Market Solutions to the International Debt Crisis and its Impact on the GCC Countries (1)

The international debt crisis cast a shadow over the international economic system after 1982. This crisis threatened at an earlier stage to severely disrupt the international financial system. A combination of financial innovation and cooperation through the International Monetary Fund (IMF) and the World Bank, in addition to measures taken by national monetary and supervisory authorities, protected the banking system from the repercussions of that crisis.

During the seventies, international borrowing was accepted as one solution to the financial problems of developing countries and international banks aggressively encouraged borrowing. It was a method of utilizing the perceived present value of these countries' natural resources. Developments in developing countries related to these debts had not been promising during recent years. Among these domestic developments were the decline in the prices of raw materials and the inability of the economic management in some of these

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countries to face these developments. Some international factors, such as interest and exchange rates, negatively affected the volume of these debts, including the debt service burdens. These developments changed perceptions, especially those of commercial banks, about developing countries' debt.

The debt problem was mainly the outcome of an overall strong credit expansion by international banks during the 1970s. This expansion came to an abrupt stop in summer 1982, when Mexico announced it could not service its US$ 80 billion international debt without a new loan of US$ 3 billion. Mexico was regarded as a minimal credit risk because of its abundance of natural resources.

Soon after the Mexican shock, other countries including Brazil and Argentina announced that they could not meet their scheduled payments either; thus the international financial system was faced with a great crisis.

Total Third World debt at the end of 1988 was estimated at US$ 1239.7 billion, mainly for the commercial banks. The total debt was expected to grow to US$ 1279.0 billion at the end of 1989, and to grow further to US$1336.6 billion at the end of 1990. For nearly five years, commercial banks, which held 60 percent of this debt, were very cautious about providing new funds; therefore, repayments were exceeded new loans. Consequently, financing gaps have increasingly appeared for the developing countries.

While sustaining stable economic growth in developing countries required that financial resources from the industrial countries be made available to these developing countries, the world economy still felt the effects of this debt problem. The problem could have been solved theoretically if the debtor countries had succeeded in gradually “growing out” of their debts through sustained economic growth. The Baker Plan, first announced at the IMF and World Bank Annual Meetings in Seoul in 1985, was based on providing structural reformation and a change in policies in individual countries. The effectiveness of this strategy depended upon many factors, three of which were prices of raw materials, expansion of world trade and suitable levels of interest and exchange rates. The main thrust of this strategy was to curb the negative factors affecting developing countries’ debts because of the noticeable decline in the prices of raw materials during those years, the appearance of commercial barriers facing the exports of the developing countries and the negative effects of changes in exchange rates on the exports of these countries, in addition to the contractionary monetary policies of the industrial countries and their impact on increasing interest rates and the volume of debt service.

The main objective of the debt strategy, namely achieving an increase in the growth rates of the indebted countries, did not materialize, but and the same time the early fears of the impact of the debt crisis on the international financial system lessened. Although the debt service ratio and the ratio of debt to exports had been declining since 1986, the total value of debt was expected to grow. So, the debt problem still represented a severe burden for many indebted countries, as well as a potential source of instability in the international banking system.

While the issue of sovereign debts was left to the Paris Club and bilateral arrangements between creditor and debtor countries, the financial markets sought to alleviate the impact of the crisis on international banks by innovating instruments to convert debts into other types of assets. Moreover, supervisory authorities intensified their efforts to support banking systems and protect them from the fall-out of the crisis by developing capital adequacy requirements for banks that were linked to their risk-weighted assets, and increasing the provisions that banks were required to maintain against loans. These criteria and requirements differed from one country to another.

In this way, banks reduced the risks of debts that were threatening the international banking system. They initiated early procedures to face the problem through modifying their utilizations' structure. Most banks strengthened their capital base and improved the quality of their assets. This helped them to build up provisions leading to marking down the book value of their debt exposure, in addition to decreasing that exposure.

Though these banks were reluctant to write off debt, there was a tendency for securitization of the debts by means of converting them into financial instruments negotiable in secondary markets at discounted prices. This conversion was achieved with innovative technical methods including the determination of the value of the securities resulting from the conversion of debt on realistic basis reflecting market prices. Part of this debt was translated into direct investment in the debtor countries.

