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THE ROLE OF BANKS IN THE NORTH-SOUTH DIALOGUE

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

Conference on International Economic Cooperation

Sponsored by the Friedrich Naumann Foundation
and the American Embassy in Bonn

Bonn/Bad Godesberg, Germany

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It is a privilege to speak at this meeting sponsored by the Friedrich Naumann Foundation and the American Embassy on the topic of the role of the banks in the North-South dialogue. In a dialogue that sometimes has been strident and frustrating, it is good to be able to report on one area where clear progress has been made -- the flow of bank credit to developing countries.

Bank credit, as you know, has played an important role in maintaining the transfer of real resources to some 70 non-OPEC developing countries. Of the total debt of these countries, estimated at approximately $160 billion at the end of 1977, the amount owed to private institutions, primarily commercial banks, has grown dramatically in recent years. At the end of 1977, debt owed to private foreign sources is estimated at about $78 billion, or nearly one-half of total foreign debt. This amount represents a 150 per cent increase over the volume of private credit to these countries at the end of 1973.

A year or two ago, there was some concern about the sustainability of bank lending to developing countries. Doubts were widely vented in the press about these countries' ability to maintain debt service. The situations of particular countries began to arouse alarm. There was fear of defaults, of domino effects and of a severe shrinkage in the availability of credit. Some observers began to talk of a repetition of the 1930's, when the bonded indebtedness of many developing countries went into protracted default.

To date, these extreme fears have proved unjustified. Today the situation of the great majority of borrowers appears a great deal stronger. Many countries whose current account deficits were excessive have made adjustments. Imports have been cut, budgets and monetary policy brought under better control, inflation has been reduced, borrowing needs scaled down, the quality of credit improved.

A few potential trouble spots that were visible some time ago have indeed developed real trouble. Several countries today are going through a painful process of debt rescheduling and refinancing, with the aid of creditors' clubs and usually of the International Monetary Fund. But even here a fundamentally reassuring pattern seems to be developing. Earlier, it was not possible to foresee whether payments difficulties could be met by orderly rescheduling and financing arrangements or were more likely to lead to outright moratoria and default. Now, a pattern of orderliness even in these cases seems to be establishing itself. Countries in difficulties have not simply walked away from their obligations. They seem to be opting instead for the standard procedure of rescheduling of official and refinancing of private debt. The ultimate outcome is by no means foreseeable in all cases, and a cautious and conservative approach remains in order on the side of both borrowers and lenders. But truly grave consequences -- a domino effect leading to widening of payments difficulties, and a withdrawal of banks from international lending -- have been far from materializing. The specter of a repetition of the 1930's has retreated into the background, although we cannot and should not ever forget this unhappy experience.

A number of factors have contributed to this favorable outcome so far. In the first place, world economic activity has not suffered a cumulative downturn, despite the "oil shock," the excesses of the 1972-73 boom, and the ensuing stagnation in wide areas of the globe. Particularly the maintenance of a good rate of growth in the United States, albeit at the expense of a current account deficit that is unsustainable in the long run, has contributed to the maintenance of economic activity and world trade.

Second, the borrowing countries themselves have been more aware than in years gone by of the implications to them of failure to meet their obligations. Many have development programs that depend critically on continued inflows of foreign capital. Many have learned to manage their economies to take advantage of the compressability of imports when the need for belt-tightening arose.

This depends, of course, on their degree of development having reached a stage that offers the necessary flexibility for such maneuvers. Moreover, they seem to have been able to persuade their creditors that, unlike a business borrower who may go out of business, their continuing existence as national entities assures that even in case of difficulty there will always be someone from whom the creditor can collect.

Third, the international credit environment has benefited from the presence of the international financial institutions. Not only have they added to the supply of credit, but they, and particularly the International Monetary Fund, have helped countries to adopt programs of restoring and maintaining their creditworthiness. The presence of a "lender of last resort" has improved the climate for bank lending, even though the banks are aware that there will be no "bail-outs" for them.

