The Debt-Bomb Threat

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After a decade of go-go lending, second thoughts about the risks

Never in history have so many nations owed so much money with so little promise of repayment. At stake is a gargantuan debt, a $706 billion lien held by banks, governments and international financial institutions around the world against a group of deeply troubled developing and East bloc countries. It is a sum nearly the size of the annual U.S. budget and more than three times that of Japan's; it is $154 for every man, woman and child on earth. It has mushroomed from about $ 100 billion only twelve years ago, keeping borrowers in bondage and lenders in growing suspense. Much of it may never be paid off, and a major default somewhere, somehow, could trigger far-reaching political and economic reactions everywhere. The global economy is sitting on a debt bomb.

The risks, according to U.S. Federal Reserve Chairman Paul Volcker, are "without precedent in the postwar world." Says British Financier Lord Lever: "The banking system of the Western world is now dangerously overexposed. If lending abruptly contracts, there will be an avalanche of large-scale defaults that will inflict damage on world trade and on the political and economic stability of both borrowing and lending countries." The financial community, says Rimmer de Vries, chief international economist of New York's Morgan Guaranty Trust Co., is "in a historic period. There is a lot of worry that things could get out of hand."

In their calmer moments, those involved insist that no such grim scenario will ever come to pass, that the unthinkable will not be allowed to happen, that the debt bomb cannot explode. But it is a fact that for the past 21 months, particularly through a nerve-racking autumn and winter, the bomb's fuse has been sputtering, forcing almost overnight major changes in international lending. Ever since March 1981, when Poland, with a debt of $27 billion, declared that it simply did not have the $2.5 billion due its creditors that year, the danger signals have been flying. Last August, Mexico announced that it could not come up with the interest on its debt of $80 billion; soon thereafter Brazil declared that it was unable to meet payments on its $87 billion borrowings. Last week Brazil told its foreign creditors that it would not make $446 million in payments on principal due in January, but denied that this amounted to a moratorium. Argentina, too, was in the headlines: about five months behind in interest payments on its debt of more than $40 billion, it encountered a delay in securing a crucial $1.1 billion bailout loan from international banks.

The shock of such big borrowers' falling on hard times over so brief a period has been sobering. Though Western banks and governments are rallying with patchwork rescues for Poland, Mexico and Brazil, their efforts are merely short-term answers to long-term problems. More important, each crisis has made it more difficult for other borrowers to raise funds and keep up with payments, hardly a reassuring prospect for a parade of more than two dozen debtor countries in Latin America, Asia, Africa and the Soviet bloc.

The International Monetary Fund (IMF) reports that 32 countries were in arrears on their debts in 1981, compared with 15 in 1975. Yugoslavia ($19 billion) is meeting its obligations, but is seeking more generous terms on future loans. Rumania late last year rescheduled $2.8 billion of its $ 11 billion debt and interest payments. Costa Rica ($3.1 billion) has told its creditors that it cannot produce $270 million in back interest. South Korea ($36 billion), despite its generally strong economy, is being closely watched. And there are others.

Although developing countries borrowed prudently to maintain growth in the face of higher energy costs after the 1973 oil shock, they were beginning to slide into deep debt by the time the second major oil-price hike came in 1978-79. Now they find themselves pinned down by a combination of events, each of which, by itself, would be troublesome enough: a lingering world recession; high interest rates; slumping exports and generally flat trade; increasing protectionism in the industrialized countries; and low commodity prices. Interest payments fall due, and national treasuries must strain to the limits to pay. Everywhere the cost of servicing debt is swallowing an increasing percentage of export earnings. Though some of the biggest borrowers have owned up to their problems, other surprises could lie ahead. A combination of three or four medium-size countries' getting into difficulty at the same time could prove more troublesome than one large default.

The debt threat has raised fears in Western Europe for some time, but was initially dismissed as Cassandra talk in Washington. Only in recent months has the Reagan Administration come around to the view that the crisis is potentially dangerous and unlikely to blow over quickly. As a consequence, the U.S. Government became involved in both the Mexico and Brazil rescues. Last month Treasury Secretary Donald Regan appealed for concerted international action to devise a new "apparatus" to handle currency and debt problems, although he admitted that he was still "groping" for what form that should take. Said Regan: "There must be a better way."

