For release upon delivery
10 A.M. CST (11 A.M. EST)
December 29, 1986

The Debt Crisis and the Future of International Bank Lending

H. Robert Heller

Member, Board of Governors of the Federal Reserve System

Annual Convention of the American Economic Association
New Orleans
December 29, 1986

The Debt Crisis and the Future of International Bank Lending

As we approach 1987, the Gordian knot of the international debt problem seems to be tightening again. Rescheduling agreements and requests for new money by several important countries are on the agenda. It will take farsighted and strategic thinking on behalf of all participants to overcome the mounting problems confronting us.

Nevertheless, I firmly believe that the problems will continue to be manageable if all participants focus on their long-term interest in coming to a satisfactory solution. It is within that general framework that I would like to approach the topic of "The Debt Crisis and the Future of International Bank Lending".

The role of the banks in the debt crisis cannot be seen in isolation. Important interdependences must be considered, including the responsibilities of the debtor countries, the industrialized countries, and the international agencies.

The Causes of the Debt Crisis and Initial Management Success

During the 1970's, commercial banks became the principal source of external finance to the developing countries. The volume of new bank-related financial flows surpassed by far the volume of official government lending, financing provided by the multinational agencies, and foreign direct investment.

The global recession of the early eighties and the associated fall in commodity prices produced a sharp curtailment of the earnings of the developing countries. At the same time, real and nominal interest rates surged, straining the financial resources of the LDCs until they were no longer able to fulfill their financial commitments, thereby triggering the international debt crisis of 1982.

The initial management of the debt crisis has been generally satisfactory. Immediate liquidity assistance was provided by the central banks of the industrialized countries under the auspices of the Bank for International Settlements.

Subsequently, the International Monetary Fund assumed a central role by assisting in the implementation of financial adjustment programs and providing $35 billion in financial assistance between mid-1982 and mid-1986. Allowing for $12 billion in repayments (albeit not necessarily by the same countries), net funds provided amounted to $23 billion.

The World Bank also made significant contributions by disbursing over $32 billion in new loans through the IBRD over the period from mid-1982 to mid-1986. Allowing for $11 billion in loan repayments, the net new money provided by the IBRD amounted to $21 billion.

Adding the concessional IDA credits further enhances the role of the World Bank. During the same 1982-86 period, IDA disbursed $10.8 billion dollars. Repayments amounted to less than half a billion, resulting in a net new IDA money flow of $10.4 billion.

Over the same period, commercial banks increased their net LDC exposure by $45 billion. Debt reschedulings were agreed upon between the banks and all the major debtor countries. Banks, and in particular U.S. banks, also increased their capital rapidly during the period, thereby reducing the ratio of outstanding LDC debt to their own capital and enhancing their capacity to withstand possible adverse developments.

Many of the developing countries implemented tough financial adjustment programs that resulted by 1985 in a drop in imports by $82 billion or 14 percent below the 1981 level. Of course, lower export prices also played a role in this drop of export revenue, but the end result was just as painful for the developing countries.

At the end of 1986, we can look back upon a record of considerable accomplishments both for the debtors and the creditors. Key to that progress has been the cooperative attitude between borrowers and lenders, facilitated by the good offices and resources provided by governments and international agencies.

A Strategic Perspective on International Bank Lending

If the international debt problem is to be solved in a cooperative fashion with the continued active participation of the commercial banks, it is important to investigate whether the long-term interests of the banks are served by such a course of action.

Similarly, from the viewpoint of the debtor countries the key question is whether the countries wish to maintain a long-term relationship with foreign commercial banks. The costs associated with debt repudiation became abundantly clear in the case of Cuba, and no country that wishes to remain part of the international commercial and financial system will consider this a viable alternative. In more recent history, Peru's unilateral decision to limit its debt service payments has not put that country on a path to economic health and prosperity.

The formation of valid expectations about the future of international bank lending requires an understanding of what motivates a bank. In that sense, the future of international bank lending to developing countries should be seen as a long-term strategic decision and not merely a credit judgement about a particular borrower at a given moment in time or the expected rate of return on a specific loan.

If banks reduce and eventually eliminate their international activities either by engaging in a slow retreat or by divesting the international division, they engage in a strategic retreat that will not be easily reversed within a decade or more. The central issue is whether it is in the banks own long-term interest to maintain a business relationship with the developing countries.

The business interests of commercial banks are highly complex, and it is clear that not all aspects can be fully considered within the limited space available. It should also be borne in mind that not all banks are similarly situated, and that business judgements by the senior managers may well differ.

