FOR RELEASE ON DELIVERY
THURSDAY, APRIL 21, 1977
10:20 A.M. EST

HOW MUCH PRIVATE BANK LENDING IS ENOUGH?

by

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

at a

Symposium on Developing Countries' Debt

sponsored by the

Export-Import Bank

Washington, D.C.

Thursday, April 21, 1977

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

HOW MUCH PRIVATE BANK LENDING IS ENOUGH?

by

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

at a

Symposium on Developing Countries' Debt

sponsored by the

Export-Import Bank

Washington, D.C.

Thursday, April 21, 1977

The title assigned to me by the sponsors of this meeting is "How Much Private Bank Lending is Enough?" Under this narrow umbrella I hope to consider three topics:

(1) Some general observations about the OPEC surplus and the difficulties associated with establishing any bank lending to developing countries,

(2) country risk analysis as a guide to lending policy, and

(3) some bank regulatory innovations.

My principal conclusions will be:

(1) There will have to be some slowing of the rate of total borrowing of some countries, and an increase in the relative share of official lending in total international financing, but the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

main burden of financing must continue to be carried by private institutions and markets.

(2) The banks are very active in improving their techniques of country analysis. Further progress needs to be made, nevertheless, especially toward coordination of procedures and definitions. More information also will have to be obtained on borrowing countries' economies and finances, through the cooperation of these countries themselves, and official financial institutions.

(3) The regulatory authorities will have to develop techniques that will allow bank examiners to comment on risks taken in foreign lending without doing irreparable damage to the credit standing of particular countries.

The OPEC Surplus and Lending to the Developing Countries

To avoid the gloom often associated with the naming of large numbers, I would like to begin with a positive point. The OPEC surplus, despite all the trouble it is giving us, nevertheless, has the potential for increased investment and growth if it is channeled properly. By taxing the world without consuming (or investing at home) the full revenue, OPEC is putting investable resources at the disposal of the rest of the world. So far the reduction in purchasing power brought about by the tax has caused mainly unemployment. But the potentially positive effects, worth perhaps $45 billion in 1977, should not be altogether ignored.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The way to take advantage of this opportunity is, not general economic stimulation which would be inflationary, but selective tax measures designed to favor the channeling of available savings into investment. In the longer term, I believe, the demand for investable funds will be strong in any event.

Second, a word of moderate encouragement concerning the position of the non-oil less developed countries (LDCs). Contrary to a widespread belief, it does not appear that the entire massive OPEC-induced deficit has been shifted to these countries. When allowance is made for changes in export and import prices, the deficits of non-oil LDCs today are about what a projection of their trends during 1965-72 would indicate. Their debt service ratios, over the last few years, have not significantly deteriorated in the aggregate. Of course, this does not apply to every single country nor does it offer a basis for complacency with respect to the future evolution of debt service burdens as grace periods come to an end and, possibly, LIBOR (London Inter-Bank Offering Rate), upon which syndicated bank loan rates are based, rises above its present level. In any case, it must be borne in mind that developing countries are structural capital importers whose total debt is almost certain to rise over time, even though individual obligations are serviced punctually.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Third, the OPEC, broadly speaking, have replaced the major industrial countries as the principal suppliers of international capital. Where previously the industrial countries functioned as net lenders (and grantors), their surplus going to the LDCs, today their role has shifted. Financial institutions in the industrial countries currently are intermediating between OPEC nations in surplus and developing countries in deficit.

Fourth, the smaller industrial countries, and a number of other developed countries as a group, have meanwhile developed deficits that could not have been predicted from their earlier behavior or their structural characteristics. It may well be that the main problems of financing in the future will have to be confronted by some of the countries in this group.

Fifth, the relative inadequacy of balance-of-payments adjustment so far is reflected in the fact that effective real exchange rates of many countries that are floating have not changed significantly. Effective nominal rates have changed, more or less in line with differential rates of national inflations. But international competitiveness among major countries has not changed a great deal as a result of nominal exchange rate movements that mainly reflect changes in purchasing power parity.

Today it has become fashionable to talk of the OPEC-induced deficits as a burden in a twofold sense. One sense relates to the burden of the real resources transfer required to eliminate a deficit.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The higher priced oil has to be paid for by an increase in exports or cut in imports, which means diminished availability of goods at home. The other sense is the burden of financing the deficits, to the extent that they are not eliminated by the first route. In other words, we are talking about the burdens, respectively, of not financing the deficits and of financing them. In this vale of tears, everything seems to be a burden. But we should not overlook that to the extent a country shoulders one burden, it is reducing the other.

