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Statement by

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Before the

Subcommittee on International Finance

of the

Committee on Banking, Housing, and Urban Affairs

of the

U.S. Senate

Washington, D.C.

Monday, August 29, 1977

I. Introduction

I appreciate this opportunity to present the views of the Board of Governors of the Federal Reserve System before your Subcommittee on recent growth of international indebtedness and some of the possible implications of this growth. In this testimony, I shall focus primarily on: (a) the major characteristics of the growth in international indebtedness and its potential associated risks, with special reference to developing countries, (b) new sources of financing for future balance-of-payments needs of deficit countries, and (c) improvements in the assessment of country creditworthiness and in the supervision of U.S. bank lending to foreign countries.

II. Dimensions of Indebtedness

Recent large increases in global external indebtedness are in part traceable to the major oil-price increases in 1973 and 1974 and the associated need for many developed and developing countries to finance the resulting large expansion in their current account deficits. But external indebtedness of many developing countries, in particular, has expanded also because they borrowed heavily during the commodity boom of the early Seventies to launch ambitious new development programs, and later to sustain these programs in the face of reduced export revenues during the 1974-75 reccession.

The flow of official financing, both for balance-of-payments and aid purposes, has grown at a much slower pace than global current account deficits. Consequently, a major portion of the increase in these deficits has been financed through private capital markets, particularly banks. The rapid change in the size and composition of external borrowing has given rise to concern about the ability of some borrowing countries to continue servicing their external indebtedness and about the corollary increase in risk for private lending institutions.

A. Debt to Banks

Data on private bank foreign lending recently have been improved, although information on the current level of external indebtedness of many countries is still incomplete. According to figures compiled by the Bank for International Settlements, total short- and long-term commercial bank claims on countries other than the Group-of-Ten major industrial countries and offshore banking centers reached $193 billion at the end of the first quarter of 1977, an increase of $44 billion or 30 per cent from a year earlier. During the same period, total U.S. bank claims on the same group of countries rose by $18 billion to $78 billion, or also a 30 per cent increase. (The share of U.S. bank claims in total claims on these countries is overstated by these statistics since the BIS data do not include claims held by non-U.S. bank branches operating in non-G-10 countries.)

B. Grounds for Confidence

It should be observed, in the first place, that world trade has increased at a rapid rate in recent years, although at a slower rate than the growth in recorded external indebtedness. As a result, debt service ratios (the ratios of interest and amortization payments to exports) hardly deteriorated in the aggregate over this period, although some deterioration may still lie ahead. Furthermore, these capital flows served to sustain productive investment in the recipient countries which otherwise might have dropped significantly in the face of world recession. These developments were made possible by the great expansion of international capital markets, especially in the form of bank credit.

There are also substantial grounds for confidence concerning the recent increase in international indebtedness, particularly with respect to non-OPEC developing countries whose total external indebtedness has been estimated at between $140 billion and $180 billion at the end of 1976. Through a combination of improved export earnings and a slower growth of imports, non-OPEC developing countries reduced their current account deficits in the aggregate by about $12 billion in 1976. Although their aggregate deficit in 1977 is expected to remain virtually unchanged from the approximately $26 billion deficit in 1976, the distribution of this deficit among debtor countries is expected to be more in keeping with these countries' financial strength. External credits arranged for non-OPEC developing countries in the first half of 1977 only moderately exceeded the volume of credits arranged for the same period a year earlier, and were sharply lower than in the second half of 1976.

A significant portion of recent borrowing by non-OPEC LDC's, moreover, may have served the purpose of building up international reserves to meet future needs. In fact, the official international reserves of six major non-OPEC LDC borrowers, -- Argentina, Brazil, Mexico, the Philippines, South Korea, and Taiwan -- that account for three-fourths of total claims of U.S. banks on all non-OPEC developing countries, increased in 1976 by an amount equal to about two-thirds of the Euro-credits arranged for them in the same period. Their reserves appear to have risen substantially further in the first half of 1977.