U.S. banks would no doubt agree. Of all the world's financial institutions, none are more deeply mired in the international debt dilemma than they.

Their loans to developing nations and the East bloc now amount to about $130 billion, including $68 billion to Latin American and Caribbean countries. At midyear $52 billion had been loaned to Mexico, Argentina and Brazil alone.

As the U.S. bankers point out, less than 10% of their total assets are at risk to foreign borrowers in trouble. But the figures loom large when compared with shareholders' equity, which, coupled with loan-loss reserves, can be thought of as what a bank would have left if it paid off its depositors and creditors. New York's Chemical Bank, for example, has $1.4 billion on loan in Mexico and $370 million to Argentina, a sum amounting to 92% of its shareholders' equity. Chase Manhattan has loans totaling $2.5 billion to the two countries, 77% of stockholders' equity, and New York's Citicorp, which refuses to confirm the exact figures, has a reported $4 billion, or 85%. On top of that, Citicorp is a very big lender to Brazil, with an estimated $5 billion in total loans. Altogether, the nine largest U.S. banks have loaned out about 130% of their equity to Mexico, Brazil and Argentina. These banks have set aside a total of $3.6 billion in loan-loss reserves, but that amounts to only 12% of their exposure in the three countries.

Some of the smaller regional U.S. banks that have ventured into the foreign market are also vulnerable, particularly those in Southwestern states that have extensive dealings across the border. The Valley National Bank of Arizona, for example, has Mexican loans totaling 60% of its equity; at Texas Commerce Bank in Houston the figure is 36%.

Much of the U.S. loan money has gone not to governments but to private borrowers — in Mexico, 47% of the total— and the debtors include many companies in financial difficulty. Last year Mexican companies missed $600 million in interest payments to American banks.

That shortfall is hitting the bottom line. Robert Albertson, an analyst with the Smith Barney investment firm, estimates that delinquent loans to foreign firms may have lowered fourth-quarter profits of major banks by some 5%. Concern about an earnings drain from bad loans has already helped depress bank stocks. While the stock market has been reaching new highs, shares of Citicorp have fallen 14% since November. Chase Manhattan has dropped 11%, and Valley National is down 26%.

To help cautious investors, the U.S. Securities and Exchange Commission has asked the banks to disclose publicly their potential foreign loan problems. As a result, in their third-quarter reports to the commission, the banks with large loans to Mexico and Argentina were, in effect, forced to reveal their total exposure for the first time. But the disclosures are still incomplete because the SEC did not ask the banks to tell what portion of their loans is to private borrowers as opposed to governments.

Clearly, many regional banks are growing restless about maintaining their loans, much less issuing new ones. Says the president of a small bank in upstate New York, which has a $3 million loan out to the Mexican state-owned oil company: "When that loan matures, it will not be renewed. We had no business getting in there in the first place."

There is ample apprehension elsewhere. Many West European banks are seeking permission to make loans to countries that are questionable credit risks tax deductible. British banks are worried enough to have increased provisions for losses to the largest levels in memory. In West Germany, the national banking supervisory agency is understood to have informally recommended that banks "write down," or unofficially write off, 40% of their sovereign risk loans. Matters are less critical in Japan, where the Ministry of Finance makes certain that banks do not lend more than 30% of their capital overseas. But even Japanese banks, which had a total of $81 billion in international loans outstanding in 1981, suffer formidable exposure.

Since U.S. banks have the biggest overseas commitment and more than three-quarters of international loans are made in dollars, there is little doubt in financial circles that should it ever become necessary, saving the world's financial system will fall to the U.S. Federal Reserve. It is the only central bank *capable, in the words of H. Johannes Witteveen, the former managing director of the IMF, "of creating the necessary liquidity." In effect, the Federal Reserve would have to pump in the dollars that a troubled U.S. creditor bank needed to survive, even to the point where it could fuel inflation in the U.S. Says Salomon Brothers' Bruce Brittain: "The international debt crisis can be boiled down to a problem of four countries, ten U.S. banks and the Federal Reserve." If things got out of hand, explains a U.S. Administration official, and inflation grew as the result of Federal Reserve action, everyone in effect would be paying a share. "It would be a tax to save the system."