With these caveats in mind it is useful to consider three broad areas of foreign banking activity in arriving at an assessment of the future prospects of international bank lending: the international short-term transaction business, medium and long-term lending, and direct investment activities in the international banking area.

The first segment of international banking activities comprises payment and transaction oriented services. Examples include the execution of international payments, foreign exchange services, letters of credit, trade finance, traveller's checks, and credit cards. Many of these transactions are self-liquidating and arise in connection with the payment for international goods and service flows. The total amount of cross-border exposure that will be generated by these transactions may be quite small. These services are generally provided by a small number of banks with an extensive international presence: the international network banks.

Only banks with an extensive international network are able to compete in this market effectively as principal players. Other banks partake in these transactions on a one-off basis through correspondent banks.

Historically, the largest North American and European banks have dominated this market, although in recent years Japanese banks have made significant efforts to become major players as well. The global total of banks in this category is probably less than 20, and due to the high costs of entry, there is little prospect that the number of banks in this category will increase significantly. Conversely, the banks active in this market see their franchise as a valuable possession and are not likely to give up this area of activity.

However, banks may well question how many countries need to be included in such a global network strategy. The potential market size, and thereby profit potential, drops rapidly after the largest countries are accounted for. The smaller countries may therefore find it increasingly difficult to retain a large number of banks that are willing to incur the substantial up-front costs of maintaining the necessary offices and overhead expenses. On the other hand, there is a strong self-interest on behalf of the banks to remain active in the large countries.

The second market segment involves the medium and long-term financing of projects and balance of payments imbalances. By their very nature, these activities involve the creation of relatively large and persistent cross-border credit exposures.

In years past, innovative financial techniques, such as syndicated Eurocurrency credits, made it possible for many banks to participate in these lending activities. The lead banks were able to spread the associated risk among a large group of smaller banks that participated in the syndications. In addition, the large banks benefited from the income derived from the management and syndication fees.

There is a broad tendency in financial markets toward the securitization of lending. International markets will not be exempt from that trend. International loan syndications are therefore likely to be replaced by the securitization technique. It also stands to reason that securitization is better suited for traditional project lending with an identifiable stream of repayments rather than for balance of payments lending to governments, where the availability of funds for repayment often depends on the implementation of appropriate policy measures.

In order to gain access to the international security markets, the credit quality of the borrowers must be unquestioned. It is therefore in the interest of both the debtor countries and the creditor banks to do everything in their power to enhance the creditworthiness of the debtor nations, so that the security markets can eventually be used to offer a broader access to world financial resources to the developing countries.

Debt to equity swaps offer one tool to ease the fixed payments commitments of the debtor countries. Several commercial banks have pioneered debt to equity swaps and many more promising opportunities exist in this field. For instance, the possibility of "mutual funds" that could be used by smaller banks to pool their equity investments is now being explored.

But even under the best of circumstances debt to equity swaps will make only a marginal contribution towards the resolution of the entire problem. This assumes the full cooperation of the debtor countries in liberalizing their regulations towards foreign direct investment.

Difficult regulatory and supervisory issues may arise in connection with debt to equity swaps. I believe that it will be possible to overcome these problems, so that debt to equity swaps can make a useful contribution by reducing the magnitude of the fixed payment commitments of the debtor countries.

Both from the viewpoint of the banks and of the countries involved it is desirable that debt to equity swaps involve more than a mere liquefication of the initial loan at a discount. From the viewpoint of the country it is desirable that the debt to equity conversion constitute a net addition to the foreign direct investment inflows. From the viewpoint of the bank it is desirable that the bank be in a position to partake in the potential profits that the equity investment affords to the holder. Merely selling a loan at a discount to a potential foreign investor does not fulfill that objective.

New investments in the financial service sector in the various countries are particularly well suited to fulfill the dual objective. The country's consumers and business establishments will gain by increasing competition in the financial service sector, the bank gains new business opportunities in a field of its own expertise, and the country and the bank forge a long-term strategic relationship.

This brings up the third strategic business relationship between banks and foreign countries: the local presence of foreign banks via branches and/or subsidiaries. Banks in this category will have a continuing involvement with the domestic economy of the country and engage in a wide variety of financial activities. It goes without saying that the deepening of such a relationship is very much in the interest of both the banks and the countries. Not only will the banks involvement with the local economy enhance their interest in the economic health of the country, but the country may gain by having access to new and varied sources of financial services. It therefore stands to reason that the rapid liberalization of financial markets in the developing countries by opening the markets to full and equal participation by foreign banks on a "national treatment" basis offers a promising avenue that will increase the long-term congruence of interests among debtor countries and their creditor banks.

