adjustment or growth elements, if you will, although traditionally, the IMF's programs have been balance of payments, stabilization programs of relatively short duration. And we have said that the IMF is not really the place to attack the long-term structural problems. Hence, in the plan, the MDB role was enhanced.

Now it was not our impression, or our intention, to build up the role of the World Bank at the expense of the IMF. The IMF will continue to perform its previous function and we want the World

Bank to perform its function incremental to, on top of the IMF's function.

So, what is likely to happen is that the IMF will negotiate a program. That exercise will determine what the financing requirements are for that country. And it will attempt to design with the country how that gap is going to be financed. In other words, how much of it will come from the World Bank, how much of it will come from IMF drawdowns, how much of it will come from the Inter-American Development Bank, and how much will come from commercial banks.

The commercial banks at that stage will assess the problem and they will look at the program and they will also at that time take a look at what the World Bank is negotiating with the country by way of structural or sectoral adjustment loans, because those negotiations will be concerned with deeper structural problems in the economies. They will take a longer time to negotiate in most cases than an IMF program.

So that will be lagging the IMF program.

Representative HAMILTON. When do the commercial banks come into the process?

Mr. MULFORD. Commercial banks will begin to make their commitments on the basis of the IMF standby program and they will be looking to what the World Bank is negotiating to see whether the kinds of program that the countries are putting forward there are credible. And as you move through time, and this may take a period of, say, 6 months, you will get a pulling together of these various elements and the banks will put up their money. They will negotiate some elements of their financing to fit in with World Bank projects, for example. The World Bank will continue the negotiations with the country on major structural reforms and the entire package will emerge at some point, but probably in phases.

Then the World Bank has the problem of how to phase in its lending in the macroeconomic area, because the World Bank has largely been a project lender and that is a different kind of business.

Representative HAMILTON. Mr. Fischer is very critical in his concluding remarks of the commercial banks. And the managing director of the International Monetary Fund yesterday said that the commercial banks were jeopardizing economic recovery in these nations by cutting back on lending.

Are you as critical as the director and Mr. Fischer of commercial banks, their role in the process?

Mr. MULFORD. We were critical of the commercial banks when we designed the strategy because we were very concerned about the rapid withdrawal of the commercial banks from these countries, because they were not putting up a sufficient net flow of new money to finance adjustment.

So we were very concerned and we were critical of the rate of their withdrawal.

But if you look at the problem from the commercial banks' side, if they don't believe that economic adjustment is being accomplished, if they think capital flight is continuing to be a problem, I think it's perfectly understandable for the commercial banks and their boards of directors to take the view that they want to reduce the rate of growth of their exposure to these countries because they don't think they're putting in a credible performance.

Representative HAMILTON. Have any of them committed themselves to lend additional money thus far under the Baker plan?

Mr. MULFORD. Yes; the Baker plan called for the sum for the 15 countries of $20 billion over 3 years of net new lending to be made visible. And we have had a number of meetings with the banks, not only United States, but others. The end result of that process of consultation with the banks, both by us and between the banks themselves and the various countries, has been that we have received a letter from the U.S. bank which indicates that 95 percent of the banks—the banks accounting for 95 percent of the exposure to these countries——

Representative HAMILTON. The major banks.

Mr. MULFORD [continuing]. Will play their role in the plan. And there have been similar expressions of support in writing by all the major countries' banking systems, either expressed to their governments or to the IMF or to the World Bank. These have been sort of collected.

And I think it's fair to say at this point that the $20 billion is, in principle, visible.

Now the debtors—this is an important element of the plan because if the debtors are called upon to make these though adjustments in their economies, it's important when they do so that they see that there will be new money for them to finance that process at the end of that tunnel. And that's the purpose of making visible the $20 billion. That has been done. And now the countries are moving forward with their negotiations with the fund and with the bank to see if they can come up with the policies to unlock these resources.

Representative HAMILTON. Now none of the major countries, major debtor countries, at this point have signed up for the program.

Mr. MULFORD. Well, we don't expect that.

Representative HAMILTON. I take it—you mentioned Equador a couple of times. That seems to be—that's not one of the major ones, as I understand, but that seems to be maybe the earliest one.