Even if there is no default crunch, the debt dilemma could prove costly. Major U.S. banks no longer get favored short-term interest rates in international money markets, and with the exception of Morgan Guaranty Trust Co., all have lost their triple-A credit ratings in the U.S. bond market, in part because of higher lending risks. Moreover, if the large international banks are saddled with too many near bad debts, they might have less money available for borrowers at home; thus new car loans, personal financing and mortgages will remain expensive. And although the risk of bank bankruptcies is thought to be slight, the industry's profits could be diminished for years to come, and some smaller institutions may have to be guided into mergers.

But there is a larger fear: a surge of defaults could turn the world recession into depression. More than 40% of U.S. exports of commodities and services and one American manufacturing job in 20 hinge on sales to developing countries; similar export figures apply to Western Europe and Japan. The nations that buy many of the industrialized world's goods are the same ones that have borrowed so heavily. Any economic contraction on their part would boomerang back in the form of less demand by them for imports. The resulting deepening recession, so the theory goes, would further hurt the poorer countries, and so on and on. Once started, the process could be difficult to stop.The development dreams of the Third World would come to a halt, markets would tumble, unemployment would soar, and world economic conditions could rival those of the 1930s.

The scope of the current difficulties has caught many in the financial community by surprise, mainly because few expected interest rates to remain so high for so long or commodity prices to drop so steeply. There has been little warning of many debt problems, and the speed with which rescue operations have to be mounted does not leave much time for reflection. Endangered

borrowers put off admitting their problems until the last moment for fear of shattering lender confidence and making matters worse. Once the bad news is revealed and digested, the banks with the largest stake have only weeks, sometimes days, to act. Working against default deadlines, they must agree on the terms of a rescheduling package that gives the borrower more time to repay and is often linked to quick cash injections from governments and the IMF.

Under such circumstances, bankers do not worry about getting their original loan money back on time—something that may come as a surprise to the general public, which, as a rule, is expected to pay back its debts to banks. The bankers' preoccupation with loans to nations is with avoiding default. This keeps interest payments coming, even if at a slower pace. In any case, rescheduling is sometimes good business, because higher rates can be charged as the price for delayed repayment. The difference is important. If the debtor defaults and payments stop altogether, the banks have no choice but to write off the loan as a bad debt, and too many of those threaten a bank's solvency.

The rescheduling process generally is not easy. The debtors need more than a delay in repayment to survive. Most require new loans, frequently large ones, and the biggest banks are in too deep to refuse. "The major banks," says John Mathis, the chief international economist for Chicago's Continental Illinois National Bank and Trust Co., "are in for the long haul. They cannot walk away."

The same is not necessarily true for smaller lenders. Loans to countries usually involve hundreds of banks: 500 have varying-size shares in Poland, 1,400 in Mexico and more than 1,000 in Brazil. Originally attracted to the international lending game by the lure of quick profits, the smaller institutions may be willing to cut their losses and, in the midst of rescheduling talks, balk at throwing good money after bad. Reports a Hamburg banker: "I come into these sessions, and I find all these hillbillies. The big American banks have made the loans and sold parts of them to the little ones. And these fellows, who don't know the Baltic from the Barents Sea, were all crying, 'I want my money back!' "

It is not just that the smaller banks' money will be missed—although it certainly will be. In some credit packages, there exists the risk that one bank might call the borrower in default. Under the terms of many loans, that move could trigger what are called cross-default clauses among other creditors, big and small. As negotiators realized during the Polish talks, it would have been theoretically possible for a small institution that loaned $100,000 or so to bring down that country's $27 billion house of cards. In the case of Mexico and Brazil, the danger was not so acute. Unlike loans to Poland, which were all made to the government, then" debts were scattered among thousands of borrowers. A default on one loan would not necessarily spark a default on others. Still, it could inspire other small creditors to consider calling in their loans. One important resource for the big banks in preventing a cross-default catastrophe is politely described as "peer pressure," the threat that anyone taking such a step would be ostracized forever.