Finally, lending to the LDCs has gained strength from the fact that it takes the form predominantly of a continuing relationship with a bank. Such a mutually sustaining relationship does not necessarily exist when, for example, a bank places bonds. The banks' self-interest in the continued performance of the borrower is thus sharpened, their willingness to help in difficult situations enhanced, and an added incentive is created for maintenance of creditworthiness on the part of the debtor. Banks, moreover, are often able and willing to offer advice -- which helps countries be better borrowers. Lead banks in syndications especially collect and disseminate information which helps make the borrowing country known to a wider range of potential lending banks.

None of this provides absolute guarantees for the future. Vigilance and caution will always have to be the watchwords. Individual cases of difficulty in maintaining payments will no doubt arise, as they have in the past. But there can be reasonable expectations that these cases will be few, and that they can be dealt with when they do arise.

Broadening of Access to Bank Credit

For those developing countries that already have access to bank credit, it is of interest to strengthen and broaden that access. For lower income countries that have not yet developed such access, or have opened it only on a small scale, the validation of creditworthiness is even more important. Lending from official sources, whether bilateral credit from individual countries or multilateral credit from financial institutions or international organizations, is bound to remain limited relative to their needs to import capital. Official credit, to be sure, is usually more attractive to the borrower. Maturities are longer, and some official credit is available on highly concessional terms. But the limitations on the supply of official credit make it desirable to give preference in the use of such resources to countries that do not have adequate access to private credit. As countries have developed, as their per capita income has risen and their creditworthiness has strengthened, graduation from the softer to the harder modes of credit has become possible and indeed necessary. Thus, debtors have graduated from concessional financing to nonconcessional, from principal dependence on international financial institutions to principal dependence on the private market, and, within the private market, to some extent from syndicated bank loans to that ultimate accolade of creditworthiness, the long-term bond issue in Euro or foreign national markets. In the course of time, some countries may even graduate from net borrowers to net lenders.

It is important, nevertheless, that graduation proceed at a measured and deliberate pace. An effort to accelerate it excessively might be counterproductive. Recourse to the international financial institutions is important both to the borrowing countries and to the banks from which these countries also borrow. Full reliance on market credit might mean, for many countries, a reduction in the availability of such credit. Adequate resources at the disposal of the international financial institutions, and access to them by middle-income developing countries for some fraction of their credit needs, will continue to be important.

Official Bilateral Lending

Developing countries will find it in their interest to remain aware of changes that are occurring in the area of official credit and that reflect evolving policies of the countries supplying credit through the international financial institutions and bilaterally. Especially in the United States, new concerns about the direction and purposes of lending to developing countries are emerging. The Carter Administration and the Congress have strongly indicated their concern with human rights and the role that human rights considerations should play both in U.S. bilateral aid and lending and in the operations of the international financial institutions. The U.S. Congress has also indicated its concern about the financing of projects that would compete with American industry and agriculture. As the consequences of these concerns become more apparent, there may be opportunities for smoothing some of the problems created by efforts to meet the concerns of domestic interests, and for compromises and adjustments that would recognize the facts of economics and the facts of politics on all sides.

An important change in developmental thinking, on the side of official lenders but to some extent also on the side of borrowers, has been the movement to orient lending toward basic human needs. This has been motivated by the realization that, successful as economic development has been in particularly the middle and higher income developing countries, large sectors of many countries' populations have failed to benefit. Many people have remained in "absolute poverty." From a humanitarian point of view, the effort to orient development lending toward these neglected sectors surely is commendable. In fact, projects aimed at the small farmer, and even the small urban producers, may often have a pay-off that compares not too unfavorably with some massive industrial or infrastructure projects.