Why haven't we seen Argentina or Mexico or one of the big debtors get started under the Baker plan operation here under the implementation?

Mr. MULFORD. Well, I think that, first of all, we don't expect to see a formal embracing of the Baker plan by the countries or, as I said in my testimony, to see a sort of official starting point of the implementation of the strategy.

This is because the countries—it's an ongoing process, first of all. They are already engaged in various elements of the plan. In the case of Equador, they did many of the right economic policy decisions before the Baker plan was announced. And they have become a very good example of the successful implementation of the plan.

But I think it's a very sensitive issue in these countries. I think it's unlikely that they will wish to come in formal or in a highly visible way embrace the plan.

What they will do is to begin to negotiate the various elements of the plan, and that is already happening. Mexico and Argentina are both in negotiations with the IMF and they are both deeply in negotiations with the World Bank on their lending program for 1986 and they've continued their meetings and negotiations with the banks, and they are coming up with their budgets. Mexico has announced a budget about a month or a month and a half ago and Argentina is in the process of finalizing its budget for 1986.

You will find, I think over a period of time, that there appears certain elements of this activity—loans are signed with the World Bank, announcements are made, et cetera—but over a period of months, there will be a coming together in these large cases of the resource package necessary for them to continue their adjustment.

But it will take some time to become a highly visible process.

Representative HAMILTON. Congressman Scheuer.

Representative SCHEUER. Thank you very much, Mr. Chairman.

I wonder whether in this ongoing business of helping these countries out of the morass into which they've sunk, are we talking basically about private finance through a private banking system? Or are we really talking about public finance, where the taxpayers ultimately are going to be on the hook?

And when the Government, in effect, raps knuckles and twists elbows and engages in a certain amount of jawboning in the banking community, why they haven't maintained continuity in these loans and why they seem to be withdrawing—are we, in effect, telling the banking community, well, since we're telling you what to do and, in effect, robbing you of your right under a free enterprise system, and the normal interplay of market forces, to withdraw from these loans, and there's a certain amount of moral coercion here—in effect, we're the guarantor of those loans. You're not going to have to pay for your mistakes of the past.

Are we really talking about private finance or are we basically talking about the taxpayers coming in and underwriting all of these egregious mistakes of the past that Senator D'Amato spoke of?

Mr. MULFORD. We definitely are not talking about the taxpayers coming in and underwriting these mistakes of the past.

The source of funds is largely private. There are funds coming from the IMF and the World Bank which are institutions which we fund in the normal course of our business. And they are using the resources from the United States and other countries that they have for their normal lending programs.

There is no subsequent claim by them on taxpayers' money beyond what has been paid in and what is callable capital in those organizations.

When you talk about undermining the private system, you touch on a very sensitive point, because we have, in designing this strategy, taken pains to converse with the banks, to encourage the banks, to try to give new momentum to this process, this difficult process to restore an element of hope and a better prospect for growth in the countries, but without taking over the private credit decisions of the banks.

We are twisting no arms among the banks. We have said from the beginning that the banks will only participate in this strategy if it is in their interest to do so. It will only be in their interest to do so if their clients, the countries, are improving their creditworthiness. They will only improve their creditworthiness if they undertake the reforms we've talked about. And if the countries do not undertake the reforms, we are not pushing the banks to put up new money.

We think it's in the banks' interest to do so.

Representative SCHEUER. Now wait a minute. Haven't the banks come under some Government criticism for having failed to renew loans, failed to rollover loans, for having withdrawn some of their capital from Latin America?

How can you say that you're not pushing them?

Mr. MULFORD. We have made to the banks what I think is a very logical and in no way a coercive point; namely, that the banking system is very heavily exposed to these countries. It's important if adjustment is to be accomplished that it be financed.

If the banks withdraw in terms of lending new money too quickly, they are going to contribute to a serious problem down the road that will make their problems even worse because they will still have exposure to those countries and they will at that time have to step up and lend to countries that are in worse shape——

Representative SCHEUER. Why will they?

Mr. MULFORD [continuing]. At a time when they are themselves more heavily exposed.