The origins of the debt crisis date back to the first major increase in oil prices by the Organization of Petroleum Exporting Countries (OPEC) a decade ago. Suddenly, a number of oil-rich nations began earning billions of dollars, far too much for them to spend on even the most grandiose of development projects. On the other hand, developing nations that had no oil found themselves sorely pressed to pay for higher energy costs. The answer to the problems of both groups lay in a magic word: recycling. The petropowers deposited much of their excess wealth with the world's major banks, which in turn loaned the money to those who needed it to buy oil or, in the case of East-bloc nations, were eager to modernize their economies. Another major source of lendable dollars was a persistent U.S. balance of payments deficit that left dollars overseas.

The new business was a bonanza for banks. From Wall Street to the financial centers of Western Europe, bankers awoke to the delights of international lending. Eager to win their spurs, young loan officers fell over one another knocking on the doors of finance ministers from Warsaw to Kinshasa. "The international side looked glamorous," recalls David Ashby, chief economist at London's Grindlays Bank. "Bankers like travel and exotic locations. It was certainly more exciting

than Cleveland or Pittsburgh, and an easier way to make money than nursing along a $100,000 loan to some scrap-metal smelter."

Based largely in London, the networks of leading U.S., West European and, later, Japanese, Arab and Latin American banks arranged syndicates of hundreds of smaller banks to put together billion-dollar deals in days. This was often done simply by telephoning around and persuading lenders to take $10 million here and $15 million there. Profits were large, because the typical developing country, a higher-risk borrower, paid a higher interest rate than a domestic blue-chip corporation. Furthermore, the bank arranging the deal normally received a fee of one-eighth of 1%, a cut that produced an instant profit of $1.25 million on a $1 billion loan. So attractive was the business that smaller U.S. regional and West European banks rushed to open representative offices in London. Between 1975 and 1982, more than 60 banks entered the game each year.

Not surprisingly, the young gunslingers, the loan-marketing officers working for such syndicate leaders as Citicorp, France's Societe Generate and Switzerland's Credit Suisse, often paid little attention to whether the borrower could repay. The fact that Mexico sat on an ocean of oil, that Zaïre had mountains of copper was thought to be collateral enough. Annual bonuses and career prospects were at stake; if one bank did not get the business, another would. "They had to meet specific profit targets, sometimes even monthly targets," recalls a senior British financier in discussing U.S. banks in particular. "Money was just a raw material to be fed into the sausage machine. They did not want to hear about the risks. By the time the country couldn't repay, the people who had made the loan were off and away to some other bank."

Not that there were no warnings. As early as 1974, Lever, then an economic adviser to the Labor government, suggested to British Prime Minister Harold Wilson that the banks could not handle the massive flow of funds. Two years later, Arthur Burns, at that point chairman of the Federal Reserve, cautioned U.S. bankers about the dangers inherent in the booming international loan business. The bankers told him that they knew more about it than he did.

As injudicious as the lenders may have been, they provided a much appreciated resource. Oil-rich developing nations, such as Mexico, Nigeria, Venezuela and Indonesia, wanted to borrow for their development plans, in effect cashing in early on as yet unpumped crude reserves. Developing countries without oil wealth, the majority,needed the money to offset higher energy prices that were squeezing their fledgling industries and threatening them with recession. Economic growth was in jeopardy—and with that the survival of some fragile regimes. The solution: borrow, borrow, and then borrow more. Some countries, convinced that they had discovered El Dorado, which in a sense they had, simply grabbed loans while the going was good, even for the vaguest of schemes. Togo, which has no crude, built an oil refinery; today it stands unused. Liberia ran up debts to host a meeting of the Organization of African Unity. Other countries constructed international airports and posh hotel complexes. Corruption was rife: in Zaire (see box), politicians poured funds into secret Swiss bank accounts; the Central African Republic spent $50 million, roughly half the country's annual budget, on the 1977 coronation of the since deposed Emperor Bokassa.