The issue whether some of the LDC loans should be written down or "marked to market" has been discussed frequently in that connection. My personal view is that there exists good reason to treat a loan on the books of a bank at face value as long as there is a reasonable expectation that the debt service payments will be made and that the loan will eventually be repaid. The bank may enhance the likelihood of this event by participating in restructuring and new lending arrangements. Such actions may therefore lend credence to a bank's expectation of eventual repayment. In contrast, banks that refuse to partake in refinancing activities may thereby signal their own doubt as to the future collectability of the loan and may wish to make appropriate value adjustments.

The Responsibility of the Industrialized Countries

The international debt problem cannot be solved on a bilateral basis between the banks and the debtor countries. To a large extent these bilateral negotiations involve arguing about who should make the bigger sacrifice: the debtor or the creditor. With the exception of the new investment opportunities in the financial sector discussed above, the argument revolves around redistributive questions rather than an enlargement of the total amount of economic and financial resources available to both parties.

Ultimately, the international debt crisis can be overcome only by enlarging the economic pie through economic growth and increased exports by the debtor countries. This involves not only a concerted effort by the debtor countries to increase their exports, but also continued access to markets in the industrialized countries. This latter condition is absolutely essential in order to allow the debtor countries to earn the foreign exchange needed to service the debt.

Total exports by the developing countries amounted to $595 billion in 1981 (IMF, Direction of Trade data), the last year before the debt crisis, but fell to $508 billion by 1985. While much of that shrinkage in exports was due to reduced trade among the developing countries themselves, the industrialized countries reduced their purchases from the developing world by over $50 billion. LDC exports to the United States remained essentially constant with $102 billion in 1981 and $101 billion in 1985. However, LDC exports to Japan dropped from $79 to $67 billion over the same period. Other countries with sharply declining imports from the LDCs include Australia, Belgium, Canada, France, Germany, the Netherlands, Sweden, Switzerland, and the United Kingdom.

It is true that much of that change in trade was accounted for by lower petroleum prices. All the more important is it that the industrialized countries that benefitted the most from the fall in petroleum prices and commodity prices utilize the funds saved to purchase more products from the developing countries.

Much of the record trade and current account surpluses enjoyed by countries like Germany and Japan is not due to their own greater export efforts, but due to reduced purchases from the LDCs. Thus it is clear that there exists much room to expand imports from the developing countries. Without access to growing markets, it will be difficult for the debtor countries to earn the foreign exchange needed to make the debt service payments. The balance of payments surplus countries are in a unique position to make a contribution toward overcoming the international debt service problems and increased international financial balance and stability. The proper way to reestablish the creditworthiness of the developing countries is through more trade and not through debt relief.

The Role of the International Organizations

The IMF and the World Bank must continue to play a leadership role not only by providing continued financial assistance, but also by assisting in the implementation of market-focused adjustment programs in the debtor countries. Strong pressure on the surplus countries to allow the necessary adjustments in their external imbalances is also called for. The record profits enjoyed by the World Bank place it in a unique position to use some of these profits to grant loans at lower interest rates. In addition, it may utilize its seldom used authority to guarantee commercial bank loans in order to serve as a catalyst for more private lending. By guaranteeing, say, 50 percent of a commercial bank loan, the World Bank may effectively double the leverage of its own scarce capital.

Conclusion

There is no doubt that international debt service problems will remain an important concern in the years to come. There is also no doubt that it is in the long-term strategic interests of the creditor banks and the debtor countries to cooperate in overcoming the current difficulties.

Banks will have to continue to make temporary sacrifices if they want to see the long-term quality of their assets improve and if they wish to maintain their strategic interests as international financial institutions. Some banks may see their own strategic interests better served by equity investments rather than a continuation of debt holdings.

The debtor countries can enhance the long-term strategic interests of the banks by opening up their financial markets and granting new franchises. A continuation of the adjustment effort that focuses on strengthened export performance, rather than arbitrary import curtailment, is also called for.

The industrial countries with strong current account positions are now called upon to lead the world toward a more open and growth-oriented economic and financial system that will not only benefit the developing countries in need of export markets, but also make their own citizens better off by providing them with a wider and cheaper variety of products.

The IMF and the World Bank should continue to play the key role envisioned in their respective charters as the providers of balance of payments assistance and development finance. In addition, they must serve as a forum for the international policy discussions on appropriate adjustment measures to be implemented by surplus and deficit countries alike.