The increasing efficiency and maturity of the international financial markets encouraged conversion and gave rise to available improved alternatives to convert debts and to decrease their volumes. These financial markets have managed to develop several basic techniques to treat debts and their interest and convert them into different types of assets:

First: Debt-equity-swaps

This technique allows the foreign investor to invest in debtor countries. The first step is to purchase bonds expressed in foreign currency issued by the debtor countries at market value. Then, the central bank of the debtor country purchases the bonds for local currency. The investor, in turn, will use the local currency in direct investment in local companies and projects. Debts of the local currency expressed in foreign currency can be translated into equity in local currency. This technique encourages direct foreign investment in the indebted countries, and thus helps to stimulate growth and to decrease obligations expressed in foreign currency.

Second: Securitization

This technique allows the conversion of the debt into negotiable securities, so a creditor bank is allowed to exchange loans at prices far less than their nominal values. Market valuation of such securities depends on relative interest rates compared to other similar instruments and on market assessment of the risk associated with these instruments.

Among methods of conversion are “Zero Coupon Bonds”, which are issued with long-term maturities and discounted prices. The investor realizes his returns at maturity. Other alternatives have been developed to take advantage of the different degrees of risk and returns, as well as taking advantage of the taxing systems available in the main creditor countries.

Third: Cash Buybacks (Debt Repurchase)

These techniques allow a debtor country to buy its debts back from commercial banks at market value, usually at a steep discount. The problem in this case is to find the sources of finance for such buybacks. As a matter of fact, certain countries have used part of their foreign reserves for that purpose. In addition, some loan agreements contain clauses that restrict early redemption at a discount, and buy-backs require that banks jointly agree to waive these clauses. It is worth mentioning that the agreement between Mexico and its creditors allowed creditor banks the choice from different alternatives that provided various merits for the concerned parties.

Additionally, banks strengthened their own funds and raised their levels of provisions against difficult debts. After 1982, the international banks, including Kuwaiti banks and other banks in the GCC-countries, made significant progress in dealing with the problems caused by a number of countries' failure to service their international debt. With supervisory encouragement this was achieved in two ways:

1- Many banks built up a substantial portion of their provisions against the risk associated with such debts. The form and ratios of these provisions varied, reflecting different supervisory and tax policies in the concerned countries, despite the difficulty of making relative comparisons among leading banks with regard to the degree to which exposures were covered. However, some international banks exceeded 50% of the required provisions against difficult debts.

2- By a combination of increased reserves and new issues of equity and other capital instruments, banks increased their own funds. As claims on debtor countries were stabilized, this growth in capital served to diminish the scale of country risk compared to the position as it stood in 1982.

While discussing the impact of these developments on our region, we should indicate that we were not a key partner in determining the method of solving this crisis, because bank claims on these debtor countries were relatively small. Nevertheless, our banks and other financial institutions in the GCC countries were engaged in lending to the developing countries during the 1980's. These banks built up the required provisions against their loans to such countries. In addition, some of our institutions participated in rescheduling and selling their foreign loans.

The international banks which encouraged the great credit expansion of the seventies are not located in the Middle East, and the innovations related to financial instruments were created elsewhere. However, from my point of view as a central banker, I see clear merits for not having taken a substantial role in that problem. For example, we were spared the worries that exist at monetary authorities in international financial centers about the implications of the new financial instruments on monetary policy and its effectiveness, and about the impact of the problem on the solvency of the banking system.

The positions related to solvency and capital adequacy of the GCC banks were not different from those of banks in the industrial countries. The capital adequacy of the GCC banks was quite comfortable when measured according to the Basle Committee. Here in Kuwait, we had already reached more than the proposed percent ratio of own funds to risky assets required for the industrial countries according to the Basle Committee criteria, without counting undeclared provisions and hidden reserves of our banks within the capital base.

In our Arab region, many countries with large debts had affected substantially by the international debt crisis. Although the debt service ratio of some of these countries exceeded that of Latin American countries such as Argentina and Mexico, these Arab countries did not benefit from the proposed initiatives. Since these Arab debtor countries are middle-income countries, they did not benefit from facilities designed for poorer countries. Also, the concentration of Arab countries' debts on official debt deprived these countries of the use of most initiatives, which concentrated on finding solutions to commercial debts.

Most debt initiatives tended to concentrate on large debtors, who were generally considered middle-income countries with diversified economic resources. Most of their debts were held by commercial banks. About 57% of the African debts and 44% of the Asian debts were held by official creditors, as compared to 25% of Latin American debt.