Eastern bloc countries, whose total borrowings from banks are substantially less than those of non-OPEC developing countries, and where the involvement of U.S. banks is relatively small, also have reduced somewhat their aggregate trade deficit and related external financing needs. In contrast, some smaller developed countries have increased their rate of external borrowing to finance expanding current account deficits.

It is important to recognize that much of U.S. international bank lending has been financed through deposits and other funds from non-U.S. sources. In fact, the United States itself is currently a net borrower of foreign funds as evidenced by a net inflow of private and official capital in our international transactions.

III. New Financing Facilities

Despite recent improvements in the international debt situation, the need to finance current account deficits will remain large at least until the OPEC surplus is significantly reduced. Recognition of this fact gave impetus to the Witteveen Facility which Under Secretary Solomon has discussed in detail with you. Although commercial banks have provided large amounts of additional financing in recent years, increases in other sources of financing are desirable for several reasons.

Banks have tended to lend to industrial and higher-income developing countries, whereas many middle-to lower-income developing countries have had to rely mostly on official sources of development aid and balance-of-payments financing to cover their deficits.

In addition, developing countries have need for long-term capital that cannot be met by banks.

Some banks may have reached prudent limits in extending credits to individual countries and may be reluctant to increase their exposure in those countries further, although they may consider loans designed to achieve broader diversification as still appropriate.

Moreover, some countries have reached levels of debt where further increases in bank debt appear feasible only if accompanied by improved fiscal and monetary policies. Some countries have spontaneously adopted such policies often followed by a notable improvement in their balance of payments. Some countries have taken appropriate measures in connection with IMF stand-by arrangements.

Commerical banks are not in as good a position as international agencies to influence the policies of countries suffering from current account imbalances to bring about needed adjustment through improved economic and financial policies. International lending agencies can more appropriately exert such a constructive influence in conjunction with their lending activities.

A. Expansion of IMF Resources

In this regard, agreement on the IMF Supplementary Financing Facility (Witteveen Facility) is a most encouraging development supplementing the increase in IMF quotas approved by Congress last fall and expected to become effective shortly. With substantial increases in its resources, the IMF will be better able to assist countries to meet their balance-of-payments needs. Moreover, these resources will lend the Fund's views greater force with members who in the past may have been reluctant to submit to IMF conditions because of the small amount of credit available to them from this source relative to their financing needs. The Federal Reserve Board urges the Congress to give sympathetic and prompt attention to the legislation approving the U.S. contribution to the new IMF facility when it shortly comes before you.

B. Expansion in Resources of other International Lending Agencies

Proposed increases in resources for the World Bank Group and the regional development banks should enhance the capacity of these institutions to meet the longer run capital needs of developing countries on terms and maturities more suitable to prevailing conditions in those countries.

Moreover, these institutions, with specialized staffs and intimate knowledge of developing countries, can provide technical assistance and influence the formulation of sound projects and development programs in ways not available to commerical banks.

These institutions also finance projects yielding long-run benefits to borrowing countries that fall beyond the normal scope of private capital markets.

C. Cofinancing

Cofinancing is one new technique for cooperation between the World Bank and regional lending institutions, on the one hand, and private banks, on the other hand, that merits careful attention as a means of channeling additional financial resources to developing countries. Cofinancing encourages private banks to participate in the financing of projects in developing countries by giving them protection through cross-default clauses and providing them access to information that is available to these international lending institutions regarding the viability and risk associated with proposed projects. Such information is often very difficult or expensive for the commercial banks to develop on their own. Moreover, countries borrowing through cofinancing arrangements may obtain funds on more favorable terms, particularly with respect to maturities.

Another noteworthy recent development has been the reluctance of commercial banks to provide additional financing to countries with serious balance-of-payments problems in the absence of assurances that the borrowing country is following sound economic policies provided under an IMF stand-by arrangement. Thus, some countries are finding that IMF approval of their economic and financial policies through a stand-by arrangement is becoming a precondition for maintaining their access to private capital markets. This development has been salutory in reducing the possibility that bank lending could frustrate Fund efforts to encourage countries to adopt better stabilization policies. The Fund is also in a position to supply information to private lenders within the limits imposed by the confidentiality of its relations with member countries. There is no indication, however, that the Fund would be prepared to become directly involved in evaluating or approving private loans.