Even financially prudent countries believed that going into debt made economic sense. They borrowed five-year money on the assumption that their economies would grow faster than oil prices. Since the loans were mainly in dollars and inflation in the U.S. was depressing the value of the dollar, the borrowers believed that they could repay loans taken today with cheaper dollars tomorrow. Everywhere, going into debt was seen as the means to put off painful, belt-tightening decisions.

The strategy paid off, for a while. Between 1973 and 1980, the World Bank estimates, the economies of low-and middle-income developing countries grew at an annual rate of 4.6%, nearly double the 2.5% growth experienced in the industrialized world. Then came the reckoning.

In late 1978 OPEC announced its second major price increase, and less than a year later the U.S. Federal Reserve moved to dampen U.S. inflation by restricting the money supply. Tighter credit in the U.S. boosted world interest rates to new postwar highs, while declining inflation in the U.S. and a rush of foreign money into the country strengthened the dollar. No longer could loans be paid off with ever less expensive greenbacks. Quite the contrary. Moreover, since the biggest borrowers—Argentina, Brazil, Mexico and South Korea—carried floating interest-rate tags (which change with prevailing rates) on most of their loans, servicing costs climbed out of sight. Between 1976 and early 1982, the London Interbank Offered Rate (LIBOR), against which most international borrowing is set, zoomed from 6% to 15%. Each 1-point rise added an estimated $2 billion to the developing countries' annual debt bill.

At the same time, the oil shock and tighter credit sent the industrialized economies into a recession that sparked industrial production cuts, ballooned unemployment and set off a chorus of calls for protectionism to stem the flow of imports from the Third World (see ESSAY). Demand for the developing nations' products, mainly raw materials, slumped. As a consequence, between 1980 and today, world commodity prices, excluding oil, have fallen by 35% to the lowest real levels in three decades. Sugar, a principal Brazilian export, dropped from $495 to $120 per ton; Zambia's copper price plunged from 950 per Ib. to 690. Tanzania's President Julius Nyerere put it plainly: to buy a seven-ton truck in 1981, his country had to produce four times as much cotton, or three times as much coffee, or ten tunes as much tobacco, as it took to purchase the same vehicle five years earlier.

The developing countries found themselves in a classic squeeze: rising debt costs eating up ever larger chunks of declining export earnings. In 1981, Third World economies grew by an average of only 2.2%, a sharp decline from the halcyon days of the 1970s. Says Robert Solomon, a former U.S. Federal Reserve economist who is now at the Brookings Institution in Washington: "It cannot be overemphasized that the recession and high interest rates in the industrial countries are at the heart of debt-servicing difficulties."

The debtors' worsening woes prompted a number of countries to ask for partial debt rescheduling in the late 1970s. But such events were isolated, the amounts small. It was only the cry for help from Poland, the most indebted of all the East-bloc nations (the bloc's total debt: $80 billion), that created a sense of urgency. Poland had used its loans from the West to buy Western machinery in the hope of exporting new products and thus repaying its debts. Spurred by the spirit of detente and profits, international banks eagerly cooperated; if it ever came to a crunch, they convinced themselves, Moscow would extend a financial umbrella to prevent the economic collapse of one of its satellites. Unfortunately, many of Poland's investment schemes were ill conceived. The country was in financial trouble as early as 1977, and by 1981 found itself severely short of money. The Moscow umbrella proved to be full of holes, and Warsaw fell into arrears on its debt repayments.

Poland's rescue was initially complicated by reluctance on the part of some members of the U.S. Administration to assist an East-bloc nation only months after the Soviet Union had invaded Afghanistan. Since the exposure of U.S. banks was not quite 10% of the total debt, opponents of a bailout both in and outside the Administration argued in favor of declaring Warsaw in default. No such sentiment existed in West Germany, where the banks had lent heavily because the Bonn government was committed to keeping political and economic channels open to the East. "What the Americans did was poison the atmosphere," says a Frankfurt banker. "We were constantly in fear that some small U.S. bank was going to play patriot and show those Communists a thing or two by calling in their debt. That could have started an avalanche."