Representative SCHEUER. Looking at it from the point of view the interplay of free market forces, why will they? They might just write off some of those and collect what they can and decide that the whole adventure in Latin America was a misguided one and that the economies are so unstable that there's really no hope of making good on those loans.

And they may be right. And there may be a legitimate government role to say, as a matter of national policy, we have to continue rolling over these loans, and we're going to help you do it.

But I just wonder whether, in the face of a clear national and international interest in keeping these economies going in some way, we aren't making the problem more difficult by relying on a free market system that doesn't seem to want to do that. And if it doesn't want to do that, maybe we ought to find another means of finance that does want to do that.

And it doesn't seem to me you're going to achieve a heck of a lot by calling this private finance when it's really public finance. And you're preventing the kind of oversight that Government could give this thing and that several committees of the Congress should give it, when what you're really involved in is public finance, what you're involved in is really public damage control.

Do you see what I mean?

Mr. MULFORD. I have to disagree that it's public finance. It is not public finance. No U.S. taxpayer's money has gone in here yet.

Representative SCHEUER. You don't think there's any likelihood that in the future, these banks are going to come back to you and back to the Congress and say, look, you really sort of made us do it.

You made me love you—do you remember that old song?

Mr. MULFORD. Yes.

Representative SCHEUER. I didn't want to do it. I didn't want to do it. You made me love you.

Do you remember that song? [Laughter.]

Mr. MULFORD. There is no implied guarantee or backup to the banks in this strategy which says, you go ahead and lend and we'll stand behind you.

That is not there and the banks understand that. The banks are still on their own.

Representative SCHEUER. I get the sense Mr. Fischer wants to say something.

Mr. FISCHER. Yes; it's a good thing that Mr. Mulford can't confess to twisting the banks' arms. But it's pretty clear that they're twisting the banks' arms in the banks' own interest.

The banks have been receiving net payments from Latin America in this period. They're increasing their exposure at very small rates and they're being paid 10 or 11 percent a year.

So they are making a good deal at the moment out of this whole set of arrangements in which the countries are repaying, continuing to meet their payments, and they're increasing their exposure at a slow rate.

The alternative for them, if they don't like this scheme, is to face the possibility that the countries will default. Then they'll get zero.

So I don't think that the banks don't have the interest. I don't see why they need a guarantee. They're doing fine out of the present system. They went into this because they knew that if there was trouble and they were in on a big enough scale, the international institutions and the Fed would bail them out.

That's what's happening.

Representative SCHEUER. That's just what I'm saying.

Mr. FISCHER. No, but——

Representative SCHEUER. And have we, in effect, joined hands with them in validating that underlying assumption of theirs that no matter how egregious their mistakes and their greed and their stupidity and a heck of a lot of other elements in that mix that produced this situation, now they have a right to say, just as you said——

Mr. FISCHER. No, no. But they can't complain to Mr. Mulford that you're telling us to go in when they knew this was going to happen and when it's in their own interest to go in.

Representative SCHEUER. It might have been in their own interest, they may have thought it was in their own interest to go in, but they obviously have had, and are having, some very sober second thoughts.

Mr. FISCHER. No.

Representative SCHEUER. Our question is, from here on in, is it public finance or is it private finance? If it's private finance, this Congress really doesn't have much of an oversight role, except to protect the depositors and make sure they're not squandering depositors' and shareholders' money.

If it's public finance, we have a much larger oversight role.

What is it? Is this fish or fowl or good red herring?

Mr. FISCHER. This is what they call in Boston a sea and turf restaurant. [Laughter.]

Representative SCHEUER. A what?

Mr. FISCHER. It's fish and fowl, both. There is a Government role because we influence the policies of the IMF and the World Bank——

Representative SCHEUER. Well, if there is——

Mr. FISCHER [continuing]. But it's not an extra-Government resources and there cannot be any, and there should not be, and Mr. Mulford has said there isn't and there's no need for one, a Government guarantee.

I don't see why it's needed and what right the banks would have to say that.

Mr. MULFORD. There's not even an implied guarantee or moral backing.

