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**MAINTAINING THE STRENGTH
OF THE INTERNATIONAL CAPITAL MARKET**

Remarks by

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

at the

Fourth Canadian Financial Conference

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Montreal

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It is a pleasure to address the Fourth Canadian Financial Conference of the Conference Board in Canada on a topic of interest to Canada as well as the United States -- our mutual concerns in the international capital market. Capital flows between Canada and the United States, which go in both directions, have been an outstanding example of a well-working international capital market. For many years, these flows represented a very substantial part of total international flows. Today, world capital markets have widened. Other industrial countries, non-oil developing countries, the East

Bloc countries, and the OPEC all participate on a scale that few would have anticipated as little as 10 years ago. These greatly enhanced international flows perform valuable functions, particularly at a time when the international imbalances resulting from the enormous rise in the price of oil as well as other international imbalances need to be financed.

But these flows can also present problems if they are not properly handled. A malfunctioning in any sector of the world capital market, be it through the creation of excessive debt burdens, instability in the placement of funds, imposition of controls, or abrupt changes in the availability of funds can have far-reaching repercussions. Such a malfunctioning may injure countries that are quite unrelated to the source of any initial disturbance. Canada and the United States, therefore, have a common interest in contributing to the safe and efficient functioning of the world's capital market.

With this in mind, let me cite a few illustrative data indicative of the magnitude of today's international capital market, and place the corresponding magnitudes for Canada and the United States in that perspective. The level of international commercial

bank credit, as recorded by the BIS, reached \$548 billion at the end of 1976. During that year, it grew by \$105 billion or 24 per cent. International bond issues during that year amounted to \$33 billion. The total level of bonds outstanding is not known. In addition to substantial claims due to governments, international financial institutions had outstanding claims of approximately \$66 billion, which during 1976 had expanded by \$17 billion or 35 per cent. In addition, of course, there exists a considerable stock of international debt due to nonbank lenders, as well as a large stock of direct foreign investment by corporations and equity portfolio investment for which worldwide data likewise are difficult to obtain.

For the United States and Canada, the stock of foreign claims due to commercial banks, including foreign branches, at the end of 1976 amounted to \$207 billion (United States) and \$17 billion (Canada). During 1976, these amounts rose by \$39 billion and \$3 billion, respectively.

Canada and the United States, as I have noted, being major participants in this great world capital market, have a joint interest in its effective functioning. Not surprisingly, our two

countries are already participating in several activities seeking to contribute to that end. As members of the group known as the "G-10 and Switzerland," Canadian and American banks have for many years contributed to the Eurocurrency market statistics collected by the Bank for International Settlements. More recently, these data are being supplemented by additional information on loans to developing countries and East Bloc countries with detail on maturities covering a sample group of banks in the same countries. A table showing the United States part of the first survey with information on external guarantees is attached to the text of this talk. A third effort that is now being considered is designed to improve the information on debtor countries available to lending banks. Such more detailed information, especially with respect to country indebtedness, including data already made available by the World Bank, will help Canadian and American banks as well as other lenders in their analysis of country risk. Borrowers should benefit in that fuller information will enable banks to respond more fully to legitimate credit demands.

The International Monetary Fund may well play an increasingly active role in connection with commercial bank lending in

foreign countries. As a source of information, but more particularly as a source of financial discipline implemented through the conditionality of its own lending, the IMF can help to strengthen commercial bank lending. At the BIS, the Bank of Canada and the Federal Reserve, together with other central banks and supervisory agencies, cooperate in exchanging supervisory and regulatory information helping to keep national banking systems sound. These central banks are also aware of their responsibilities, in line with the usual function of central banks, to give lender-of-last-resort support where such responsibilities come into play.

The intensive supervisory attention, and the efforts made by the banks themselves to monitor and control their international lending, indicate that such lending is regarded as being subject to special kinds of risk. It is important, therefore, to clarify the differences that exist between domestic and foreign lending risk.

The crucial difference is not in the degree of ordinary credit risk experienced by international lenders. Banks' experience so far is that losses due to credit risk have been substantially less in international than in domestic lending. The principal reason for this favorable loss experience is that banks lending

abroad usually can pick the best risks, such as subsidiaries of multi-national corporations and other large firms.

Nor is the difference to be found, as is sometimes alleged, in the fact that loans to particular countries have tended to increase with the debtor country seemingly getting "deeper and deeper into debt." Much the same happens at home. Many growing corporations keep increasing their debt to domestic lenders. Frequently, their financial policies do not and, as in the case of public utilities, cannot envisage net repayment. What matters is that individual maturities are met punctually, and that the funds borrowed are productively employed. So long as mounting debt is matched by mounting assets and income, and adequate liquidity is maintained, a domestic borrower is perfectly able to keep borrowing.

Likewise, persistent one-way flows of capital among regions of a particular country are perfectly normal. For many decades, New England has tended to be a capital exporter. Florida and California have been capital importers. The flow of amortization and interest proceeds smoothly, so long as ordinary prudence is observed.

Nor is there anything at all unusual in the fact that a particular region of a country draws part of its financing from other regions, while many local residents invest their savings elsewhere. There is no compelling reason why the residents of Connecticut should invest in Connecticut, or those of Ontario in Ontario. In fact, the principles of portfolio diversification imply that savers should diversify geographically as well as in other ways.

Why then is international lending regarded as in some sense more risky than domestic lending? The principal difference resides in the fact that the foreign lender exposes himself to foreign laws, customs and institutions. He becomes subject to the policies and politics of foreign governments. He runs the risk of currency problems, such as exchange rate movements and foreign exchange control even though he usually lends in his home currency or perhaps in U.S. dollars. Possibility of social and political disturbances or war cannot be precluded.

It is often argued that the degree of risk in international lending can be minimized by making sure that the funds are productively employed. There is an important sense in which this is true but

unfortunately another also in which it is not. It is true that ordinary credit risk is reduced by proper use of the funds. Indeed, unless the earning power of a borrowing corporation or the tax base of a borrowing government is enlarged by a loan, the loan clearly is a high-risk one. But even if a particular loan is as solidly based as borrower and lender can make it, it may not offer complete protection if the country in question at the same time is attracting a large amount of lending of a different kind. If the bulk of the funds borrowed is poorly employed, the ensuing difficulties could drag down the sound loans in economic and financial disorders except in rare cases where the lender has been able to arrange for extra-territorial security. On the other hand, if foreign borrowing not directly related to particular investment projects nevertheless enables the borrowing country to increase its income and foreign exchange earnings, that improved overall performance will also lend strength to the loan. Thus the lender, no matter how careful he is, cannot necessarily protect himself by looking at the individual loan in isolation. He has to analyze the debtor's economy as a whole in order to evaluate country risk.

Into this analysis of country risk a great deal of ingenuity and effort is now being put. It goes without saying that no single criterion can even approximately measure the degree of country risk. The information on any one country assembled by sophisticated lenders may fill a small book. Domestic macro-economic data, balance-of-payments statistics, monetary data, price behavior, foreign debt and foreign assets are all commonplace ingredients. Political analysis to assess stability of governments, social psychology to assess popular reaction to foreign investment all go into the hopper. After all the work has been done, well-informed observers may still differ and a large margin of uncertainty may remain in some cases.

Nevertheless, there are a few common sense indicators that can bear a lot of weight in this kind of analysis. They comprise the interest burden, total debt service (interest and amortization), exports and their variability, exchange reserves, GNP (total and per capita), and the maturity profile of the debt. Ratios formed from variables such as these have been shown to possess considerable predictive power. The reason is, of course, that a country's ability to sustain and service a given volume of debt

depends in good part upon these magnitudes. To be sure, a country strongly determined to maintain its good credit standing, whether for selfish reasons or on moral grounds, can meet its international obligations by cutting back on its domestic use of resources even under very unfavorable circumstances. Likewise, a country that seems strong in relation to its debt, if unconcerned about its credit standing, may end up defaulting. Even so, the key ratios suggested are indicative of the effort required of a country to meet its obligations.

An important prerequisite of this type of analysis is full and up-to-date information. Even moderately complete debt data are not available even today for a fair number of countries. Where interest payments are known, amortization schedules sometimes are not.

Such simple data, of course, are only the beginning of sophisticated country risk analysis. But even very simple measures contain implicitly some of the information that one would want to get by more searching examination. For instance, the ratio of debt service to exports will be lower, i.e., better, the more effectively a country uses borrowed funds to build up its exports. The ratio of

debt service to GNP will be lower the more effectively a country uses borrowed funds to add to its productivity. In other words, even when investment does not directly serve exports but instead displaces imports or contributions to output in general, ability to maintain service improves.

Canada, unlike many other countries, is in the fortunate position of being able to decide how much it wants to borrow abroad. In Canada, as in other free economies, the decision of how much to borrow is largely made in response to market factors, such as interest rates. Nevertheless, public policy also influences the outcome, through taxes, regulations concerning ownership of local enterprises by foreigners, and borrowing by official bodies. The importation of capital provides an opportunity to accelerate economic growth beyond what it would be if the economy had to rely entirely on domestic savings. Canada's high rate of economic growth over many years suggests that foreign capital, in its various forms, has helped to accelerate growth.

Of some economies it has been hypothesized, with some evidence, that easy access to capital from outside sources has the effect of discouraging local saving. In that case, imported capital

would not add or not add fully to local investment, but would merely substitute for local resources that are then devoted to consumption instead of investment. Such evidence as has been gathered on this subject for Canada seems to indicate that Canadians' native thriftiness has not been undermined by ready access to foreign capital. At most, Canadians may have taken advantage of access to foreign capital in order to effectuate some foreign investments of their own, mostly in portfolio form but also through direct investment. This, as I pointed out earlier, may reflect a wholesome tendency toward portfolio diversification and may actually improve debt carrying capacity.

In recent years, Canada has acted to limit the flow of direct investment but at the same time has encouraged inflows of portfolio equity money and particularly of debt money. The net result probably has been to reduce the overall cost of foreign money, quite aside from gains made in terms of social and political objectives. At the same time, however, it must be recognized that debt service is a more rigid flow than is the more flexible return on equity investment, so that the risk element in Canada's foreign borrowing probably has increased.

The recent period of high rates of inflation and high nominal interest rates has opened up a new dimension in Canadian foreign borrowing decisions. In the absence of disturbing factors, inflation gives rise to a simple relationship between domestic and foreign price movements, interest rates and exchange rate movements. If inflation in Canada is X per cent lower than it is abroad, then Canadian interest rates will tend to be X per cent lower than foreign interest rates and the Canadian dollar will tend to appreciate by X per cent per year against foreign currencies. In other words, the differential between domestic and foreign rates of inflation should be reflected in interest rates and in the movement of the international value of the currency. When those relationships hold, an investor will do equally well in Canadian dollars, which draw less interest but lose less purchasing power domestically while gaining value internationally, and in a foreign currency for which the opposite would be the case.

Of course, there are always disturbing factors. Interest rates in Canada have tended to be higher than in the United States, for instance, even during periods when neither inflation or exchange rate movements were expected, reflecting perhaps a greater scarcity

and higher productivity of capital in Canada or possibly higher risk. The exchange rate, over long periods of time, has been influenced primarily by capital flows rather than by relative rates of inflation. The fact that from 1973 to the present, the United States dollar value of the Canadian dollar has moved almost exactly with the purchasing power of parity of the two currencies does not prove much. Almost all the downward adjustment in the Canadian dollar came after the political change in Quebec. Previously the Canadian dollar had largely resisted the recent inflation differential with the United States.

Over longer periods of time, if Canada and the United States do not both succeed in reducing inflation sufficiently, there may well be continuing differentials in one direction or the other. In that case, one would expect the exchange rate eventually and perhaps with long lags to reflect these differentials. Investors and borrowers who merely had taken into account interest rates in the two markets might find that they had miscalculated the ultimate cost of borrowing.

I would like to close with a reference to a criterion for foreign borrowing that is new in the world but nevertheless currently

of great importance. I have in mind the deficit that the world outside OPEC must somehow absorb because of the OPEC surplus. Some countries which initially were able to take on an appreciable share of that deficit have begun to run out of financing capacity and must cut back. To the extent that the OPEC surplus cannot be reduced, other countries must reduce their own surpluses or go into deficit. The United States has experienced a massive shift in its current account position from a surplus of \$12 billion in 1975 to a projected deficit above \$10 billion in 1977. In that sense, the United States has helped to ease the financing problem of the rest of the world, although our profligate use of oil has also contributed to the large OPEC surplus. Canada has maintained a current deficit of the order of \$4 billion since 1975, which it has been able to finance without difficulty.

As I look at the U.S. deficit, I must admit to mixed feelings. Quite aside from the failure to conserve oil and hold down oil imports, the sight of a large current deficit in the accounts of a country that is responsible for the world's principal currency, is not a comforting one. Capital flows to the United States have been sufficient to maintain the effective exchange rate of the

dollar. But that effective exchange rate is a weighted average containing a number of currencies that have been notoriously weak. Against the strong currencies of the world, the dollar has not, of late, maintained its value.

Thus, for the United States, as well as for the entire world, a rising United States current account deficit has negative as well as positive aspects. I do not feel qualified to make an assessment of Canada's current account deficit, but I would assume that you would take into account aspects such as those I have enumerated as you weigh the pros and cons of foreign borrowing.

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U.S. Bank Claims on Selected Foreign Countries: December 1976
(millions of dollars)

	<u>Total Claims of Reporting Banks ^{1/}</u>		<u>Maturity Distribution of Claims of Domestic Offices and Offices in Offshore Banking Centers</u>			
	<u>Amount</u>	<u>Percent Externally Guaranteed</u>	<u>Total Claims</u>	<u>Amount Maturing In:</u>		
				<u>One Year Or Less</u>	<u>Over One Year To Two Years</u>	<u>Over Two Years</u>
I. <u>Non-G-10 Developed Countries</u>	<u>14,358</u>	<u>8.2</u>	<u>8,171</u>	<u>3,690</u>	<u>1,412</u>	<u>3,069</u>
Austria	1,049	19.5	277	165	39	73
Australia	1,296	6.3	850	488	97	265
Cyprus	19	15.8	12	10	2	--
Finland	1,175	1.6	627	199	126	302
Greece	1,353	8.7	586	195	131	260
Iceland	77	--	74	37	15	22
New Zealand	407	4.7	277	58	83	136
Norway	1,820	12.4	707	286	131	290
Portugal	450	0.7	333	260	31	42
Spain	3,137	8.7	1,882	596	367	919
South Africa	2,236	6.1	1,581	841	217	523
Turkey	1,339	6.5	965	555	173	237
II. <u>Non-Oil Exporting Developing Countries</u>	<u>42,187</u>	<u>10.9</u>	<u>37,381</u>	<u>19,621</u>	<u>4,668</u>	<u>13,092</u>
A. <u>Latin America</u>	<u>29,600</u>	<u>7.3</u>	<u>27,013</u>	<u>12,525</u>	<u>3,670</u>	<u>10,818</u>
Argentina	1,847	10.0	1,687	954	231	502
Bolivia	337	2.9	305	146	42	117
Brazil	10,437	10.6	9,349	3,304	1,453	4,592
Chile	620	5.8	606	424	93	89
Colombia	1,472	4.3	1,381	1,034	126	221
Costa Rica	338	8.9	306	115	53	138
Dominican Republic	283	4.6	239	128	30	81
El Salvador	201	3.0	187	106	21	60
Guatemala	287	1.7	229	75	85	69

	<u>Total Claims of Reporting Banks</u> ^{1/}		<u>Maturity Distribution of Claims of Domestic Offices and Offices in Offshore Banking Centers</u>			
	<u>Amount</u>	<u>Percent</u>	<u>Total Claims</u>	<u>Amount Maturing In:</u>		
		<u>Externally Guaranteed</u>		<u>One Year Or Less</u>	<u>Over One Year To Two Years</u>	<u>Over Two Years</u>
II. <u>Non-Oil Exporting Developing Countries cont'd</u>						
A. <u>Latin America cont'd</u>						
Guyana	20	45.0	19	5	5	9
Haiti	22	--	22	16	--	6
Honduras	193	9.3	163	82	21	60
Jamaica	304	2.0	291	147	39	105
Mexico	10,746	5.0	9,883	4,680	1,236	3,967
Nicaragua	459	3.7	429	270	34	125
Paraguay	60	11.7	40	28	3	9
Peru	1,810	6.6	1,736	949	190	597
Trinidad & Tobago	28	3.6	20	16	1	3
Uruguay	136	5.1	121	46	7	68
B. <u>Asia</u>	10,366	6.1	8,918	6,355	814	1,749
Bangladesh	31	16.1	21	21	--	--
China (PRC)	11	90.9	1	1	--	--
China (Taiwan)	2,100	4.5	1,858	1,343	162	353
India	395	1.3	288	101	59	128
Israel	692	15.5	583	450	68	65
Jordan	19	10.5	15	7	2	6
Korea (South)	3,070	4.7	2,795	2,141	221	433
Malaysia	649	6.3	512	212	102	198
Pakistan	165	4.2	46	44	--	2
Papua New Guinea	23	--	19	3	4	12
Philippines	2,368	6.5	2,034	1,387	167	480
Sri Lanka	35	2.9	30	27	1	2
Syria	82	--	75	74	1	--
Thailand	726	9.1	641	544	27	70

	<u>Total Claims of Reporting Banks^{1/}</u>		<u>Maturity Distribution of Claims of Domestic Offices and Offices in Offshore Banking Centers</u>			
	<u>Amount</u>	<u>Percent</u>	<u>Total Claims</u>	<u>Amount Maturing In:</u>		
		<u>Externally Guaranteed</u>		<u>One Year Or Less</u>	<u>Over One Year To Two Years</u>	<u>Over Two Years</u>
II. <u>Non-Oil Exporting Developing Countries cont'd</u>						
C. <u>Africa</u>	<u>2,221</u>	<u>19.3</u>	<u>1,450</u>	<u>741</u>	<u>184</u>	<u>525</u>
Angola	27	59.3	21	10	3	8
Cameroon	33	9.1	26	7	7	12
Congo (Brazzaville)	12	100.0	12	1	1	10
Egypt	598	8.9	279	230	22	27
Ethiopia	14	--	14	8	2	4
Ghana	75	4.0	61	46	--	15
Guinea	12	100.0	12	--	--	12
Ivory Coast	241	13.7	163	43	35	85
Kenya	26	3.8	17	14	1	2
Malawi	38	86.8	4	1	2	1
Morocco	308	10.4	262	106	41	115
Mozambique	47	--	5	3	--	2
Senegal	32	--	22	4	4	14
South-West Africa	17	--	17	2	4	11
Sudan	216	36.1	139	91	7	41
Tanzania	10	--	9	9	--	--
Tunisia	81	0.8	70	63	2	5
Zaire	258	56.6	221	69	35	117
Zambia	176	3.4	96	34	18	44

	Total Claims of Reporting Banks ^{1/}		Maturity Distribution of Claims of Domestic Offices and Offices in Offshore Banking Centers			
	Amount	Percent Externally Guaranteed	Total Claims	Amount Maturing In:		
				One Year Or Less	Over One Year To Two Years	Over Two Years
III. <u>Eastern Europe</u>	<u>6,020</u>	<u>5.7</u>	<u>2,974</u>	<u>816</u>	<u>685</u>	<u>1,473</u>
Bulgaria	408	--	191	68	46	77
Czechoslovakia	130	0.8	7	4	2	1
E. Germany	740	7.4	355	198	80	77
Hungary	590	--	280	23	52	205
Poland	1,261	3.3	580	166	127	287
Romania	351	1.7	78	49	17	12
U. S. S. R.	1,553	1.2	788	159	147	482
Yugoslavia	987	22.4	695	149	214	332
IV. <u>Oil-Exporting Countries</u>	<u>12,473</u>	<u>8.4</u>	<u>10,526</u>	<u>6,726</u>	<u>956</u>	<u>2,844</u>
Algeria	1,234	17.3	922	158	131	633
Brunei	13	--	12	1	4	7
Ecuador	660	5.2	605	314	91	200
Gabon	126	1.6	77	12	16	49
Indonesia	2,067	9.4	1,893	987	297	609
Iran	1,390	19.3	1,129	726	124	279
Iraq	73	5.5	46	4	15	27
Kuwait	371	1.6	263	251	5	7
Libya	110	--	63	59	1	3
Nigeria	70	--	40	35	--	5
Oman	66	--	47	23	6	18
Qatar	32	9.4	12	9	1	2
Saudi Arabia	600	3.3	499	489	3	7
United Arab Emirates	568	3.3	234	157	31	46
Venezuela	5,093	5.5	4,684	3,501	231	952

	<u>Total Claims of Reporting Banks ^{1/}</u>		<u>Maturity Distribution of Claims of Domestic Offices and Offices in Offshore Banking Centers</u>			
	<u>Amount</u>	<u>Percent</u>	<u>Total Claims</u>	<u>Amount Maturing In:</u>		
		<u>Externally Guaranteed</u>		<u>One Year Or Less</u>	<u>Over One Year To Two Years</u>	<u>Over Two Years</u>
V. <u>Miscellaneous</u>						
Liberia	1,788	69.2	1,211	326	187	698
Other ^{2/}	<u>91</u>	<u>12.1</u>	<u>64</u>	<u>51</u>	<u>3</u>	<u>10</u>
Total Claims on Non-G-10 Countries other than Offshore Banking Centers	<u>76,917</u>	<u>9.2</u>	<u>60,327</u>	<u>31,230</u>	<u>7,911</u>	<u>21,186</u>
Memorandum: <u>Offshore Banking Centers</u>	<u>45,801</u>	<u>10.3</u>	<u>25,727</u>	<u>24,063</u>	<u>680</u>	<u>984</u>
Bahamas	24,338	6.0	12,720	12,519	57	144
Bahrain	2,737	3.0	1,007	1,005	1	1
Barbados	15	20.0	23	16	2	5
Bermuda	446	12.1	369	252	33	84
Caymans and other British W. Indies	7,006	20.8	5,337	4,937	376	24
Hong Kong	3,185	11.0	2,318	2,099	47	172
Lebanon	153	7.8	135	70	24	41
Netherlands Overseas Ter.	623	29.7	488	334	31	123
New Hebrides	37	--	32	29	--	3
Panama	2,831	21.3	1,927	1,514	90	323
Singapore	4,430	10.5	1,371	1,288	19	64

^{1/} Includes data for U.S. offices and all foreign branches and subsidiaries.

^{2/} Includes all countries on which reported claims were less than \$10 million.