In the end, the default hawks in the U.S. lost out, mainly because such a drastic step would have taken the Polish regime off the hook and erased all Western leverage. But the fuse on the debt bomb had been lit, and in ensuing months the vast dimensions of the global problem became ever more apparent. Facts were hard to come by. A recurrent, although totally unfounded, report had it that the borrowing nations were planning to form an OPEC-like cartel to repudiate their debts en masse. Just before the annual joint meeting of the IMF and the World Bank in Toronto last

September, former British Chancellor of the Exchequer Denis Healey warned that "the risk of a major default triggering a chain reaction is growing every day."

Mounting uncertainty quickly shrank the lending markets. In general, creditors began to cast a more critical eye on applications for rescheduling and new loans. The result was a sharp cut in the amount of money available to Mexico, Brazil and a host of other borrowers.

Mexico was the first to show signs of distress. Just as the West European banks dominated the loan business to Poland, U.S. banks had taken the lead in Mexico. Last August, Mexico's Finance Secretary, Jesus Silva Herzog, summoned representatives of international banks to the fortress-like Federal Reserve Bank of New York to ask for a postponement of loan repayments. The request came as a particularly shocking blow to the U.S. financial community. Only two months earlier, after all, the Bank of America had happily put together a syndicate to provide Mexico with $2.5 billion. Recalls Morgan Guaranty's De Vries: "It was like an atom bomb being dropped on the world financial system."

The Reagan Administration moved in with immediate aid: $1 billion in oil purchase prepayments, another $1 billion in agricultural credits, and half of a $1.85 billion short-term loan put up by the Bank for International Settlements (Bis) in Basel, Switzerland, the so-called central banks' central bank and the keeper of international lending statistics. This was closely followed by an IMF announcement that it had approved a Mexican adjustment plan and would extend a new credit of $3.9 billion. But the commercial banks were not happy over the IMF's conditions that they increase their lending by 7%, or $5 billion. Before agreement could be reached, increasingly worried bankers began to realize that Brazil, long regarded as most creditworthy, was also in deep trouble. Meanwhile, in December, shortly after the U.S. Government came up with a $1.2 billion short-term bailout loan for Brazil (where U.S. institutions carry $18.9 billion of a total debt of $87 billion), several large U.S. banks combined forces to rescue Brazil's largest commercial bank, the government-controlled Banco do Brasil, from a severe cash shortage. This support operation is still continuing.

For days on end, the financial world waited in suspense as bankers tried to patch together the two rescue packages. In the case of Mexico, 13 leading U.S., Japanese, British and West German bankers worked around the clock for nearly two weeks in the 29th-floor dining room of Citicorp headquarters in New York City to keep the country from defaulting. "It was handled like a money-raising telethon," one observer recounted later. Just the process of sending out the 27-page rescheduling proposal to some 1,400 banks involved in Mexico's loans gobbled up 600 hours of telex time.

At one stage, during discussions in Washington over oil prepayments, the Mexican delegation came close to walking out. Recalls a U.S. diplomat: "They balked at paying a service fee on the money. They said they were seeing imperialism in action and threatened to take the next plane home. That would have meant default." In the end, the U.S. conceded. During the Brazil operation, a New York banker roused Volcker out of his sleep one night to plead for a $500 million Federal Reserve contribution to that salvage attempt. Volcker came up with the money. In either case, there was no margin for failure.

At year's end, responses from Mexico's creditor banks to the IMF's earlier request for new loans were reported to be coming in at a fast clip, with about $4 billion of the needed extra $5 billion already pledged. The biggest banks, which have been masterminding the complex operation, were said to be confident that everything could be pulled together successfully, even though some smaller lenders in the U.S. and Western Europe were still seeking further assurances. Brazil's request for a new jumbo loan of $4.4 billion remained under consideration at New Year's Eve.

The large U.S. and West European banks are right to be concerned about the drift of events, even if governments are not likely to permit big bank failures. The blow to public confidence would be so great that the U.S. Federal Reserve or any other central bank would step in first to support a

troubled major institution. "No central bank would allow its prime commercial bank to go bust," says Grindlays' Ashby. Says a West European central banker: "We cannot say what they already know, that the big banks will not be allowed to go under."

