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LDC DEBT -- TO WORRY OR NOT TO WORRY

Remarks by

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

at the 59th Annual Meeting of the

Bankers' Association for Foreign Trade

Boca Raton, Florida

Tuesday, June 2, 1981

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SUMMARY

1. Recycling of the OPEC surplus to non-oil-developing countries has proceeded more smoothly than many observers had expected. Indeed it accelerated substantially toward the end of 1980.

2. There is no indication, in the absence of prudential or other restraints, that the debt of developing countries measured as a fraction of their GNP may not continue to increase.

3. American banks have not continued to reduce their share in this form of lending, and have taken on a fairly stable share of a little less than 40 percent since mid-1979.

4. LDC lending by American banks continues to be concentrated among a relatively small group of large banks and this type of lending is shared only very moderately outside this group.

5. Country exposure, in relation to capital, has tended to rise for many of the lending banks. The bank examination process, focusing on concentration of risk exposure, is designed to restrain concentration.

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I am glad to have this opportunity to speak to the 59th Annual Meeting of the Bankers' Association for Foreign Trade at a time when the latest data made available by the Bank for International Settlements and others confirm that banks have behind them an extraordinarily successful season of lending to less developed countries, that is, if success is to be measured by the dollar volume of lending. Under the circumstances, the answer to the question that your program chairman posed for me -- to worry or not to worry -- is an easy one. Of course you should worry. Credit is suspicion asleep. If I ever found a banker who did not worry about any of his loans, I would worry about the banker.

This, however, does not answer the question whether to worry primarily about the less developed countries or about the banks. My answer to that question will be that this is a time to worry a little about the banks. But before doing so, let me raise a few worries also about the

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borrowing countries, more specifically the non-OPEC developing countries, to which I shall refer hereafter as LDCs, I would like to point out, however, that while this speech is about LDCs, in line with my assigned topic, these are not the only countries to which there are risks in lending. Neither Turkey nor Poland are officially classified as LDCs; and the Iran experience demonstrates that lending to OPEC countries is not risk free.

LDC Debt Developments

Turning now to LDCs, their total debt has risen, over the years 1971 through 1980, from $50-65 billion to about $400 billion. In real terms, the increase, of course, is considerably less. As a percent of GNP, the volume of debt rose on average during the years 1970-80. Debt service increased from $8 billion in 1971 to $75 billion in 1980 due in large part to increased interest payments. However, debt service as a ratio to total export earnings increased only from 16 percent in 1970 to 19 percent in 1979.

These data seem reasonably representative of the general trends of events. I must confess, however, that after looking at a variety of data from a variety of sources, the only firm conclusion that emerges is that averages and aggregates are not very meaningful. There are different groups of countries with very different debt capacity. So-called "non-OPEC" LDCs differ substantially in their position with respect to oil, today the principal import burden for most developing countries, some of them being actually net oil exporters although this is by no means a decisive distinction. Averages are distorted by the fact that the two largest borrowing countries

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account for close to one-third of total debt and also of debt service. The interest burden, in turn, looks very different depending on whether it is stated gross or net (after allowing for interest income on reserves). This applies particularly to countries other than the largest borrowers. Furthermore, comparability of data suffers from the different degree to which private and particularly short-term debt may be excluded.

Finally, the traditional debt ratios, used routinely for many years, are becoming increasingly undescriptive of what is happening. Needed, and no doubt available to many banks, are data measuring "investment performance" of borrowing countries. Only if the growth of indebtedness is matched by growth of income-producing assets, can the lender be sure that productive use is being made of his funds and that debt service can be sustained in the years to come.

The overall picture, which must be qualified in all the above respects, is one of only moderate increases in the volume of debt relative to relevant magnitudes, such as GNP, exports, and reserves. The growing burdens of oil imports and of interest payments are more noticeable, however. Each country clearly must be analyzed on its own terms.

Projections of balance-of-payments positions suggest that the developing countries as a group are making very little progress in overcoming the deficits imposed upon them by the second round of OPEC price increases. While the OPEC surplus is expected to diminish from $100 billion in 1980 to something on the order of $80-85 billion in 1981, this decline will be largely matched by a decline in the combined current account deficit of OECD countries. The LDC deficit over the same period is expected to rise

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about $10 billion to an estimated $70 billion or thereabouts and may stay at that level in 1982. That is to say, such a deficit could be expected provided it can be financed. About one-half is expected to be financed by bank credit. With such an increase, total debt of developing countries would rise into the $500 billion range. A good part of this debt, it must be remembered, was incurred when borrowers' creditworthiness was measured against an oil price of $13.50 per barrel, and against interest rates usually well below 10 percent.

The sharp increase in the rate of borrowing over the last two years reflects, for most of these countries, the rise in the price of oil, with related direct and indirect effects on developing countries. The increase in credit without a substantial increase in spreads makes it clear that the concerns about the markets' ability to recycle the new enormous OPEC surpluses have so far at least proved unnecessary. Pessimistic forecasters have had to revise their predictions and to move the period of probable difficulties further into the future.

Some observers who have tried to answer the question of how long this heavy financing of deficits can continue, given the accompanying rise in the ratio of debt to GNP, have argued that at some point in the not very distant future many borrowing countries will reach a relationship between their external debt and their GNP that would tend to stabilize at some manageable level. Obviously, this would depend on the rate of growth of the country's debt and the rate of growth of its GNP. When rates of growth of debt and of GNP were equal, a stable relationship would have been established between debt and GNP that would put an end to continued deterioration of this important measurement of a country's debt burden.

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In the nature of things, such relationships are unlikely ever to be stable. Yet they can supply some guidance regarding the magnitude of debt that might have to be contemplated. Calculating some examples with not untypical country features quickly makes clear that the hope that debt might taper off in relation to GNP in the near future depends entirely on the persistence of a very high rate of inflation. For instance, take the case of a country growing at a real rate of 5 percent, which is not untypical, and borrowing abroad to finance a deficit equal to 5 percent of GNP, which also is not untypical. Assuming a rate of inflation of 10 percent applicable to the dollar value of its GNP, the nominal growth rate would be 15 percent. If these conditions were to continue, the debt would converge to a stable relation to GNP of 1:3, i.e., debt would equal one-third of GNP. Such a ratio might be considered bearable; however, the interest on that debt presumably would reflect the rate of inflation, and would be somewhere in the range of 10-20 percent. If the precise nominal interest rate happens to be 15 percent, which would make it 5 percent in real terms, the real interest burden would amount to 5 percent of GNP. Under these conditions, a country would in effect be borrowing exactly what it needs to pay the interest. One must wonder whether this would be a sustainable situation or even, from the point of view of the debtor, one that made continued debt service an attractive proposition.

In the absence of inflation, much the same result would emerge. A country growing at a real rate of 5 percent and also financing a payments deficit of 5 percent of GNP would find its debt settling down to a stable relationship to GNP of 1:1, i.e., debt would equal GNP. Few observers today would regard such a debt burden as acceptable, even though the interest

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burden, assuming a noninflationary interest rate of 5 percent, would again work out at 5 percent of GNP and equal to the deficit to be financed.

One might construct an analogous example of a country growing at 5 percent in real terms and financing a deficit equal to only 1.25 percent of GNP, which in today's conditions would seem very low. The debt burden, depending on the rate of inflation, would settle down at one-quarter of the values arrived at in the previous example and so would the interest burden. These relationships might be regarded as sustainable. But they would imply a far more moderate pace of borrowing than is maintained today by many developing countries.

These illustrative calculations serve no other purpose than to demonstrate that today we are in a transitional phase that in the long run is not sustainable. In the short run it is made to appear sustainable, in some degree, by inflation, which causes a country to amortize its debt via interest rates. Fundamentally, a good number of countries are borrowing amounts that cannot be continued far into the future without leading to debt burdens that appear unsustainable from historical experience. In other words, some of these proportions must change, presumably through more effective balance-of-payments adjustments on the part of the borrowers.

Of the total debt of non-oil developing countries at the end of 1980, approximately $200 billion was owed to banks. Indebtedness to banks has been increasing in the range of 25-30 percent per year since 1978, and there was a special spurt in the final quarter of 1980, when gross LDC indebtedness to banks in countries reporting to the Bank for International Settlements increased by nearly 11 percent.

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For a while, it appeared that U.S. bank lending to LDCs was slowing. The U.S. bank share declined through the later part of the 1970s, reaching about 38 percent in mid-1979. However, since that time, U.S. banks have participated fully in the increased LDC lending and their market share has remained relatively stable. About 83 percent of U.S. bank lending to LDCs is held by 24 large banks. For these banks, claims on LDCs amount to nearly 10 percent of total assets and about 180 percent of their capital funds.

One could make illustrative calculations also as to what would happen to the balance sheets of banks in the unlikely event that they were to continue to increase their loans to LDCs at recently prevailing rates. Recently assets of U.S. banks have increased on the order of 10-12 percent per year. So, very roughly, has bank capital. Claims on developing countries have increased in the range of 25-30 percent since the oil price rise in mid-1979. Both figures are influenced, of course, by the high rate of inflation which, nonetheless, does not change the underlying picture. The high growth of LDC lending plainly cannot continue indefinitely. The picture makes clear, however, that greater adjustment on the part of the borrowing countries is needed. We know, of course, that trees do not grow to the sky. But in the banking field, one would also like to know that a mechanism that will prevent them from trying to do so is in place.

That mechanism, of course, is activated by the natural caution and prudence of bankers in the face of opportunities and pressures. The rapid growth of LDC lending tells us that the opportunities are there. The generally low level of spreads on this lending, which have not improved significantly in the first quarter of 1981, seem to indicate that the business is very attractive to the banks engaging in it. If it were not, and if they were lending mostly under the pressure of past engagements, why should they be doing so at rates that seem hardly remunerative?

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To be sure there are rewards other than spreads -- fees, below London Interbank Borrowing Rate (LIBOR) financing costs, collateral advantages for banks' worldwide establishments. Also, for a very few countries, spreads have recently widened substantially. It is interesting to note that this seems to have much facilitated these countries' borrowings, although changes in domestic policy also seem to have played a role. Nevertheless, the overall monetary return from LDC lending does not seem to be very high. One is puzzled by the seemingly strong competition for the business and eagerness to expand it on the part of the banks.

U.S. Bank Exposure

On the other hand, it is observable, among American banks at least, that the range of banks lending substantial amounts to developing countries has been slow to widen, although there has been some widening lately. From our country exposure surveys, we see that regional banks have not enlarged their market share and that lending in relation to capital has not increased for this group since 1977. As already mentioned, the 24 largest U.S. banks account for 83 percent of the lending by U.S. banks to LDCs, the same share as they had in 1977 in a much smaller market. This concentration of LDC business among American banks raises a question whether the business is truly as attractive as the competition for it among a limited group of banks would lead one to believe.

Some data will illustrate this development. For the nine largest U.S. banks, exposure to non-oil developing countries has risen from 156 percent of gross capital funds in 1977 to 204 percent of capital in 1980. For a group

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of the next 15 largest banks, this ratio rose from 105 in 1977 to 129 in 1980. Meanwhile, for all other banks reporting on the country lending survey, the figure remained relatively stable at 61 percent of capital funds. Of course, some smaller banks that are particularly active in international lending have exposure levels that are similar to those of the largest banks. I have cited these data primarily in order to raise the question whether LDC business is really attractive to banks, or whether perhaps it is attractive primarily to a group of highly specialized banks, or even whether it is being done because it has been done by these banks in the past, has become institutionalized, has generated strong ties between bankers and borrowing countries, and may reflect other factors not directly related to inherent attractiveness.

Whatever the reasons, the rapid increase in LDC lending by the most active banks has as its consequence another kind of concentration -- that of exposure to a particular risk in the portfolios of the banks doing this type of international lending. In June 1979, there were only 36 instances where a U.S. bank had an exposure to a single LDC in excess of 30 percent of capital funds. By the end of 1980, the number of such exposures had increased to 80. Obviously, there are some that are higher. In some cases one wonders whether for some banks their in-house country limits are not more nearly marketing objectives.

When figures like these are brought up, it is sometimes pointed out that almost all banks in the United States have a concentration to a single country of one thousand percent of capital or more -- namely a concentration in the United States. How much concern should there be about international country concentration?

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The answer is, of course, that in one particular sense a country is like a single customer no matter how many individual accounts a bank may have on its books in that country. In many, but not all, circumstances of those individual customers will share in the fate of their country if that country gets into trouble. The most obvious kind of trouble is an inability to supply foreign exchange, although many other forms might occur. With respect to country risk, therefore, the prudential concepts of diversification as the ultimate protection against risk cannot be set aside. Whether a benchmark for adequate diversification to an individual "entity" is set at 10 percent of capital, as the National Banking Act does, or at 25 percent, as New York State does for governments, is a matter of judgment rather than of principle. Either number is a significant distance away from some of the exposure ratios that are now being encountered. In any event, there is enough commonality of economic experience tying together individual borrowers in any single country to make meaningful the application to country risk of some such benchmarks, even though convincing fixed standards cannot be laid down.

One may go one step further and ask whether developing countries as a group have enough in common so that they might have to be considered as a single combined credit risk. It is not by accident, after all, that in our data and our analysis we distinguish developing countries from others. In international economic and political groupings, in the International Monetary Fund, the United Nations, the UNCTAD, developing countries form a cohesive group with common demands and purposes. From time to time, demands for massive debt rescheduling or forgiveness are heard. How strong, one must ask, is the common factor affecting the performance of loans to this group of countries?

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There is reason to believe that this common factor is far from dominant. In international discussions of LDC debt, the large LDC borrowers do not vocally side with the faction pleading for debt relief. Non-oil-developing countries have not even been able to establish a working relationship with the OPEC nations, which also rank as developing countries and which support their non-oil counterparts vigorously in general matters but not nearly so strongly when the issue of financing non-oil LDC deficits appears. Nor have we observed "domino effects" causing a debt rescheduling by one country to be imitated by others.

Indeed, econometric work suggests that, in terms of a portfolio approach to diversification, a "portfolio" of loans to different LDCs is a rather well diversified portfolio. The experience of individual countries with respect to rescheduling, while of course reflecting the fact that each of these countries encountered some difficulties, is quite varied and shows little correlation. It could even be argued, although I shall not pursue this point, that international diversification may reduce a bank's overall credit risk in some respects. In any event, it seems reasonable to conclude that the risk resulting from portfolio concentration in a diversified group of developing countries is a good deal less than the risk resulting from concentration in any particular country. Concentration in a more homogeneous group of LDCs, such as copper exporters or coffee exporters, falls somewhere in between.

Diversification in this field of lending is particularly important since events and circumstances that may trigger a failure of debt service are very diverse and often are hard to foresee. I need note only that the

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case causing the most market concern at the present time is not that of a developing country at all, but of an Eastern European country. The difficulties that lenders encountered in Iran and Nicaragua were not easily foreseeable, certainly in terms of the economic performance of those countries. There are other cases, to be sure, where deterioration was progressive and the eventual failure of debt service should not have been very surprising, as for instance, in Zaire and Turkey. The only explanation why some banks might have wanted to make a loan under those circumstances would seem to be that other banks were making loans.

Excessive Regulation?