Nevertheless, an economist is bound to reflect that, in the long run, capital will best be employed where it obtains the highest rate of return. The essence of productive employment of capital lies in the "round-about methods of production." Efforts to reduce poverty directly run great risk of bestowing only temporary benefits and leaving the beneficiaries ultimately less able to cope than before. The economist cannot help but remember the old saying that to give a man a fish helps him for a day, to give him a fishing net helps him until the net wears out, but that teaching him to make a net helps him for the rest of his life. Here, too, developmental lending policy will have to seek a balance among competing objectives.

Foreign Debt Management

A good deal has been learned by borrowing countries and their financiers about the management of foreign indebtedness. Good debt management has become an essential ingredient in creditworthiness.

Among the elements of debt management, there is first the decision of how much to borrow, assuming that a country has not fully exhausted its credit capacity. During the boom of the early 1970's, when raw material prices were rising, many countries also increased their foreign debt because lenders evaluated their credit capacity more favorably. This led in some cases to top-heavy debt and unproductive use of funds. The lesson is plain: pro-cyclical foreign borrowing is ill advised. A commodities boom should be a time for accumulation of reserves and scaling down the rate of foreign borrowing. That would make it possible to maintain development programs during the leaner times that may follow. Given the intensive competition among banks in foreign lending, this is a lesson that will have to be heeded and enforced particularly from the side of the borrower. In countries with strong private sectors or with numerous independent government agencies, subdivisions, and enterprises, proper cyclical timing will require a degree of centralized control over the incurrence of foreign debt.

Second, the debtor and his banker will have to be concerned not only with the timing of the borrowing, but also of the repayment. The need for a good maturity profile of the foreign debt is increasingly becoming recognized. A bunching of maturities may create rollover problems, particularly if the bunched maturities occur at a time when credit may be tight or the economic outlook unfavorable. Since many loans have grace periods, the amortization component of the debt service is likely to rise over time. Failure to take account of this kind of bulge will interfere with efforts to maintain a well-distributed debt profile.

Third, it is becoming increasingly understood that rapidly growing countries cannot and should not be expected to make net repayments of debt. That would convert them into capital exporters, a condition which they may reach at some stage in their economic development but typically only after the economy has reached some degree of maturity. The rhetorical question "how will all this debt be repaid?" is beside the point. The point is that particular maturities must be met punctually, but that debt paid off must be replaced by new debt or that the old debt must be rolled over. So long as the debt and its service does not outgrow a reasonable proportion to the productive capacity and particularly the exports of the economy, creditworthiness and the ability to refund and roll over can be maintained.

An essential condition for maintaining debt and debt service in a proper relation to GNP and exports is, of course, the productive and functionally appropriate use of borrowed resources. That means borrowing for investment rather than consumption. It means also the selection among alternative investment possibilities, of an adequate proportion of export-increasing or import-substituting projects. The rise in the price of oil has increased the temptation to borrow to meet payments needs without careful regard to the use of the funds.

Much of recent borrowing necessarily has been balance-of-payments or program-oriented rather than project-oriented. Even project borrowing does not, of course, guarantee an increase in total investment, since it may displace domestic financing of the same projects. The principal tests must be the maintenance or preferably the increase in the ratios of investment to GNP and of exports to debt service.

Information

Much has been said and written about the need for more and more up-to-date information concerning the indebtedness of developing countries. Progress has been made, through the cooperation of central banks with the BIS, through the new country exposure report of the U.S. regulatory authorities, and in other ways. We need not go into detail here on what is available and what is still missing. It is understandable if the authorities of some developing countries believe that they should tell their bankers no more than the bankers ask to know, but it is not in their long-run interest. Ignorance is not bliss where credit is concerned. In the long run more information usually will mean more rather than less credit. If there are banks that, in competing for loans, also engage in a competition in laxity with respect to debtor information, they surely are storing up trouble for both themselves and the debtor. These things are as true as they are platitudinous. Here, I believe, is an important avenue to enhancement of creditworthiness that has not yet been fully exploited.