Perhaps with that in mind, most lenders try hard to play down the problems and insist that talk of default, let alone bankruptcies, is ill founded. "Foreigners have been borrowing our money since 1902, when we opened our first [overseas] branch in Shanghai." Citicorp Chairman Walter Wriston told TIME. "Our loan losses overseas are not a third of what they are from those good people who borrow our money and speak our language. There are few recorded instances in history of governments, any government, actually getting out of debt. Countries do not fail to exist." The rescheduling of Mexico and Brazil's debts, Wriston suggests, is not unlike the U.S. Government's weekly Treasury bill auction: both raise new loans to replace old borrowings.

"Cotton candy," retorts Robert Roosa, a former U.S. Treasury Under Secretary and now a Wall Street banker. Salomon Brothers' Henry Kaufman agrees with Roosa. He contends that the U.S.'s public debt cannot be compared with that of a developing nation: the U.S. has an infinitely more powerful economy and a more stable political process. Others, echoing that view, note that banks can hardly send gunboats to seize Poland's steel plants, Mexico's oilfields or Indonesia's rice mills if debt repayments are halted. Says Britain's Lever: "I call [Wriston] the Peter Pan of bankers because he still believes in fairies."

Countries may indeed last forever, as Wriston says, but governments do come and go. More to the point, even if they do not go, they can stop payments, whatever the cost—most likely no more access to the world's credit markets. In the mid-1800s, when the U.S. was a developing nation, four American states (Pennsylvania, Maryland, Louisiana and Mississippi) defaulted on British loans. Though three subsequently paid up, Mississippi is still listed in London as a bad debtor; it owes $5 million for a bond issue, excluding interest. More recently, whole countries have repudiated their foreign loans, among them have been Cuba in 1961 and North Korea in 1974.

"The possibility of a country defaulting rather than accepting the IMF'S austerity demands cannot be dismissed out of hand," says New York Financier Felix Rohatyn. Notes Stuart Greenbaum, professor of banking and finance at Northwestern University: "Imagine you are a Latin dictator deep in debt. If you [accept IMF terms and] cut back on imports, you get riots in the streets. If you default, you are ostracized by the world capital markets. Now if the first approach leaves you swinging from a tree branch, you know you are going to go the default route."

Under the circumstances, small banks may be frightened enough to stop lending internationally. Geoffrey Bell, a former British Treasury official, believes that of the 1,200 banks active in international loan syndicates in 1981 "only half are likely to remain." Morgan Guaranty Trust Co. estimates that loans to developing nations, before the rescue operations at year's end, dropped by about 20%, from $33 billion to $27 billion, in contrast to a 40% increase in 1981. That kind of severe retrenchment could precipitate the very troubles the banks fear most.

Not surprisingly, those advocating renewed lending have become more vociferous, among them Regan, Volcker and IMF Managing Director Jacques de Larosiére. Former U.S. Secretary of State Henry Kissinger told a bankers' convention in Atlanta last October that "new loans must be in excess of [the borrowing countries' existing] interest payments to allow these countries to keep growing." In Western Europe, the central banks are doing more than talk: many are pressing smaller lenders to produce the new loans. In the U.S., Volcker is trying to do the same thing in a different way. He wants new loans made to support the economies of troubled debtors to be exempted from the normal "supervisory criticism" of bank regulators.

One aspect that will help in general is a frank discussion of the dilemma; all along the crisis was worsened by denials that it existed. Stephen Marris, an economist at the Organization for Economic Cooperation and Development in Paris, explains that only recently has it become "respectable" to admit that the debt problem will not go away in a hurry. That sentiment, thanks

partly to the Mexico and Brazil rescues and Regan's call for new solutions, has now been reinforced.

No one has yet produced the sort of wide-ranging answers needed. What is acknowledged is that there are no quick fixes. The only lasting solution would be an upturn in the world economy, setting the industrialized world's plants humming with new business, lessening calls for protectionism, and increasing demand for the borrowing nations' commodities. That would sharply improve the economies of the Third World and the East bloc as well and in turn make it easier for them to repay borrowings on time and in full. Says Nicholas Hope, chief of the World Bank's external-debt division: "Trying to solve the debt problem without solving the economic problem is much the same as putting out the fire in the ashtray when the living room is alight."

