FOR RELEASE ON DELIVERY
FRIDAY, FEBRUARY 8, 1985
3:00 P.M. (9:00 A.M. EST)

THE INTERNATIONAL DEBT SITUATION IN AN AMERICAN VIEW:

BORROWING COUNTRIES AND LENDING BANKS

Remarks by

Henry C. Wallich
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Verein fuer Socialpolitik

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At this time, the total external debt of developing countries may be estimated to be something less than $900 billion. About three-fifths of this has accumulated since 1977. Before asking whether and how this debt can be serviced, it is useful to place it in a context of world magnitudes.

Annual world (non-Communist) savings out of a world GNP of something in excess of $10,000 billion can be estimated at perhaps a gross 20 percent and net (after depreciation) at something less than half, or $1,000 billion. During the time when developing-country debt was growing at its fastest rate, of about 20 percent per year, it absorbed close to one-tenth of current world saving. More recently, such debt has been growing at an annual rate of the order of five percent or a little more, absorbing perhaps one-twentieth of world saving.

At the time of maximum borrowing, therefore, the developing countries claimed a more substantial part of world saving, in contrast to today's relatively modest demands. However, during the heyday of developing-country debt

expansion, OPEC surpluses still were making a substantial contribution to world saving. Today, in contrast, the United States makes demands on world saving on the order of $100 billion annually and soon probably more. At all times, therefore, factors other than developing-country borrowing dominated the pattern of world sources and uses of saving.

Uses of Borrowing

If, from a world sources and uses point of view, developing-country borrowing is seen to have been of only moderate importance, this borrowing nevertheless has been highly significant for the domestic absorption of resources in the borrowing countries. What did the developing countries do with the money they borrowed, and what did the money do for them? If the borrowings were largely invested in income-producing assets, productivity and income would have risen and the service of the resulting debt should present no basic problems. Only rather tenuous guesses are possible, however, as to the part of the inflow that directly or indirectly went into incremental investment. Ratios of investment to GNP, or to a measure of total absorption, did rise on average for developing countries during the 1970's.[1] Saving ratios also rose. The rate of growth of most developing countries was high during the period of heavy borrowing. But the return on investment seems to have declined as investment rose, and there was some slowing in basically still high growth rates.

Some "investment" of a very different kind took place, in the form of capital flight. In the case of Mexico and Argentina, this outflow is estimated, from 1974 to 1982, to have accounted for perhaps one-half of the net amount borrowed; in the case of Venezuela, about 90 percent; in that of

Brazil about one-eighth.[2] This "investment" benefits, not the home, i.e., developing country, but the country where the flight capital went. Even so, the diversion of borrowed funds into capital flight is less detrimental to world development than if the owners had chosen to consume these resources. Some downward pressure may be exerted on interest rates and rates of return not only in the country receiving the flight capital, but all over the world. The resources, to be sure, for the time being produce neither income nor probably taxes for the home country. Nevertheless, appropriate policies, including positive real interest rates, plus political stability, could bring some of it back.

Unfortunately, one must assume that a large part of the borrowed money went for consumption, in the form of excessive imports of high-priced oil and various consumer goods. Frequently this spending was financed through government budget deficits, caused by subsidies and other unproductive expenditures, including purchase of weapons. A worldwide shift from negative real interest rates to significantly positive real rates, and the consequent rise in debt service, also used up some of the funds borrowed.

In adding up incremental investment, capital flight, and increased outlays (in nominal terms) for consumption, there is a danger of overexplaining the absorption of borrowed funds. The best judgment seems to be that the borrowing countries experienced a substantial increase in their income and debt-carrying capacity and that these benefits of added investment could be enhanced in future if measures are taken to induce flight capital to return. It must also be remembered that easing the impact of higher oil prices provided benefits as contrasted with the consequences of an unassisted brusque adjustment, even though the easing may often have gone too far.

Debt Capacity and Growth

An alternative approach to exploring the ability of developing countries to service their debt involves the familiar comparisons of growth and the real interest rate. If the growth rate of the economy (measured conveniently in terms of exports but more fundamentally in terms of GNP) equals the interest rate, the country can potentially borrow all the interest it pays without changing the ratio of debt to GNP or exports. Debt and the economy grow at the same rate. This holds true at any relationship of debt to the scale variables -- whether debt is 10 percent or 1,000 percent of exports or GNP.

In this conceptual model, it is implicitly taken for granted that the outstanding debt is rolled over continuously. Debt service means interest payments. At no level of the debt/GNP relationship does the country retain any part of its annual borrowings for investment, so long as the interest rate equals the growth rate. If the interest rate falls below the growth rate, some of the borrowing that keeps the debt at a constant relation to GNP can be used for investment, via a trade deficit. If the interest rate rises above the growth rate, the country must pay some of the interest via a trade surplus.

In any event, a stable debt/GNP relation is sustainable only if the creditors regard the country as creditworthy and are satisfied to roll over the debt. This approach tells us something about the dynamics of keeping debt afloat. It does not tell us what debt/GNP ratio the lenders will regard as acceptable. Presumably a debt ratio rising without limit is not acceptable to them. How far they will allow the ratio to rise without curtailing their lending cannot be read off the model. Conceptually, any ratio, once attained,

can be stable. If the interest rate equals the growth rate, the country would have the full use of its export revenue for importing purposes.

The practical application of the model in any event is subject to all the uncertainties of the interest rate and the growth rate. Although there are fundamental reasons why over long periods, and for the world as a whole, the two should be equal, making all the required assumptions, in the short and medium term obviously the growth rate fluctuates substantially, while the real interest rate can shift from negative to positive and back.

Interest Burden and Trade Surplus

A third approach to the question of an acceptable debt ratio is the empirical one via modeling. This is the approach employed by William R. Cline in a study that finds that, under reasonable assumptions, a 3 percent growth rate of the OECD countries will over time enable the major debtor countries to reduce their debt ratios to a level that the lenders, in the circumstances of the past, have considered creditworthy.[3] Before reaching that point, lending is assumed to continue in the "involuntary" mode made familiar by various reschedulings.

In order to reach lower debt ratios, the borrowing country must at least for a while pay some of the interest out of exports (unless the interest rate should fall below the growth rate). But since it continues, by assumption, to finance some of the interest by borrowing, the debt will continue to rise. It will rise, however, at a rate lower than the growth rate, and the country's debt ratios will improve. That is the condition of many of the developing countries today -- they have a trade surplus, but a current-account deficit, their debt rises, but more slowly than exports or GNP.

What is the significance of the incipient trade surplus? So long as the trade surplus is exceeded by interest payments, on any reasonable definition the country has an inward resource transfer. It is paying interest for the services of capital. To treat a trade surplus as a net outward transfer would seem to deny that capital services should be paid for, much as the services of rented planes or ships, or any other services in the balance of payments.

It is sometimes argued that a debtor will feel motivated to default when he experiences a trade surplus and believes that in future he will always be borrowing less than the interest he pays. This is contrary to historical experience. Many countries have gone through the familiar stages of borrowing, from incipient debtor with a small initial stock of debt, who is likely to have both a current-account and a trade-account deficit, to more mature debtor, with a large debt, who still has a current-account deficit but also has a trade surplus and, after perhaps many years, to the position of net repayer of debt with both current-account and trade surpluses. No stage in this process has ever become occasion for systematic repudiation of debt.

It is true that this historical experience generally has reflected private borrower/creditor relationships, rather than the decisions of a single monolithic debtor capable of taking a macro view of the costs and benefits of maintaining debt service. But it is true also that the cost of default, in terms of damage to trade credit, damage to long-term developmental facilities of all kinds, and, in effect, isolation in the world, would be high. To this must be added the uncertainty about future relationships of growth rate and interest rate, and about future borrowing needs, which implies that at some

future time the country may indeed find it possible to sustain a trade deficit, i.e., to borrow more than its interest payments. These considerations make deliberate default unlikely, as I have argued repeatedly.[4]

A Perpetual Debt?

The ability of developing countries to service their debt so far has been treated in terms solely of the interest burden, without regard to amortization and maturities. In other words, it has been assumed that the principal of the debt can be continuously rolled over, and that the existing debt is in effect perpetual. In economic terms, this is a realistic assumption, because it conforms to the structural characteristics of most developing countries. They are structural capital importers, because typically the capital/labor ratio is low, the marginal productivity of capital high, and the domestic saving rate, even though frequently equal to that of many industrial countries, inadequate to satisfy the demand for capital at prevailing rates of return.

A perpetual debt without periodic maturities, however, is not acceptable to the lending banks. Given the nature of their liabilities, they should not and cannot make long-term loans. This creates a somewhat specious problem. The banks need well-defined short- and medium-term maturities, which must be met punctually. The banks, therefore, tend to think and speak in terms of debt service and the ratio of debt service to exports (or GDP), thereby seemingly increasing the annual debt burden very substantially. They know, of course, that the debt must largely be rolled over. But from their point of view, this rollover must occur through normal access of borrowers to the market, so that maturing loans can be replaced with voluntary new loans, possibly from the same but also from new lenders. These

market rollovers are important to the banks as evidence of creditworthiness, and creditworthiness, therefore, becomes an essential condition of the continued servicing of the debt.

This does not alter the premise that, in a fundamental economic sense, the only burden with which the debtors need to count is the interest burden. Indeed, it is reasonable to assume that at least part of this interest burden can be financed through additional debt. A move in the direction toward reconciling appearance and reality, or, more concretely, the institutional needs of the banks and the functional permanence of the debt, has been made through the introduction of the concept, and increasingly the reality, of multi-year rescheduling. This would help avoid the practice, fairly general until recently, of annual rescheduling of debt. The creditors, in other words, would not gather together with a given debtor once a year, conclude that not only can he not pay the maturities on schedule, but that he also needs some additional money for interest and other purposes, and then grant an "involuntary" loan. These "involuntary" loans have been made in connection with particular IMF arrangements. In these credit arrangements, the Fund obtained the country's acceptance of an economic adjustment program, and in return supplied some resources of its own and brought along the banks who typically provided an amount substantially larger than the Fund did.

This procedure has the advantage that the borrowing country is committed formally to a particular IMF program. Failure to adhere to the program, possibly as modified by mutual agreement, means loss of any still pending drawing on the Fund, and possibly of undrawn tranches of the banks' loan. The procedure gives the country a strong incentive to abide by the program.

The procedure has the disadvantage, on the other hand, of periodically drawing attention to the fact that the country is unable to borrow in the market in a normal way, thus making more difficult a return to normal market borrowing in the future. The method of multi-year rescheduling reduces this somewhat prejudicial connotation. The country's foreseeable needs can be taken care of in advance, or at least placed in a less negative context whenever they need to be met. For the banks, possible risk in multi-year rescheduling has the possible disadvantage that the IMF arrangement which is the condition of the original rescheduling runs out well before the loans mature. Thus, the country's policies would no longer be constrained by an IMF program and the banks may see themselves confronted with mounting risks. The means that have been found to deal with this problem consist in an agreement between the IMF and the country for "enhanced surveillance," i.e., an intensification of the normal annual consultation between Fund and country with the "results" or "conclusions" in principle affecting continuation of the process.

A multi-year rescheduling may enable a country to do without "involuntary" lending. Even when that practice continues to be necessary for some time, creditworthiness can be expected to be restored eventually as debt and debt service ratios are reduced to levels that, at least in the circumstances of the past, the market has regarded as signalling creditworthiness. This gradual reduction in debt ratios is consistent with moderate increases in the absolute level of the debt. For instance, William Cline calculates that under his assumptions for Mexico the debt/export ratio would drop from 310 percent in 1983 to 210 percent in 1987; for Brazil,

from 370 to 230 percent; for Agentina, from 490 to 320 percent.[5] For the banks, growth of absolute developing-country exposure at moderate rates should in general imply diminishing exposure with respect to capital, since in recent years, capital, at least in the United States, has tended to grow at a rate of 8-10 percent.

For many countries, bringing down debt/GDP and similar ratios and returning to voluntary financing implies changes more basic than the short-term balance-of-payments adjustment sought by many of the Fund's arrangements with formal duration of one year or a little beyond. The latter typically imply a return of a viable balance of payments with no major changes in the structure of the economy. For instance, reduction of domestic excess demand and appropriate adjustment of the exchange rate would improve the balance of payments both by reducing imports and stimulating exports. But for many developing countries with troubled debt, more may be needed than a turnaround in an otherwise unchanging economy. Structural changes may be needed enhancing the export base and substituting domestic production for imports. The Fund's extended-facility programs, typically over three-year periods with ten-year repayment, are designed to deal with medium-term adjustment problems. The World Bank, traditionally focusing on long-term project loans, has shifted a moderate part of its activity to structural adjustment loans, a factor which has contributed to the recent debate over the need for greater cooperation between the two agencies.

The foregoing considerations naturally lead to a more detailed discussion of banking aspects. Before turning to that subject, a brief conclusion from the preceding section, dealing with the ability of debtor countries to pay,

is in order. That conclusion is, on the whole, positive. Conceptually and in the abstract, there are no obvious narrow limits to debt capacity. Empirically and in terms of the willingness of banks to lend, a good case can be made that, with an adequate growth rate in the rest of the world, developing countries can reduce their debt ratios (not the absolute value of the debt) to levels at which adequate borrowing opportunities will open up again spontaneously. Trade surpluses, however, are likely to prevail for most countries much of the time.

The Banks' Side

I now turn to the side of the lending banks, in keeping with the framework established for this paper by our chairman. In particular, I would like to focus on American banks and on their cooperative and competitive interaction with non-U.S. banks in lending to developing countries.

American banks took the initiative in such lending during the 1960's and early 1970's, holding a share of about 55 percent of total bank loans to developing countries in late 1975 as reported by the Bank for International Settlements. Vigorous competition on the part of foreign banks, often coming in waves that seemed progressively to reduce spreads, on the part of German, Japanese, British, and other banks, reduced the American share to about 40 percent by 1979, where it has approximately remained. The share of U.S. banks in loans to Latin American countries, for obvious reasons, always has tended to be higher than their worldwide share.

The competitive posture of American banks, especially the large money-center banks, has been influenced by the unique structure of the American banking system which limits their expansion both geographically

and functionally. Being unable to have a nationwide branch network deprives them of a broad base of core deposits and forces them to rely more heavily on often-volatile purchased funds. Lending, unlike branching, while not limited to the state of the bank's residence, nevertheless is affected in some degree by the difficulty of reaching local borrowers. This, together with the limitation on functional expansion beyond activities closely related to commercial banking, such as into securities and other types of financial business, may have helped to push American banks in the direction of developing-country lending. Participation in a syndication is a means of increasing assets and earnings when loans to regular customers may be hard to find. This may also help account for the fact that foreign lending by American banks seems to be less oriented toward financing of customers' exports than that of non-U.S. banks.

A deregulatory movement is underway in the United States that would change many of these characteristics of American banks. If the orientation favored by the Reagan Administration and by the Senate prevails, banks would be allowed to enter into the securities business, insurance, and real estate, always subject to prudential limitations. Given existing resistance in the House of Representatives and on the part of financial industries that would face increasing competition, it is not clear at this time how far the expansion of bank powers will go in the functional direction.

Currently, and without benefit of legislation, the geographic limitations on bank expansion are being circumvented by the development of so-called "nonbank banks" and "nonbranch branches," i.e., dependencies of banks permitted to operate interstate because they do less than a full commercial banking

business. The resistance of small banks has inhibited though not completely prevented such expansion.

Capital Increases vs. Provisioning

While the energies of large American banks are deeply absorbed in these possible restructurings of their business, they must confront also the debt problems of developing countries. In the face of mounting risks on developing-country loan portfolios, banks in all countries have taken prudential action, but not in identical fashion. European and also Canadian and Japanese banks seem to have predominantly gone the provisioning route. In addition to setting aside reserves against loans to problem countries, weak loans have been written down against earnings or reserves, disclosed or undisclosed. American banks have made relatively few specific provisions against international loans, although for loans to a small number of countries in the "value-impaired" classification specific provisions are now mandatory. Allocations to loan-loss reserves that may be ascribed to international loans went up by two-thirds from 1981 to 1983.

American banks, on the other hand, in the face of mounting risks and under the mandate of their regulators, have increased their capital/asset ratios. About half of the large multinational bank holding companies, which do the bulk of international lending, had allowed primary capital ratios to fall into the 3-4 percent range during the late 1970's. They have since come up to well over 5 percent. Bank regulators, in addition to their general supervisory authority, have received explicit legal powers to set minimum capital standards. At present, for large banks and bank holding companies, these have been set at 5 percent (primary capital/total assets) but are likely to be raised soon to 5.5 percent.

Increases in capital ratios clearly strengthen a bank if they are brought about by raising new capital, by restraining dividends, or by slowing the normal growth of the bank's assets. A bank is not strengthened, of course, if it raises its capital ratio by placing some of its assets "below the line," reduces total assets by cutting down on highly liquid but not very profitable interbank placements, or substitutes contingent for ordinary liabilities. Provisioning, on the other hand, adds nothing to the strength of a bank unless it implies a tax saving or leads to a change in behavior (in the direction of restraint) by the banks. Otherwise, assets, liabilities, and cash remain unaffected except in a bookkeeping sense.

American banks appear to be reluctant to provision partly because, in the absence of a documented loss, there are no tax benefits. European banks, in varying degrees, seem to be able to reduce taxes by provisioning and so increase cash. American banks further differ from many of their foreign counterparts in being constrained by quarterly reporting requirements, by tight rules governing the accrual of interest in arrears, by a high degree of disclosure, and by the inability to accumulate hidden reserves. Unlike some foreign banks, however, they are not required to write down negotiable assets to the lower of cost or market. All this reflects differences in regulatory philosophy. The American system stresses the discipline of the market, brought about by full disclosure. This ordinarily enhances bankers' prudence, but once something has gone wrong, the exercise of market discipline, through withdrawal of funds, makes the bank more vulnerable. Abroad, discrete silence minimizes this risk, at the possible cost of greater trouble once difficulties break out into the open.

Comparisons of the capital positions of American and foreign banks are difficult to make. Published capital/asset ratios for the most part show American capital to be higher than that of foreign banks, with respect to some countries very substantially so. But the existence of hidden reserves, in the form of appreciated assets or assets written down below true value, may compensate for this to an unknown degree. In addition, there is a host of technical differences concerning the inclusion in capital of borderline accounts, such as subordinated debt, convertible securities, property valuation reserves and loan loss reserves, among others. Differences exist in national preferences also as to whether and how assets should be weighted by risk in calculating the capital/assets ratio. Efforts are going forward to develop a higher degree of international comparability of capital positions, although at this time harmonization of actual national practices and ratios does not seem in sight.

Profitability is another important factor determining both the ability to make provisions and the ability to accumulate capital. Whether differing conditions of competition in the various national markets allow banks in some countries to be more profitable may be a moot point. But the ability to avoid full disclosure of unusual profits, through an absence of total transparency, may be an important factor.

Accounting Practices and Bank Policies

Continuous cooperation and joint efforts to solve common problems have enabled the international banking community to overcome the effects of institutional differences. The implications of these distinctions for bank policy have been fully explored and, where needed, reconciled by pragmatic

adaptation. Some of the issues that had to be resolved will be briefly reviewed. One issue, very often, is the provision of "new money," that helps the borrower to pay the interest. A bank that has already written off a significant part of a loan and no longer is counting on the interest will be less eager to supply new money. It will be particularly reluctant if new money for a partly written-off borrower requires an immediate write-off also against the new loan.

For a bank that is disposed to continue lending in one form or another, the question of "new money" on some past occasions has come up in still another way. For instance, it is in many respects simpler to capitalize unpaid interest than to provide a new loan that serves to pay it. If the amounts are equal, the results are the same. In fact, it is probably easier for the lead banks to get reluctant smaller banks to stay with a loan via interest capitalization than via the new-money route. The latter gives a bank a clearer opportunity to avoid participation. For the debtor country, too, there may be an advantage in interest capitalization because it creates a presumption, if not a certainty, that a large part, if not the full amount, of the unpaid interest will be capitalized, i.e., in effect relent. A new money loan may be more parsimonious. Moreover, in some countries, a new-money loan to a debtor against whose earlier indebtedness provision has been made may call in question the tax deductibility of that provision.

For the banks, however, capitalization raises the question whether this interest can properly be treated as income. American accounting rules say, very broadly, that it can be so treated if ultimate repayment is reasonably assured. In plain language, this means that it usually cannot because reasonable assurance of repayment is lacking. Conceivably, capitalized

interest can be taken into income if some write-off required by accounting rules is practiced. Interest paid with the proceeds of a new-money loan can be taken into income like all other interest.

Non-American banks seem to have greater flexibility with respect to the capitalization of interest. Accounting rules differ among countries, and in some countries capitalized interest treated as income is penalized by write-offs. At one time, non-U.S. banks seemed to prefer the capitalization route, American banks the new-money route. Because of the American concern, foreign banks usually have acceded to the new-money route, and so this issue has largely quieted down.