Debt Relief

Having dealt so far with what countries can do to enhance their access to bank credit, I now turn to certain notions and tendencies that would produce the opposite result. One sure way of damaging the prospects for bank lending to developing countries is to press for generalized debt relief. Demands for generalized debt relief emanating from UNCTAD fortunately have been scaled back recently so that they apply only to relief of official development assistance for the least developed among the developing countries. Even so, enough of a precedent has been set in acceding to these scaled-down demands to cause concern, because of the risk that developing countries may now consider generalized debt relief a viable form of development assistance for certain countries. Generalized debt relief is an inefficient and probably counterproductive way of providing aid even where aid rather than lending is the purpose. The resources derived from debt relief are not tied to any particular development project. They do not exert pressure toward good economic policies. They impinge on the "recipient" countries in proportion to past borrowings rather than present need. These considerations form the rationale behind the United States' attitude toward debt relief in the form of ex post conversion of loans into grants.

From the point of view of creditworthiness, the very discussion of generalized debt relief has adverse repercussions. Many of the countries for whom it is being proposed are not candidates for bank credit, but they could well become candidates at some future time. A history of seeking and relying on debt relief will weigh against that development. For countries that now have access to bank credit, pressure for generalized debt relief constitutes a major threat. These countries have sought to differentiate their position in the Group of 77, but they have not come down hard against the proposal. Yet it is not possible to talk about debt relief being appropriate for one group of countries without raising questions about all the rest. A ripple effect could go from countries with the lowest credit ratings to those with the highest, and could damage all. A firm stand against generalized debt relief on the part of developing countries would make a significant contribution to creditworthiness.

Commodity Stabilization and a Common Fund

Present discussion of commodity stabilization and a common fund for that and other purposes cuts two ways as far as the creditworthiness of developing countries is concerned. Commodity stabilization, soundly conceived and executed, should enhance creditworthiness. It would help to reduce the danger of overborrowing in boom periods and the difficulty of maintaining debt service during recessions. Banks, no doubt, would be interested in exploring the possibility of making sound loans by financing well managed buffer stocks.

But concern is bound to arise when stabilization of prices of export commodities threatens to take the form of efforts to push up these prices, create market overhangs, and subject countries to production controls. All these can lead to unexpected and severe market developments that could interfere with the debt services of participating countries. Such efforts would be all the more dangerous if they are undertaken with inadequate means, are heavily leveraged, and carry high risks for the financing banks.

Avoidance of Confrontation

Bank credit thrives when international relations are harmonious. Money pulls back when it fears confrontation. Lowering the rhetoric in the North-South dialogue would be one way to encourage the flow of bank lending. This advice can fairly be addressed not only to the South, but also to the North. While Northern official utterance, to my perhaps biased observation, has seemed relatively restrained, the same cannot be said of the utterance of some Northern intellectuals. In some Northern academic circles, among which after all are opinion leaders, the South has been criticized as elitist, as unconcerned with absolute poverty, as exploiting its own poor, as willing to tolerate an income distribution far more uneven than that of the North, and as seeking to extract aid from the poor of the North in order to benefit the rich of the South. While not always without substance, confrontational debates of this type can damage official as well as business relationships. Stagnation of aid, particularly in the United States, reflects disenchantment with the needs of the South at the political level. This disenchantment also is reflected in criticism of the foreign lending activities of the banks, in demands for credit allocation in favor of domestic uses, and in resistance to measures that would enhance the creditworthiness of developing countries such as the Witteveen Facility.

Some developing countries may believe that by generating strong pressures, they will produce results favorable to development. Whether this is a promising gambit, at the political level, is not for an economist to assess. But it is the economist's proper function to point out that the gains at stake for the developing countries through the working of the private sector, including the banks, are vastly greater than what is likely to be accomplished in the public sector. It would seem to be in the interest of both sides to let these private sector forces proceed.

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