The decline in interest rates is already taking some of the heat off. In what has been described in financial circles as a "kiss of life," the U.S. Federal Reserve relaxed its tight-credit policies last summer, and the prime rate has since dropped from 15% to 11%. Lower rates will aid the debtor nations in another way as well: they help spark recovery in the industrialized world, which in turn lifts demand for developing nations' products. That will lower interest payments on floating-rate borrowings by the debtor nations and reduce the cost of new loans. Morgan Guaranty Trust Co. estimates that each single-point drop in international interest rates saves Mexico $600 million a year, the developing nations as a whole as much as $3 billion.

But a global upturn lies months, possibly even years, away. In the meantime, experts are trying to move beyond the Band-Aid measures applied in recent weeks. Few ideas are completely worked out or indeed acceptable and appealing to all. Among the proposals:

An Early-Warning System. Top international bankers recognize that they need more up-to-date information on the state of debtor nations. At the moment, banks have to rely on their own estimates of how much a country has borrowed, until the BIS publishes worldwide lending statistics after a six-month lag. One approach has been proposed by William Ogden, vice chairman of Chase Manhattan, who has persuaded 31 of the world's largest commercial banks to set up a "private IMF."

Like the fund, which collects information on debtors (but releases only limited material), Ogden's group, to begin working in Washington some time next spring, would keep tabs on who has borrowed what from whom and how the funds are being used. Such details should help the banks prepare for impending crises, even if they would not entirely prevent the crises.

A Debt Takeover. Some bankers hope that the World Bank or some other international institution could be persuaded to take over troubled loans from commercial banks, perhaps by buying them at a discount. From the banks' narrow viewpoint, this would solve the problem. It is unlikely to happen, however. Not only might the World Bank resist being saddled with such burdens, but most parliaments would balk at letting the banks off scot free. Says one international financial official: "The people who must get help now are the most irresponsible borrowers and the most irresponsible lenders. If govern ments decide that they must take over, they will certainly try to extract their pound of flesh."

New International Institutions. Some experts believe that the world needs a new agency to help debtor countries, but to establish one could inflame North-South political tensions that would endanger the present rescue measures. Discussions center on how the world's largest economies can expand short-term lending to developing economies and how the IMF can step in with added scope and power. Up until now, the IMF, which is funded by 146 countries, has concentrated on aiding its member nations in weathering balance of payments difficulties, often with loans, and always with recommendations for tough economic-adjustment measures.

The IMF's main shortcoming is lack of money. Though its resources, which were seriously depleted by the Mexico and Brazil operations, are likely to be in creased by 50%, to more than $90

billion, through greater member contributions, that might not be enough to contain a worsening rate of near defaults. While a richer and stronger IMF might boost banks' confidence to a degree that they would continue lending, objections focus on fears that a strengthened IMF could worsen the situation by demanding of borrowers austerity measures so harsh that the moves would spark political unrest.

Even if some of these suggestions are implemented, they will not douse the debt-bomb fuse. But they will help defer new crises and buy time until an economic up turn does occur. For the moment, all that can be done is to encourage the debtor countries to practice as much austerity as is feasible and to exhort the banks to continue debt rescheduling and new lending, even if that perpetuates the illusion that the debtors are not yet bankrupt and leaves them owing ever more money. Says Chairman Volcker: "What is especially important is that all the participants achieve a high degree of common understanding, recognizing the potentialities and the limitations of each for action. On the basis of that under standing, we can then deal forcefully and effectively with the problems at hand." That scenario is one on which the world's bankers are staking the future. Crossing their fingers all the way.

— By Jay Palmer.

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*"The central bank of a country is the bankers' bank. Its powers vary from nation to nation. But whether it be the U.S. Federal Reserve system, the Bank of England or the West German Bundesbank, its official duties usually include issuing banknotes, controlling the money system, supervising the banking industry and acting as a lender of last resort.