Today concern is primarily over the burden of financing. Thinking runs along the lines of allocation of current account deficits with the intention of making the debt burden most readily bearable. This makes good financial sense. But we must nevertheless remember that there is another side to the matter. The "minimum financial burden" criterion requires the strongest and richest countries reduce their surpluses or go into larger deficit. This is not what economists had in mind when they developed the proposition that capital should flow to the areas where its marginal product was highest. Structurally the strongest and richest countries should expect to be capital exporters. Instead, the requirements of financial balance may cause the United States to become a capital importer.

Under these conditions, the issue of greater safety for financing and more efficient allocation of capital becomes a trade-off. The decision must be a political one. To the extent that the nations of the world prefer a more efficient allocation of capital,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the ensuing higher risks will have to be borne predominantly by official lenders. The banks, when they lend to finance capital movements, must lean toward safety. And the greater the share of the overall financing job assigned to them, the more of the financing will have to go toward the stronger and safer countries.

In this context there is no good answer to the question "how much bank lending is enough," any more than to the question whether enough is too much or whether perhaps, as Mark Twain said about whiskey, too much is barely enough. It all depends on to whom, and in what form, the lending goes. Banks are very much aware of these problems and most have integrated country risk analysis into their international lending decisions. I would, therefore, like to say a few words about the subject of country risk.

Country Risk Analysis as a Guide to Lending Policy

The analysis of country risk involves two major topics: (1) the definition and measurement of exposure, and (2) the examination and assessment of the risk factors presented by particular countries.

With respect to the first of these the Federal Reserve System has been engaged in an informal and preliminary survey of bank practices and capabilities. This survey, which has been conducted in a structured interview form, has produced some interesting results. On the whole, the banks are doing an effective job of monitoring and analyzing their foreign country exposure. There are, however, a significant number of differences in the treatment of particular forms of exposure. One

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

of the most significant differences in country risk measurement involves the allocation of interbank placements, which can be considered as exposure associated with either: (a) the country of the banking office in which the deposit is placed, because activities in that country might affect repayment, or (b) the country of the head office of the banking office accepting the deposit because the depositing bank is looking to the parent institution as the ultimate source of repayment.

Another difference arises in allocating exposure on shipping loans, where the owner may not be a citizen of the same country in which the ship is registered. To make things more complicated, the loan may be secured by a charter to a company which holds its assets in a third country, or perhaps multinationally. A further difference concerns the treatment of intrabank transactions and whether these transactions, which are netted out in preparing consolidated balance sheets for a bank, affect foreign exposure. When intrabank transactions are included in country exposure measures, the total foreign exposure of the bank may well exceed its total foreign portfolio. Still another difference involves the treatment of local loans. Is country risk-exposure affected when a bank's foreign branch funds its local-country loans through local deposits?

In addition to these questions of country allocation of risk, many of which perhaps ought to be resolved by allocating the risk to all countries whose policies might affect the exposure,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

consideration needs to be given to differences in the degree of exposure resulting from different forms of commitment. Bank placements do not involve the same degree of risk as medium-term loans. Short-term export credits are more self-liquidiating, in foreign exchange terms, than short-term import credits. Medium-term loans to or guaranteed by an official agency of the borrower country may be safer than those to private parties.

More important than these issues pertaining to the treatment of risk within the bank's decision framework is the analysis of the economic, financial and political situation of the individual debtor country. Practitioners of this activity are the first to point out that analysis of country risk is not a science. I hesitate to call it an art; perhaps it may be dignified with the term "craft."

A number of familiar ratios and relationships exist which throw light on the ability of a country to service, or allow its residents to service, a foreign indebtedness. The ability to service foreign debt clearly is positively related to the level of exports and, not quite so closely, to GNP. In the very short run it is positively related to the level of reserves and to available credit facilities. It is positively related also to the "compressability" of imports, which in turn tends to be a function of per capita GNP and of the composition of imports.

But these are very partial relationships. In some of them, the variables are not even accurately defined. Far more subtle and detailed relationships and data can be brought to bear on the problem.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Even then different views may be supported by the same basic facts.

Finally, the behavior of the units in this universe of debtor countries cannot be expected to be altogether independent of one another. If one country were to suspend service or its debts, others may follow. The reaction of lenders to the first default might deprive other borrowers of credit. The onus of default also might appear less to the second than to the first. The very limited cases of rescheduling experienced of late did not produce such a domino effect.

Regulatory and Supervisory Action

Three important areas invite the attention of bank regulators when they focus upon the international bank lending scene: (1) the need for adequate information, (2) IMF policy with respect to conditionality, and (3) the proper role of country risk in bank supervision and examination. With respect to information, very considerable efforts are being made today by banks to keep themselves fully informed of all developments affecting the countries to or in which they lend. This, at any rate, appears to be the present case of the lead banks in syndicated loans. Banks that participate in loans without ever taking the lead are sometimes less active in seeking information. Nevertheless, "investigate before you invest" applies to syndicate participation just as much as to stock exchange investments even though the costs

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

of acquiring that information may be high for banks planning limited participation in a credit. Each bank must consider every loan in relation to its own special circumstances. What is good for a leading money market bank, such as developing collateral or possibly getting approval to open a branch, is not necessarily good for a medium-sized regional bank which has limited contact with the borrower.