Concern has sometimes been expressed, especially from the side of borrowers, whether bank regulatory practices in the lending countries were unduly constraining the ability of banks to serve the credit needs of developing countries. The evidence seems to say that this is not the case; and I do not observe restraints any stronger than seems desirable. As I noted earlier, a long-run continuation of the rising trends in country indebtedness and bank concentration of country risk could lead to unsustainable levels before reaching some "steady state." Therefore, there must be restraint from some source. That source could be a reduction of the OPEC surplus, which would reduce financing needs. But that would not necessarily provide a motive for developing countries to slow their borrowing. Their development after all has a long distance to go. A more likely source of restraint might be an increase in the real cost of credit and a somewhat decreased availability of credit as the major international banks approach their saturation points.

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I would like to look briefly at the nature of different regulatory restraints in this process. The nature and intensity of such restraints, of course, will differ significantly from one lending country to another. One such restraint is the move, in some jurisdictions, toward the practice of worldwide consolidation of balance sheets. It may create some new restraint on lending here and there, as a better picture of worldwide exposure emerges. That does not apply to the United States, however, where we have practiced consolidation for many years.

Capital ratios applied by regulators may also produce restraints on LDC lending. Some countries are strengthening their rules with respect to minimum capital ratios. In the United States, we have no legal minima in general, although there is, I believe, a rather pervasive feeling that the capital of large banks and bank holding companies has become very low in relation to the risks. We have, of course, the examination approach installed a few years ago focusing upon country exposure in relation to capital. In this analysis, a low capital position leads to a higher exposure ratio with respect to any particular dollar volume of lending to a country. An excessive exposure could be remedied by increases in capital, although admittedly that is the hard way. More effective would be to limit lending to countries where concentration in relation to capital is already high. It is the purpose of the procedure to alert management and directors to the possibility that this course of action is desirable.

My overall impression is, however, that these restraints, such as they are, are working with great moderation. They can hardly give rise to justified complaints on the part of potential borrowers. The banks' interest, and indeed obligation, is to avoid concentration in their country

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lending and to this end review with greater care the risk rewards available in enlarging their exposure to any particular country. In this way, the bank is helping ensure its own health and allowing market conditions to operate in the allocation of credit. Borrowers should appreciate such moves by banks since it is in the borrowers' own self-interest that the strength and soundness of the American and every other banking system be maintained. They will be in need of credit for many years, and the worst that can happen to them would be if the banking system from which they draw this credit should suffer injury because of this lending. Lenders and borrowers both have a common interest in the soundness of the other.

Some Possible New Approaches

Given the limitations on the LDC lending capacity of individual banks, it is a natural reaction to look for innovative techniques that would enable banks to be active in this field without substantially increasing their exposure. In a different forum, I have examined proposals made by various authors for insurance schemes, as well as proposals for cofinancing, brokering of loans and the use of passthrough techniques modeled on prototypes available in U.S. domestic financial markets. Today I just want to reiterate my view that these approaches are worth exploring, even though any particular variant presents obvious difficulties.

Any insurance scheme meets the basic difficulty that an adequate insurance fund is needed to inspire confidence. Probably some outside contributor would be needed at least initially, since it would take too long to build up a credible insurance fund built up from insurance premia collected. The question would have to be addressed who or what is to be

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insured -- a particular loan, a bank, or a depositor. Each technique would have its pros and cons. There is no lack of proposals along any of these lines.

Cofinancing and brokering of loans are practices that already exist and perhaps could be expanded. The World Bank has significantly stepped up its cofinancing activity. Cofinancing would increase the ability of all participating institutions to serve their customers.

Brokering of loans would involve private placements with nonbank lenders, allowing banks to utilize their expertise in setting up loans without commensurately lengthening their balance sheets. It seems to be a not-infrequent practice domestically, but not as yet in use for loans to developing countries.

In short, banks are not necessarily limited to the traditional techniques of direct or syndicated lending in their relations with developing countries. As exposures rise, the exploration of these alternative techniques will probably be activated. I would hope that this would occur sooner rather than later.

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