IV. Debt Renegotiations

Despite the somewhat improved outlook for many countries that have incurred large increases in external indebtedness in recent years, some individual countries may encounter difficulties in servicing their external debt and may require some refinancing or rescheduling. This topic has been covered in greater detail in Under Secretary Cooper's testimony and I will only add a few general observations.

A. Official Rescheduling

Reschedulings of debts of governments to other governments have taken place periodically since World War II under Paris Club and similar arrangements. Since 1956, there have been close to 40 international agreements providing debt relief for roughly a dozen countries. These exercises, which have been conducted under a case-by-case approach, have generally aimed at encouraging debtor countries to undertake measures to reduce the underlying sources of their difficulties while providing debt relief that would enable them to move toward financial recovery and permit a resumption of normal capital inflows. Private debts usually have not been rescheduled in this context, in part because the amounts involved have in the past been relatively small compared with official claims.

B. Private Rescheduling

Workouts of debt to private creditors have been much more infrequent and have tended to take the form of refinancing rather than rescheduling of existing debt. Nevertheless, as a consequence of the rapid expansion in international bank lending in recent years, banks now hold a growing proportion of the external debt of a larger number of borrowing countries, often in the form of syndicated credits. In the event that severe debt problems should precipitate debt renegotiations for any of these countries, care will have to be taken that private and official creditors receive equitable treatment. While governments should avoid exerting pressure on private banks to influence the outcome of the banks' negotiations with debtor countries, official debt relief should not be looked to as a bailout for private banks.

G. Generalized Debt Relief

Some developing countries have advocated the idea of generalized debt relief or automatic criteria for debt rescheduling as a method of dispensing aid. Such generalized debt rescheduling is highly undesirable. It would, for one thing, be certain to reduce the access of developing countries to private external capital, by calling into question their future creditworthiness. Furthermore, proposals for generalized debt rescheduling, if implemented, would prove very inefficient economically since the aid they imply would be channeled on the basis of past borrowing rather than to countries with the greatest current needs. Finally, such a mechanism would create disincentives to the pursuit of economic and financial policies designed to promote economic stability and the most efficient utilization of resources.

V. Assessment of Country Risk

Let me turn next to the problem of the assessment of creditworthiness of individual borrowing countries. Despite the rapid growth and current size of their international lending, U.S. banks' loss ratios on international credits have continued substantially below loss ratios on domestic credits. We know, however, that past history may be a poor guide to the future. There are risks to be guarded against. Consequently, the Federal Reserve has been active in improving the flow of data needed by lending banks to assess creditworthiness of international borrowers and has been reviewing better ways to incorporate the concept of country risk into the supervisory process.

The Federal Reserve has taken several steps to provide new or improved sources of data useful for assessing country risk.

As part of a data-gathering operation sponsored by the Bank for International Settlements, the Federal Reserve conducted a special survey of foreign lending by U.S. banks at the end of 1976 which provided for the first time information on maturity structure, guarantee status, and commitments to lend by country. It is anticipated that the BIS effort will be repeated in December 1977.

The Federal Reserve is also cooperating with other U.S. bank regulatory agencies in collecting similar information on U.S. banks' country exposure as of June 1977. I should also note that in an ongoing revision of a number of Federal Reserve and Treasury reports received from banks, special attention has been given to improving the usefulness of international data derived from these reports.

In addition to the improvement in banking statistics, the Bank for International Settlements, at Chairman Burns' suggestion, is developing a list of information that borrowing countries would be encouraged to provide to commercial banks, and the banks would be encouraged to ask for, as an important step in loan negotiations. Work is now going forward in examining what types of information are most in need of improvement in order to serve banks in evaluating country risk. More complete data on the amount of external borrowing by the private sectors of individual countries should be one useful outcome of these efforts.