Representative SCHEUER. There is or is not?

Mr. MULFORD. There is not an implied guarantee or a moral backing for the banks suggested in this scheme. We must be very clear about it. It does not exist.

Representative SCHEUER. Do you think all these banks that are going in sort of reluctantly, sort of against their will at your urging, feel there is no implied moral backing——

Mr. MULFORD. I don't believe the banks are going in against their will because, as I already said, they know what the future looks like. They know that their exposure is very large. They know that if there's a difficulty down the road, they're going to face a very tough decision and have to go in, anyway, or, as you say, turn around and write it off.

And we have not said to the banks, don't write anything off. If they want to write something off, we're perfectly happy to see them do that. But I think you'll find if you talk to the banks that they see their exposure as so large, as really impossible to write off in one fell swoop without really severely damaging themselves.

Representative SCHEUER. That's absolutely true. A number of these banks have gotten in way over their heads and if they had to value those loans properly and write off some of them, their balance sheets would give their shares a very different market valuation than what they have now, the value of those loans at 85 percent.

Let me go on to one more somewhat different question.

Mr. MULFORD. Sure.

Representative SCHEUER. Mr. Mulford, you referred in your statement—in the beginning of your statement, you mentioned that we were encouraging them in support of growth-oriented policies. Toward the end of your statement, you mentioned the same phrase, "growth-oriented economic program." And then you mentioned "substantial economic reforms in their economies to contain capital flight and restore growth."

Some people, myself included, feel that one of the big sources of instability in Latin America, or elsewhere in the Latin American world, but certainly in Latin America, both political and economic instability, is the question of underemployment and unemployment. Going from the global region—the World Bank and the international labor organizations tell us that by the year 2000, which is now a short 14 years off, the developing world is going to have to find somewhere around 600 or 700 million new jobs just to stay even with where they are, at approximately a 50-percent rate of unemployment.

All Latin America by the year 2000, all Hispanic America, is going to have to find about 4 million new jobs a year.

Now the United States, in the halcyon days of the 1970's, with a GNP approximately 10 times that of Central and South America never created more than 2 million jobs a year.

So, just to stay even with where they are in terms of unemployment, destabilizing political economic effects of unemployment, they're going to have to do 10 times better than they've ever done before.

It costs $10,000 a job, to create a job in Egypt; it costs $25,000 to $50,000 a job to create a job in Mexico. Taking it at $1,000 a job—you're talking about 600 or 700 million jobs, you're talking about $600 or $700 billion, close to a trillion dollars that they would have to invest there in the next decade.

That's astronomically beyond anybody's wildest dreams.

Yet, if you look at the kind of economic development programs that have been funded both by the private community and by the World Bank and the Regional Development Bank, you'll find that in these countries where employment is desperately needed, where capital is scarce, they're engaging in capital-intensive economic development that's laborsaving. And they've been doing it year after year after year after year.

The last thing they need is laborsaving economic development and the last thing they need in the countries where capital is desperately scarce, where they have a terrible flight of their own capital, is capital-intensive development.

What they do need is some kind of an approach that includes the concept of appropriate technology, intermediate technology—call it what you will, there are lots of good names for it.

And this is nothing that I just thought up this morning. This is being talked about a great deal.

The typical economic development in Latin America doesn't use much in the way of raw materials from that country, doesn't use very much in the way of labor from that country. It doesn't produce a product that's appropriate to that country or that they really plan to market or merchandise in that country. They don't use raw materials. They don't use local raw materials, labor, and they don't produce a product for international trade.

They're mostly controlled by the elites of those countries and, in effect, they're piling up all the fertilizer in one very small corner of the field and very little of it gets out to fertilize the whole field.

These economic development projects have very little impact on individual living standards, with the result that when you talk about gross national product and even per capita income, per capita income figures in Venezuela and Mexico are a fraud. You simply cannot take their gross GNP and divide it by the population and say, this is their per capita GNP.

It ain't like that. It doesn't work that way.

Most people are not very much affected by most of the economic development that takes place.