The problem of official debts did not receive enough attention in the past. Given that most of these debts were concentrated in the poorest developing countries, it was obvious that official parties in the world community had to take the initiative. This was acknowledged by His Highness the Amir, Sheikh Jaber Al-Ahmed Al-Sabah, when he proposed during his address to the United Nations General Assembly in September 1988 a three-point initiative:

First, he called upon all creditor nations to convene among themselves to examine the question of writing off the interest due on their loans to the debtor countries. Such a move should be coupled with giving up a certain portion of the loan principal due on the poorest nations. His Highness expressed Kuwait's readiness, as a creditor country, to attend such a meeting and its willingness to comply with the resolutions adopted. Such an initiative offered a far better approach than leaving it to be resolved on the basis of debtors' demands. It also had its merits in view of the divergent views of the creditors themselves. This proposal, if carried out, would benefit the debtor countries in helping them implement their development projects. It would also had favorable implications for the economic and social activities in both creditor and debtor countries.

Second, he called upon the International Monetary Fund and the World Bank to reconsider their stringent conditions affecting states seeking development assistance from both institutions. He called for amendments that would introduce more flexibility and take the humanitarian factor more into account in such a manner as to reflect the variances among individual states as well as to suit the conditions prevailing in the debtor nations. Ultimately, this would reinforce their development efforts.

Third, His Highness the Amir urged the expansion and regulation of scientific and technical assistance provided by the North to the South. Human resources development is especially important in this context, which would lead to concerted efforts aimed at the conservation of natural and human resources, and to the support of development projects in these countries.

His Highness stressed the importance of a comprehensive general framework for dealing with official debts of the poorest countries during his address to the Ninth Summit of Nonaligned Countries in Belgrade last August. He suggested the following four elements, aimed at expediting a solution:

First, the Secretary General of the United Nations would convene a conference to be attended by the Group of Ten industrial countries and other creditor countries, and with the participation of representatives of the International Monetary Fund and the World Bank. The meeting would consider the necessary basis and criteria for the implementation.

Second, in view of the importance of the time element in this problem, and in order to avoid its repercussions on debtor countries and the world economy, His Highness proposed that such a meeting be held within a period not exceeding six months.

Third, regulations would be set for dealing with individual cases of debtor countries.

Fourth, the meeting should also look into projects and techniques for promoting development efforts, with the active use of scientific experiences, technology from the industrial countries and domestic human resources available in the debtor countries. Such a process should take into consideration environmental issues and improving the productivity of local manpower.

Debt reduction would allow the most heavily indebted countries to concentrate on the process of economic reform and on lifting the burdens of accumulated debts. As for the creditors, the reduction of debts would decrease the risk associated with their claims on debtor countries, and would guarantee themselves a flow of repayments. Thus would emerge the importance of securing a commitment from concerned countries to sound economic policies, as a pre-condition for achieving needed growth rates, essential for solving the debt problem.

Major industrial countries started to face reality and gave indications of their acceptance of the need to revise the debt strategy to include the possibility and the suitability of reducing debts or interest in some cases. This attitude appeared during the IMF-World Bank annual meetings in Berlin during September 1988. This was acknowledged in the plan put forward by U.S. Treasury Secretary Brady in March of 1989. This initiative added to the strategy of solving the debt problem the possibility of accepting debt and interest reductions. It also concentrated on commercial debts, leaving official debts to be handled through the Paris Club as a coordinator for restructuring and rescheduling these debts.

It was conceivable that the major debtors would grow out of their problems through a combination of an appropriate international environment, structural economic reforms and resorting to the various market techniques for debt relief. There were a few countries which some political decisiveness on the part of all concerned parties, coupled with adequate export growth, could have transformed from major financial distress cases into model cases for growing out of the debt problem.

I believe there was another aspect of the debt crisis which was more important in human terms, and that was the plight of the poorest countries, the lowest in terms of per capita income. This issue needed to be solved through the coordination among concerned creditors, mostly governments. The initiative of His Highness the Amir aimed specifically at this group of countries. Other creditor countries took limited unilateral action to help either on their own or in cooperation with the IMF and the IBRD facilities. For example, President Mitterrand declared in 1988 a French initiative aimed at writing off part of the official debts to France of some poorest countries. In addition, Japan contributed additional funds through the IMF and the facilities rendered by Japanese financial institutions, in order to alleviate part of the debt burden of the developing countries; other nations took limited steps in that direction.

We must all learn the correct lessons from the experience of the international debt problem of those years regarding the role of the banking system in the development of the problem, and the method of adjusting the system in order to decrease the risk of the debt crisis. There was a need for a serious and speedy solution to the debt problem, especially that of the poorest indebted countries, with a substantial role to be played by major industrial countries.

While a case -by- case approach was reasonable for each debtor country regarding commercial debts, the special case of the poorest countries required an agreement on a general framework for a comprehensive solution to the crisis faced by those countries.