Better information can be provided if commercial banks are able to draw on data supplied by borrowing countries to international institutions such as the IMF, the Bank for International Settlements (BIS), and the World Bank. Questions of confidentiality may impose limits on what these institutions can communicate to private parties. Nevertheless, through the intervention of central banks, and best perhaps through the authorization of the country in question, part of this difficulty can be bridged.

But the confidential character of some of the available information is not really the essence of the matter. More fundamental is the fact that information that ought to be readily available simply does not exist either at the public or confidential level for the simple reason that it has not been collected. Data on total indebtedness, including private debt, the maturity profile of this total indebtedness, the interest burden thereon, often is simply unknown. Countries that maintain exchange controls certainly ought to be able to collect this type of information. Countries without controls could make a greater effort to approximate such data by statistical rather than regulatory

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

methods. In short, the fundamental point often is not that banks do not have access to data that are known to official agencies, but that the data are simply not known to anybody.

I next turn to the IMF's conditionality. By this I mean the IMF's practice of conditioning access to some of its credit to the establishment by the borrowing country of certain economic and financial policies. It has been argued that the International Monetary Fund should play a greater role in private bank lending, through negotiation of standby loan agreements, followed perhaps by co-financing with commercial banks. I believe that this is a promising approach. At the same time, we should not take for granted that commercial banks cannot establish some kind of conditionality even without the help of the IMF. Where a country has continuing relationships with major banks or expects to come to the market with some frequency, the bank's counsel with respect to domestic policies will be an influence without implying any lack of respect for the country's sovereignty. By paying out a loan in instalments, contingent on performance reviews, private banks can exert an influence on a country's willingness to follow agreed policies even in the absence of a binding contract. On the other hand, the IMF's power to influence a country's policy through the conditionality of its lending is not unlimited. National governments face domestic political realities that they cannot, in an effort to conciliate the IMF, ignore without danger to social and political stability.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

What matters is that commercial banks and international institutions act in coordination with each other. The borrowing country should not be able to look to the banks as a means of circumventing conditionality that the IMF had attempted to establish. The banks, on the other hand, should not look to the IMF as a means of a bail-out from injudicious loans.

At the level of bank supervision I would like to stress the great importance of maintaining bank soundness and safety without injuring the credit of debtor countries. Classification of bank loans that the examiner wishes to criticize into "substandard," "doubtful," and "loss," as well as the category "special mention," is a useful supervisory practice at home. We are all aware of the problems that use of the same technique internationally may produce. The impression that occasionally has arisen abroad that examiners have classified entire countries, instead of particular loans to borrowers located in those countries, can have unfortunate consequences.

Consideration might be given to an alternative approach that would focus, in bank examination of foreign loans, on the degree of concentration of such loans in particular countries. Criticism of concentration, in an industry, or in an area, is a normal feature of bank examination, due attention,of course, being given to the nature of each bank's market area. If such a procedure were to be applied to foreign lending, no country would be altogether deprived of access to bank credit, so long as individually sound loans were available.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Under such an approach, no country would be classified as such, although there could be distinctions between stronger and weaker credit risks among countries. Concentration might be defined, as it is domestically, with respect to the share of a bank's capital exposed to a particular country risk. This procedure would give the examining authorities a means of coming to grips with weak foreign risks and excessive bank exposure without doing damage to the credit of an individual country or depriving a country of bank credit altogether. It should be noted, in this context, that a bank's awareness that a particular loan will be "classified" by an examiner does not legally prevent the bank from making that loan. If the bank has reason to believe that the loan is appropriate, it may decide to make it even though its examination report will be adversely affected.

In conclusion, I would like to stress that, with respect to foreign lending, the role of the bank supervisory authorities today is a delicate one. There is need for increased caution and restraint. There is need also, however, for continued bank lending to countries where risk is acceptable. Bank supervisors must seek to control excessive exposure without damaging the international flow of capital. Excessive restriction would be counterproductive by possibly impeding necessary roll-overs as well as desirable new capital inflows, thereby possibly provoking the defaults that bank supervision seeks to guard

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

against. It might also discourage banks only marginally involved in foreign lending from continuing that activity, thereby throwing an additional burden on large banks and increasing their concentration in foreign lending. Success in walking the fine line between too much caution and too little will be essential not only to the safety of the American banking system, but also to the prosperity of the United States and the entire world.

#

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis