FOR RELEASE ON DELIVERY
FRIDAY, FEBRUARY 18, 1983
1:15 P.M. EST

FINANCING DEVELOPING COUNTRIES

Remarks by

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

at the

Annual Conference for U.S. Commercial Bankers

sponsored by the

Export-Import Bank of the United States

Washington, D.C.

February 18, 1983

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

FINANCING DEVELOPING COUNTRIES

Remarks by

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

at the

Annual Conference for U.S. Commercial Bankers

sponsored by the

Export-Import Bank of the United States

Washington, D.C.

February 18, 1983

It is a great distinction to be invited to speak at this luncheon of the Export-Import Bank on the subject of financing developing countries. In what I have to say, I shall be concerned with some of the basics of developing-country financing in the context of the world economic situation.

How Much Debt Is Sustainable?

It seems fairly clear, in today's perspective, that the foreign borrowing of developing countries for some time has been moving at a pace and in a pattern that is not sustainable in the long run. That is to say, the debt of the middle and higher income developing countries has been rising -- with some notable exceptions -- relative to their debt-carrying capacity. This has been possible because most countries, early in the postwar period, had not gone very far in using the debt capacity generated by their

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

income and exports. There was something like a vacuum to be filled. Under such conditions, a country's debt for a time can grow faster than its economy and its capacity to carry debt. But this cannot go on indefinitely. At some point, the growth of external debt must slow down to a rate commensurate with that of the economy, even if the country in other respects remains a structural capital importer, and even though, in some degree, productive use of borrowed funds enhances debt capacity.

I am stressing these somewhat abstract relationships for a purpose. It is important to make clear that we are not talking about a total cessation of net borrowing. That is to say, we are not talking about stabilizing the absolute level of debt and thereby bringing down the ratio of debt to debt capacity. For most countries, debt can continue to grow. But in the general case -- I am sure there are many exceptions -- debt probably should not grow faster than debt capacity from here on out. Likewise, we are not talking about paying off the existing debt, without replacing it with new debt. That would for a while make the repaying country a net capital exporter, which would probably be at odds with its economic structure and state of development. A growing organization, whether it is the telephone company or a developing country, can carry a growing debt. The question is one of proportionality of debt to the underlying base.

Liquidity and Solvency

Banks have worked hard, of course, at analyzing developing countries' debt capacities. Presumably when they made their loans, they did so because their calculations told them there was adequate capacity to service the debt.

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

Recent events in international lending do not necessarily indicate that all those calculations were defective. But, evidently some countries have been pushing their borrowing to the point where debt could only be serviced under relatively favorable circumstances. A cumulation of unfavorable circumstances, such as we have observed recently, in some familiar cases has proved too much for continued smooth debt service.

The adverse circumstances that have coincided, in different degree for different countries, are familiar. The rise in the price of oil, the rise, temporarily at least, in interest rates, the world recession which depressed commodities prices and led to increased protectionist restrictions, all may not have been foreseeable at the time when many of the loans were put on the books. But medium- and long-term loans must be made with the expectation that they will be tested by unexpected developments. That is an essential difference between medium- and long-term loans and short-term commercial loans. In particular, the possibility that several adverse circumstances might occur simultaneously apparently has not been adequately taken into account either by the authorities in the borrowing countries or by the lending banks.

The fact that the present difficulties have arisen under a rather unusual combination of adverse circumstances suggests that most problems are those of liquidity rather than solvency. Some of the difficulties clearly are temporary. They can be bridged. A problem of solvency, i.e., a structural problem, might be judged to exist if even under more average circumstances a country were expected to encounter difficulties in servicing its debt. Obviously such distinctions are matters of degree. In any event, the emergence of liquidity problems is a signal that utilization of debt capacity has been pushed to the danger point. It would be altogether unwise to push

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

debt utilization to the point where even under average conditions servicing difficulties would make their appearance. There has to be a substantial safety margin to take care of developments that are not average.