Now when you talk about growth-oriented economic policies, and substantial economic reforms in their economies, growth-oriented economic programs, can you think of any way in which the private banking community can factor into their loan programs some kind of scrutiny as to whether they're appropriate programs for that country and whether they're at all addressing the question of job creation, of whether they're really going to affect the economy of that country?

Are they going to use local labor? Are they going to use local materials? Are they going to produce something that is of benefit to that country, that that country needs? Or is it all going to end up in Swiss bank accounts owned by the fortunate elites that really control the destinies of those countries?

Mr. MULFORD. Well, you've asked a very comprehensive question. In fact, you may have blinded me with statistics. But let me try to give you a response to that. I'm sure Mr. Fischer can respond rather better.

But you have, I think, in describing the situation, in many of your comments, really touched on what the essential problem is and on the need for economic reform, which means, in shorthand terms, opening these economies, letting market forces play a greater role, operating in their foreign exchange policy and in their interest rate policies, for example, in such a way as to create real returns in their domestic economy for their own people, therefore, encouraging them to have the confidence to keep their capital at home, or at least some large portion of it, to open their economies to direct investment from overseas on a free basis so that foreign investment can come in, earn a fair return—you can own more than 50 percent of a local company. You can have 100 percent, if you like, for example.

These are economies, for the most part, which have been very heavily state influenced. They have created enormous state enterprises which are highly inefficient. And they have done that, in part, at least, they say, to help create jobs, but, in fact, it works the other way because these enterprises, although they may have a number of employees, are very inefficient and when it comes time to reform them, cut them back, it produces a contribution to unemployment at that point.

Whereas, if those enterprises could be privatized and there was a greater dependence upon supply-side actions to mobilize savings and foster more efficient investment in these economies and market-opening measures of the type I've mentioned, you would, in my opinion, get the kind of grassroots economic development that we have already seen in many Southeast Asian countries, where the model is clear toward giving free market forces some reign and encouraging individuals to become entrepreneurial in their own right.

The results in Southeast Asia have been pretty interesting. These are countries, of course, with high populations, overcrowding, and so on. And yet, they've made very considerable progress.

Representative SCHEUER. Far less in the way of natural resources than many countries in Latin America.

Mr. MULFORD. That's right. So, in my view, we are attempting in this strategy to emphasize and to encourage among the countries the recognition that this is the way to go.

The commercial banking community, which you asked a question about, feels very strongly at this point that these kinds of reforms must be accomplished because they see in the past 3 years that they have put up new money packages and that a large proportion of their new money has fled the country, has helped fuel capital flight.

They take the view that they've learned some lessons and they don't want to see this go on. So they're going to insist that the IMF and the World Bank, where the negotiations over what these broad structural reforms are going to be, will take place.

The banks are going to watch this process very carefully and insist that there are credible reforms in those programs before they put up their new money to go along with them.

That is why, and I come back to the point of implementation and the feeling that there's not much momentum or you don't see any major events taking place in the debt strategy—the reason for that is that there is a very tough, long-term negotiation now commenced between the debtors and the IMF and the World Bank and the commercial banks and various participants in the strategy to try to see how this is going to work out. It's going to take time.

If you're the World Bank and you're going to lend more money to a country, you don't accomplish reform in the country by putting the money up front and just saying, here, just take some more money. I mean, we all know that.

What happens is you express the willingness to do more, provided the debtor is willing to put his house in better order. There's going to be a negotiation whereby, overtime, the debtor is going to have to respond or he's not going to get the money.

Representative SCHEUER. Now let me just narrow my question and repeat the focus.

Does your definition of putting their house in order of a particular country in Latin America include some scrutiny of whether the particular investment that the World Bank or the Regional Development Bank or the IMF is being called upon to support, in an appropriate kind of development looking at that country's overall needs, specifically its scarcity of capital and its superabundance of people?

And is some kind of appraisal going to be given to—well, with underlying, barely rebuttable presumption, just barely rebuttable, that if it's a country with enormous labor excess and very scarce capital, with its own domestic capital in flight, that a capital-intensive laborsaving, economic development project is probably not going to help that country very much. It's not really designed to meet the needs of that country. Either its economy or its polity.