A. <u>Information from International Lending Agencies</u>

International lending agencies could also make a contribution to improving the flow and quality of economic and financial information on individual countries. The IMF and World Bank, as well as regional lending organizations, have developed considerable knowledge about and expertise on individual countries. If some of this factual information, particularly of the kind contained in their country reviews, were to be made available to the private market on an up-to-date basis, it would represent an important contribution toward improving risk evaluations. Such sharing of information must be done in a way, however, that would not reveal sensitive material and judgments, or reduce the explicit and frank nature of the discussion and analysis. Otherwise, the usefulness of such reports for the countries and official lending institutions themselves might be impaired.

B. Federal Reserve System Committee on Foreign Lending

The Federal Reserve System Committee on Foreign Lending is considering the treatment of country risk in bank examinations. As part of its work, the Committee has conducted an informal survey of the methods used by major U.S. banks to define, monitor, and analyze country exposure. That survey indicated that while U.S. banks differ somewhat in their approaches to these questions, the major U.S. banks that are active in international lending have well developed systems of country risk analysis. Moreover, these banks are devoting considerable resources to improving their country analysis.

Judging the degree of risk attached to foreign borrowers and making effective use of this judgment presents problems for both banks and supervisory authorities. While it is important to delineate problem areas to banks in the examination process, bank regulators need to be sensitive to the fact that admonishments to banks can result in damage to the creditworthiness of borrowing countries. As a possible way of dealing with this potential problem, the Federal Reserve is exploring a supervisory approach that would focus on the degree of country concentration of foreign loans in portfolios of individual banks, and on the quality of information possessed by banks in assessing the degree of risk attached to their international loans.

VI. Proposals for Limiting Payments Imbalances

In his statement announcing these hearings, Senator Stevenson has noted several possible methods by which international payments imbalances, which have given rise to the large accumulations of international debt over the past several years, might be reduced in the future.

A. Economic and Financial Policies

An essential first step in correcting imbalances is to ensure that countries with large balance-of-payments deficits move to adopt sound monetary, fiscal, and balance-of-payments policies. An important mechanism for encouraging countries to pursue policies that facilitate adjustment is the conditionality attached to drawings under IMF stand-by arrangements. And, as noted earlier, a substantial increase in IMF resources should enhance the Fund's leverage in encouraging better adjustment policies.

B. Exchange Rate Policies

It should be recognized that realistic exchange rates are a necessary ingredient in balance-of-payments adjustment policies. Under the current exchange-rate regime, the IMF is charged with the responsibility for surveillance of individual countries' exchange rate policies to discourage the maintenance of exchange rates at variance with underlying economic and financial conditions.

Substantial official intervention and capital market controls both tend to result in exchange rates different from those that would be determined by basic market forces. Some official intervention may reflect a desire on the part of authorities to counteract private speculation or, in some cases, may reflect commitments to the IMF. However, it must be recognized that private speculation often merely stems from an effort to avoid losses. Whatever its purpose, speculation that leads to greater stability in exchange rates should not be discouraged. The best means of achieving stable exchange rates is the pursuit of monetary and fiscal policies that contribute to domestic stability.

C. Trade Liberalization

A smoother, more effective adjustment process will also require that all countries avoid protectionist trade policies and restrictions which lead to global economic inefficiency and frustrate the adjustment process. Protectionism not only inhibits countries in deficit from expanding exports in order to reduce their current account deficits, but, in the form of capital controls, protectionism can also retard movements in foreign exchange rates which may be necessary to achieve and sustain a better global payments position.

VII. Conclusion

In summary, the surge in external country indebtedness that has accompanied a large increase in world payments imbalances since 1973, while attracting substantial attention, does not seem to pose any imminent threat to the stability of the world economic and financial system. We must nevertheless take measures to meet evolving situations lest the potential sources of instability that exist eventually develop into real threats. The Federal Reserve, in exercising its supervisory role, must keep in mind both the necessity of a sound and stable U.S. banking system and the positive role our banks play in meeting the financing needs of other countries. The Federal Reserve will also maintain an active role in seeking greater cooperation between banks and official lending institutions and in supporting new mechanisms that can contribute to sound and lasting international economic growth and stability.

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