Preferences of American and foreign banks have differed also in the matter of currency denomination. A very large portion of developing-country loans is denominated in dollars. This gives American banks the advantage of lending in their home currency, in which it may be easier for them to fund, and in which they have the advantage of a lender of last resort capable of creating that currency, as well as the further safety net provided by domestic deposit insurance. Foreign banks may find it less economical to fund in dollars, their lender of last resort cannot create dollars, their deposit insurance system, if there is one, may be limited to their home currency. These features may not weigh heavily with respect to short-term commitments. They seem to weigh more heavily over longer periods. This became evident in the process of multi-year rescheduling, when, as noted above, non-U.S. banks asked for the opportunity to switch into their domestic currency. Typically, the non-U.S. banks have been accommodated as regards currency denomination. The possible costs of currency switches seem to fall principally upon the borrowing country, if the currency structure of its exports and imports makes dollar financing preferable.

Bank Strategies

Differences exist among banks, but not necessarily by country, with respect to a large variety of additional factors. In every rescheduling, it matters whether a bank's lending is concentrated in the public sector or in the private, and whether its private-sector loans have government guarantees. Likewise, guarantees by parents of multinational subsidiaries can be an important factor enabling a bank to adopt a tougher attitude. The net result of the jockeying for position between private- and public-sector creditors probably is to weaken the private sector and enhance the role of government in the developing country in question. But such macro considerations may not carry much weight in micro decisions.

Another area in which there seem to be differences of view among leading banks is with regard to the desirability of keeping continued participation by all lenders to a given country. A great deal of effort has been spent, in various reschedulings, to keep smaller banks in the lending group. Typically, it is these banks that have an opportunity to get out, while the large banks are substantially committed. Attitudes of local boards of directors and reluctance of officers to expose themselves to criticism begin to play a role. Some large banks, therefore, seem to feel that it would be preferable to phase out the participation of smaller banks whose quantitative contribution may not be very important.

Banks have shown themselves of different opinion with respect to the degree of control and conditionality to be exerted in lending. Particularly in multi-year rescheduling this difference may surface. Multi-year rescheduling gives the borrowing country more "rope" than one-year arrangements, the latter

sometimes referred to as a "short leash." On the whole, the banks have shown themselves to be poor administrators of conditionality, i.e., unable to induce a country, by holding out money, to adopt and abide by good policies. The International Monetary Fund, on the contrary, seems to have shown considerable ability to administer conditionality.

Institutional differences may also affect attitudes toward rescheduling, including multi-year rescheduling. On dollar loans, which are practically the only kind American banks make, they have the advantage of a lender of last resort capable of creating that currency, as well as the further safety net provided by domestic deposit insurance. Foreign banks lending in dollars do not have the same advantages. The significance of this became apparent in the recent multi-year reschedulings where non-U.S. banks received the right to switch their loans into their home currencies.

Likewise significant for lending policy to developing countries is the degree of supervision and examination to which national banking systems are subject. The American banking system, with its 14,000 banks, is probably the most extensively supervised and examined among major countries. With respect to lending to developing countries, nevertheless, supervision has not prevented the occurrence of problems. Moreover, once exposure has become high, forceful application of regulatory restraint may bring on precisely the problem that the supervisors are concerned to avoid. There seems to be no substitute for the basic quality of bankers' prudence.

The Changing Role of Bank Credit

Many considerations that have come up in the course of this paper inevitably raise questions as to whether commercial banks are really a suitable channel for capital flows to developing countries. In the long-distant past,

the typical form of lending to developing countries was a bond issue. Countries that the bond market would not accept could at best get official credit. The banks performed a great service for developing countries when they undertook to fill the vacuum left by the demise of the international bond market, but perhaps not altogether to their own good. It is clear that the rate of expansion of bank credit cannot return to what it was in the 1970's. It is far less clear what can take its place to avoid a corresponding cutback in the rate of borrowing by developing countries, recognizing that capital flow will probably be relatively smaller hereafter than during the 1970's. The most interesting problems of financing developing countries, therefore, may lie in the area, not of shoring up and improving bank lending practices, but in the creative innovation of new forms of international capital movements.

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