Where are we factoring this into our scrutiny of perhaps loans in the private sector, but surely loans from the IMF, the World Bank, and the Inter-American Development Bank?

Mr. MULFORD. Well, I think the answer to that question is that, from the World Bank, in the project area, which is the traditional lending area of the bank, there is obviously an important consideration in making a project loan on what it does for employment in that project and in that sector and so on.

That's an ongoing business and I agree with what you're saying there and I'm sure our policy is to encourage these loans to be efficient.

But in the lending area we're talking about here this morning, where there is a sector or structural adjustment loan that is not a project loan, it is tied to a general one sector or two sectors with macroeconomic policy reform and structural reform within those sectors as the major aim of change.

There, obviously, I think, one has to tie the loan to broader reforms.

It may be that a reform will be needed in a sector which will increase unemployment temporarily because, for example, in the financial sector in Argentina, they have a highly inefficient banking system—too many branches, highly inefficient. They're going to have to shrink that, make it more efficient. That means people are going to move out of that sector and have to find employment in other sectors.

In agriculture, they have a system in Argentina with regard to the export of a product which is very onerous to the farmer-producer because as he becomes an exporter, the government take on his return is very substantial.

They're hoping to do away with that policy. But in order to get the revenue to replace what they lose, they are going to turn to a land tax, and this is a very important political issue. It takes time to negotiate that, but that is thought to be a better solution to that problem and, in the long run, to encourage greater agricultural production and employment than the system they presently have.

I give that as a simple example of how this works.

Representative SCHEUER. Mr. Fischer, do you have any thoughts on that?

Mr. FISCHER. I absolutely agree with Mr. Mulford. I was bearing in mind as you talked, the example we had in the United States, I think only 10 years ago. The topic was the capital shortage that was facing the country in the next 10 years. There were many articles about how we needed a billion billion dollars for modernizing this, that, and the other, including all the electricity-generating plants in the country.

Well, it didn't happen and that's because we let prices work. You need to let the market system work down there.

I think that there is actually pretty careful scrutiny in the World Bank and the IMF of these programs. I think the programs that are agreed to, particularly on the World Bank side, are usually careful, well thought out. It's the implementation which is politically difficult, where the problems arise.

Representative SCHEUER. I've had talks with Bob McNamara about the operation of the World Bank and this very problem and he makes no bones about it, that the World Bank is constantly under pressure from members of the board of directors from those member countries. What they want to finance are capital projects where their own countries can sell steel mills and pulp and paper mills and petrochemical plants—design them, sell them, build them, operate them.

He makes it clear that these labor-intensive programs have very tough sledding. And he gives you an example. He said, if you were a top official in the World Bank or the IMF and country *x*, a developing world country, came to you, or you had a project for designing a $2 billion steel mill there, or you could do 2,000 $1 million rural labor-intensive factories to produce widgets or squidgets, or whatever, would you rather, as an executive of the World Bank, would you rather approve one $2 billion steel mill that would be designed by the Germans and built by the Japanese and run by the Swedes, very savvy, sophisticated Western technologists and managers, or would you like to get into the exercise of trying to find 2,000 competent, honest managers of rural labor-intensive employment projects?

That's part of the problem of engaging in the kind of policymaking that I'm talking about.

Mr. Chairman, can I have time for one more question?

Representative HAMILTON. Certainly.

Representative SCHEUER. OK. One more question while we're talking about these broad policy discussions.

I just came back from a trip to the Mexican border with the Select Committee on Narcotics. We were told down there by the Mexican immigration officials that we have 600,000 legal immigrants over that border, but approximately 2 million illegal immigrants annually over that border.

And we spent a number of days discussing the vast flow of drugs from Latin America over the Mexican border into our country. I'm not going to go into details, but I'm talking about heroin, cocaine, and whatnot. Some of it produced in Latin America, some of it produced in Mexico, but most of it flowing across the Mexican border.

Does it seem reasonable, without focusing on Mexico, but focusing on the Latin American drug-producing, drug-shipping countries that you're perfectly well aware of, does it seem reasonable, when we're giving them vast financial assistance, both public and private, to establish some kind of conditionality, to use the carrot and the stick approach and say, look, we want to help you, but we need some help, too, with kids in our communities who are injecting all these awful substances into their systems, destroying lives by the thousands, devastating the quality of life in our cities, creating crimogenic communities.

Do we have the right to tell them, look, we want you to get your act together on this whole drug scene, while we're helping you with tens, if not hundreds, of billions of dollars over a decade at this time?

I'd be interested in hearing from both of you.

Mr. MULFORD. Well, I think that in those countries where we have this problem and where we have, as a Government, a financial relationship, a bilateral relationship, where funds, aid funds, are provided and so on, I think we do discuss regularly that problem and we seek to improve in any way we can their awareness of the problem and their ability to shut off at the source the problem that arises in their country. And I think that's perfectly appropriate to have, as a condition of that aid, progress in those areas.

If your question is, do I think that that should be expanded to the general question of the debt problem, I would say that that's very, very difficult to do and probably undesirable because the debt problem is a broad international problem which requires the cooperation of international financial institutions that are owned by all the world's governments, by banks that are spread all through the world, that are in syndicates working under agreements with those countries and where it would be very, very difficult and I think undesirable to insert essentially a bilateral, political issue into that whole process.

And I don't think we need to do it because I think our leverage on a bilateral basis and with aid flows and so on is sufficient to gain the results we want without turning to that.

Representative SCHEUER. Mr. Fischer.

Mr. FISCHER. Yes; I think that's right. And furthermore, it's when their economies become stronger that they'll be more able to handle the drug problem. It has an economic dimension. It provides employment in those countries. If their economies pick up, they'll be better able to——

Representative SCHEUER. By and large, it's pretty labor-intensive employment, too.

Mr. FISCHER. One of your ideal projects?

Representative HAMILTON. Your gentlemen have been here quite a while. Let me try to wrap up things very quickly here.

Mr. Mulford, do you have any suggestions to us, any clues for us about the U.S. nominee for the World Bank president?

Mr. MULFORD. No; I have nothing to say on that, Mr. Chairman.

Representative HAMILTON. All right. Second, you say in your statement, we are prepared to look seriously at the timing and scope of a general capital increase for the World Bank.

At what point and how much?

Mr. MULFORD. That's a question that's impossible to be specific on because the basis of our position at the moment and this has been, I think, widely accepted throughout the world, is that the present debt strategy calls upon an enhanced role for the World Bank, and we've defined how big that role is. And we believe, and I think it's widely shared, that this belief is correct, that there are resources presently in the World Bank to carry out that enhanced role as presently visualized.

Representative HAMILTON. Including the extra $2 billion higher that Secretary Baker called for yesterday?

Mr. MULFORD. I'm sorry. What was that?

Representative HAMILTON. Well, it's reported in the press today that Secretary Baker told a meeting of bankers and business leaders yesterday that overall lending for the World Bank should go up another $2 billion over last year.

Mr. MULFORD. Yes.

Representative HAMILTON. That would not require——

Mr. MULFORD. No; that does not require——

Representative HAMILTON [continuing]. The U.S.——

Mr. MULFORD. That is correct. The resources are there for that increase to take place.

In the past year or two, there has been a substantial underlending by the World Bank below its targeted levels and there's ample resources for the World Bank to carry out its enhanced role.

Now, as I've already said, this is going to take time to implement this new role in a very complex situation and we have said publicly and privately to the various countries that when the debt strategy is up and running and the enhanced resource flow is actually taking place, which is going to take some time to negotiate and get in place, but when that's actually happening and those resources are being drawn down by the World Bank and put into use under this program, we will at that time look at the timing and size and scope of a capital increase and we said we would look favorably upon that.

Representative HAMILTON. And that's not likely to occur in 1986.

Mr. MULFORD. I don't think so, no, sir.

Representative HAMILTON. Mr. Fischer likes the idea of requiring the banks in any future agreements to use the LIBOR rate.

What do you think of that?

Mr. MULFORD. Well, we've said the same thing there because I made a correction when I think you may have been out of the room, because I didn't want it to stand in the record.

The debt initiative did have in it with regard to the commercial banks the suggestion by us to them that they should consider cutting their spreads, reducing their fees, and taking the expenses that are accumulated in the negotiations and legal processes, et cetera, and instead of billing the countries for those, to absorb those expenses.

If they were to follow that advice, that would have the effect of reducing the interest on these loans to the LIBOR rate because the spread would be eliminated, the fees would be eliminated, and the expenses would be absorbed by the banks.

So we're really saying the same thing. It was a suggestion by us without dictating to them. We didn't put ourselves into their business. We said, we would suggest that you look at this because this is a way to reduce the burden for the debtor countries without violating the interest rate levels in the market and reducing in some false way interest rate levels.

Representative HAMILTON. Now it's my understanding that the Baker plan can be implemented, then, without any additional taxpayer liability.

Mr. MULFORD. That's correct.

Representative HAMILTON. Mr. Fischer, do you have any concluding remarks?

Mr. FISCHER. I'd just like to comment on what Mr. Mulford said at the end—I have two comments. The first is that that's very important. That's not a generally known fact that the Treasury has made that suggestion. It is equivalent, given that the average rates are about 2 percent above LIBOR, to a reduction of 2 percent in the interest rate these countries would pay.

That reduces their interest bill by a very large amount, something like 1 percent of GNP. That's substantial relief.

Now I don't think that the borrowing countries knew about this and it's something that's very worth emphasizing and important that it came out.

Mr. MULFORD. I'd like——

Mr. FISCHER. Sorry.

Mr. MULFORD. Can I make one point there? I'm sorry to interrupt you. I think it's also worth pointing out that the spreads that applied to these loans in the past have been reduced during the reschedulings that have been negotiated.

So there has already been some reduction in spreads.

I would say the reason you haven't heard a lot about the other comment is the banks have not talked it up. [Laughter.]

Mr. FISCHER. The other thing I'd like to say is much of what Mr. Mulford said was very encouraging. The one part that was mildly discouraging was that the Treasury was not envisaging a change in the relative roles of the IMF and the World Bank. And the description of the processes all started with the IMF.

The IMF has a very simple strategy for handling most problems, which is cut the Government budget deficit, devalue, and call us tomorrow and things will be fine.

This is a much more subtle process that we're trying to get underway now—curing short-term problems and restarting growth.

The IMF doesn't know how to do that. If there is expertise anywhere, it's in the World Bank. I think that we should be thinking, and the United States should be thinking, of how to shift the power a little bit away from the IMF.

Representative HAMILTON. My impression from Mr. Mulford's testimony, and correct me if I'm wrong, is that in this process, you see an enhanced role for the World Bank, do you not?

Mr. MULFORD. Yes; I think, to clarify that, because the point is an important one, both the IMF and the World Bank have an important role to play. The IMF has been an effective performer of certain parts of the function. We don't want to lose that. They've been an important player in setting a stabilization program behind which the banks have been willing to come in and finance.

We don't want to throw that out the window. We think the IMF has done a good job in many, many respects.

We are asking that the IMF sensitize itself a little more in its program to various growth policies and structural changes. I've made that comment in my remarks, and try to sort of broaden their perception of the problem. But we recognize the IMF has its own role as the world's international monetary institution. We do not wish it to become a development institution.

The World Bank, we hope, will enhance its role, that it will be an important role over and above the role of the IMF. But, as perhaps I didn't make clear enough, they will work increasingly closely together, we hope, to come up with a framework for these programs, in the case of the big debtors, where there has to be a full-fledged utilization of the plan, to effect greater coordination there. So that the World Bank contribution can come earlier in the process and can play a more important role than it has in the past in the assemblage of all the resources.

So I hope that makes a clear exposition of our view on that.

Representative HAMILTON. I think we've had a good hearing this morning. I want to thank my colleague, Congressman Scheuer, and the other colleagues who have now left, and especially Mr. Fischer and Mr. Mulford.

Thank you very much.

The subcommittee stands adjourned.

[Whereupon, at 12:20 p.m., the subcommittee adjourned, subject to the call of the Chair.]

O

60-668 (64)