Criteria of Debt Burden

This leads me to an examination of some of the criteria by which banks have been guided in making their loans. One of the defects in the routine assessment of debt capacity has been excessive reliance on export data. Exports are not an ultimate measure of debt capacity. For many countries, exports have grown faster for many years than has their gross domestic product. Exports, to be sure, are essential to service foreign debt. Their growth may also be a good test of the efficiency and competitiveness of the economy. But fundamentally, foreign suppliers of capital, like the suppliers of other factors of production in the economy, are paid out of income, not out of exports.

In any longer-run analysis of debt burdens and debt capacity, it also needs to be remembered that interest, and not interest plus amortization, constitutes the true debt burden. Amortization is necessary in order to demonstrate the continued ability of the borrower to pay, to relate the maturity of the debt to the purpose for which it is incurred, and in order to meet the lender's particular maturity needs. Debt service ratios, therefore, are tests of liquidity as well as of solvency. But, in a normally growing developing country it must be assumed that maturing debt will be replaced by other debt and, in fact, by additional debt. Though each individual loan must be serviced punctually, the debt as a whole can increase so long as the economy grows. The same applies, of course, to any ongoing and growing enterprise.

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

In particular cases, of course, a net capital importing country may graduate to the role of net capital exporting country. Its net indebtedness will then go down. Most of the world's industrial countries, including the United States, have gone through that process. But, it is not a necessary development.

Another important element in assessing debt capacity is to study the use that countries have made of their past borrowings. Effective use of borrowed funds to build up the economy raises capacity and allows the lender to lend more. Use of borrowed funds for inefficient projects or, to an excessive extent, for consumption, makes the wisdom of further lending questionable.

The broad evidence on past use of borrowed funds is mixed. For large groups of developing countries, there is some indication that borrowing facilitated higher rates of investment and growth. For instance, a study by the OECD (Organization for Economic Cooperation and Development) shows that over the 1960's and 1970's, the rise in capital imports experienced by all groups of oil-importing developing countries was accompanied by rising domestic capital formation. Nor did capital imports appear to discourage domestic saving, since domestic saving, too, rose for these LDC groups. Of course, this does not demonstrate that all foreign capital went for investment or that such part of it as did was efficiently used. But, the finding does seem to refute the allegation sometimes heard that what the developing countries did with the money was mainly to pay for higher oil bills.

Not all available evidence is equally favorable, however. Other studies seem to show that while investment rose as capital imports increased, the return on investment deteriorated. As a result, the rate of growth of the LDC economies on average slowed down after the first oil shock.
Given the need for structural changes imposed on some countries by the rising

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

price of oil, this does not necessarily point to a faulty use of the imported resources. But the rise in oil import bills makes it difficult to believe that part of the borrowing did not occur implicitly or explicitly for the purpose of paying these bills well after the oil price shock.

It is apparent, in any event, that not a great deal is known about the uses to which much of the borrowing was put, even realizing that the ultimate economic effects may not be very closely related to the imports financed with borrowed money. This does not speak well of the manner in which some of the loans were granted. Certainly, it would seem that the granting of bank credit for general balance-of-payments purposes and without ties to specific investment projects or even to a broader investment program is not an optimal procedure. Money, to be sure, is fungible, and funds can be reshuffled by the borrower to frustrate the purpose of tying loans to a project. But, some minimum assurance of productive use of some of the money can nevertheless be achieved.

In addition to incomplete knowledge of the use of funds, another problem in bank evaluation of international lending seems to be the propensity to view a loan proposal in terms of the bank's own lending limits for a particular country more than in terms of what should be the country's borrowing limit from all lenders. Naturally, a bank's own lending limit must be the primary constraint. But, if this is matched with a tendency to view a major country as a market rather than as a single borrower, the risks of international lending are understated. The problem is aggravated by the fact that a bank has no means of anticipating future borrowing decisions of the borrowing country, or of restraining them. If the debt rises rapidly, the quality of initially sound loans may deteriorate. Recently, we also have seen that if the availability of credit from certain creditors contracts suddenly, then

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

the quality of claims held by other banks may deteriorate. Evidently, the behavior of lenders and borrowers in sovereign loan markets has differed in significant ways from their behavior in other markets. This is a problem that bank supervisors may need to keep in mind.

Finally, failure to assess realistically the potential debt-servicing problems of borrowing countries has led to the charging of spreads that often, and not only in the light of subsequent events, were clearly inadequate. Higher spreads (including fees) would have discouraged some of the high-risk borrowing that took place during the period of high and rising LDC deficits in 1979-81. Instead, low spreads combined with negative real interest rates made borrowing for consumption as well as investment appear costless. When one considers that for many countries this borrowing merely postponed an earlier and more complete balance-of-payments adjustment, its unfortunate connotations become readily apparent.

Prospective Credit Flows

In the light of what I have said so far, an attempt can perhaps be made to evaluate how much developing countries might reasonably try to borrow, and where the money might come from. At the present time, there is no doubt that the flow of capital to developing countries has diminished, and that lending by commercial banks also has diminished. In 1980 and 1981, the net external borrowing of non-oil developing countries rose to an average rate of $75 billion per year. Commercial banks, roughly speaking, financed about one-half of that, although in very different proportions for developing countries at different income levels. A total cessation

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

of bank lending, which is neither desirable nor probable, would reduce the LDC borrowing by roughly one-half unless other sources move into the gap.

How do the numbers shape up on the side of the borrowing countries? I have argued that, on average, countries might begin to stabilize their debt/GDP ratio hereafter. Debt then would grow no faster than GDP. Allowance would have to be made for both real growth and for inflation in the currency of the lending country. A high rate of real growth might be 5 percent, and a moderate rate of inflation might likewise be 5 percent, allowing for total growth of debt of about 10 percent annually. That would contrast with a rate of growth of LDC debt of perhaps 25 percent in the middle seventies and declining to less than 20 percent more recently. It would imply a considerable cutback. It would also mean, however, that the banks could reduce the growth of their international lending to about the same rate as the growth of their capital base without making an excessive dent in the amount reasonably required for developing-country growth. Again, it needs to be noted that the share of banks in the financing of particular countries has varied from almost zero to not far from 100 percent. High-income developing countries, therefore, would continue to be dependent on the flow of bank credit.

Motivation for Debt Service

It has sometimes been argued that continued debt service by LDC borrowers is dependent, in terms of simple self-interest, on a continued net flow of capital. Indeed, it has been alleged that unless the net capital inflow exceeds the interest on the debt (or, equivalently, unless gross capital inflow exceeds total debt service), the borrower is better off if he defaults. Otherwise, supposedly, he will just be borrowing the interest and will be increasing his debt with no benefit to himself.

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

It would be a great mistake to deduce, from these abstract propositions, that debtors have a meaningful motive to default. A great many countries, including the United States, have passed from the role of net importer to net exporter of capital. They, therefore, must have passed through a phase in which their interest payments exceeded their capital inflows. Nevertheless, they did not draw the conclusion that they would be better off ceasing to pay interest and forego receiving net capital imports.

But, even for a country that is not on the way to becoming a capital exporter, such calculations are not meaningful. A country visibly and demonstrably repudiating its debt would find it very difficult to avoid cutting off at the same time most of its existing trading relationships. Not all the coffee, grain, and minerals in the world can be sold to the Eastern Bloc. Assets abroad and goods in transit might be subject to legal action by creditors. The country would risk cutting itself off from the sources of technology. Repudiation does not look like a realistic option.

Nevertheless, it is clear that a significant net inflow of capital increases the short-run incentives of developing countries in maintaining their debt service on schedule. IMF adjustment programs and debt rescheduling sessions probably raise awareness of such considerations. It is worth noting, therefore, that in 1980 and 1981 average annual interest payments of about $50 billion have been somewhat less than net capital inflows to non-oil developing countries of the order of $75 billion per year. For high-income developing countries, which have borrowed more at commercial and less at concessionary rates, the relation of interest payments to net capital inflows has been substantially less favorable, on the order of $22 billion annual

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

interest payments to $26 billion annual net capital flows in 1980-81. A reduction in bank lending would very predominantly fall upon these same countries and might at least initially turn the balance of new borrowing to interest payments in their disfavor. Of course, these calculations depend very much on the level of interest rates.

Alternative Sources

Given the cutback in the flow of credit to be expected on the part of the banks, and the cutback in borrowing that the developing countries will have to make to prevent their debt ratios from deteriorating further, it is not clear at this time whether additional money will be needed from alternative sources. Nevertheless, this is not implausible. Whenever such real or imaginary financing gaps are discerned, it has become customary to plead for some kind of official money to fill them. I do not believe this should be our first reaction. In particular, I do not believe that calls for the International Monetary Fund to fill any real or imaginary void in bank lending are well founded. There is indeed a great need for the IMF in the traditional role in which it has of late been very active. The debt situation has demonstrated abundantly that to promote adjustment and to provide financing during that interval, a strong IMF is required, as are the increases in the IMF's resources that are now being proposed by the United States Government. But, that is entirely different from proposing for the IMF a new role in taking over part of the function of the banks as a quasi-development lending institution. The Fund's function is not to build up a steadily growing portfolio, as other private and official financial intermediaries do. It must have available large resources which it can employ for temporary periods when liquidity problems arise for individual countries or worldwide.

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

That is very different from providing the funds that developing countries may need for their continued growth.

Rather, I believe that if financing gaps remain, this is a time to give the market a chance to remain effective in development financing. The market seized its chance the first time when the commercial banks became the biggest market-oriented lenders to developing countries. But, the financing that resulted was not entirely appropriate for economic development. Medium-term bank loans are not the best means of financing long-term development projects. They are just the best that the banks can do given their own liquidity needs.

Neither is a development financing structure optimal if it rests almost entirely on debt. A greater admixture of equity would seem desirable. That would make the financing burden more flexible, spread the risk beyond the banking sectors, and also contribute to more effective transfer of technology. Developing countries, I believe, were not well advised when they erected diverse barriers to direct and portfolio equity investment. It would be constructive if more developmental financing could come from the equity side, be it direct or portfolio. Under modern conditions, the old fear of exploitation has become an anachronism.

If other sources of funds remain scarce, I should think that there is a fair chance that developing countries would learn to use the various sources of equity capital more effectively. Creating attractive conditions for private, direct and portfolio investment is the key. Developing countries could roll back the panoply of restrictions -- on royalties and dividend remittances, employment practices, domestic-content requirements, unrealistic price controls on large firms -- that have

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

discouraged direct investment in the past. New techniques of financing could be developed. Perhaps necessity, which has been the mother of many inventions, will help here, too.

Financing Gaps?

All this does not mean that official funds are not needed. For many years, the balance of official to private funds in total development finance has shifted in favor of private, and that has been basically desirable. But, there are some things that the market does not do as well as it might, and indeed sometimes does not do at all. Among these market gaps is lending to very low-income countries. Their long-term needs have had to be met almost entirely through official financing. Much of it has been on concessional terms.

Another financing gap seems to have existed in the financing of long-lived capital goods for export. It is here that Eximbank has had to play a special role. For exporters of durable capital goods, the declining availability of international bank financing comes at an especially difficult time when the dollar has been very high and U.S. interest rates have been high also. Indeed, I would believe that the best prospects for American exports of this kind lie in a policy that creates the conditions that lead to a more stable dollar and to lower interest rates. In the long run, both of these objectives can be achieved only by a reduction in inflation and a lowering of the federal deficit. These circumstances, of course, would also benefit developing countries that must raise a good part of their money in dollar denominations and at dollar interest rates. At the same time,

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

economic policies that lead to stabler prices, a stabler dollar, and lower interest rates, will enhance growth and employment in our own country where they are needed as much as they are in the developing world.

#

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