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Statement by

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before the

Committee on Banking, Finance and Urban Affairs

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I am glad to have this opportunity to discuss some recent international economic and financial problems and measures to deal with them. These problems have emerged in the context of deep and prolonged recessionary forces in the industrialized world, with severe unemployment of labor and productive facilities, stagnation of private investment initiatives, and strains on the financial capabilities of many borrowers and lenders, domestic as well as international. At the same time, some signs of recovery are emerging in the United States, there has been striking progress against inflation, and active efforts are underway to deal with and contain the problems in the financial system. We now have an opportunity to build a prolonged expansion on the basis of a far healthier outlook for price stability and productivity.

One of the potential threats to that outlook arises in the area you have requested that I particularly concentrate on today -- the heavy indebtedness of some developing countries and the related exposure of the commercial banking system of the industrialized world. Failure to manage and diffuse these strains could deal a serious blow to the recovery of the United States and the world economy. But the essence of my testimony today is that that problem is increasingly well understood, and on the basis of that understanding, for all its complexity and difficulty, it can be dealt with effectively. The United States, and the United

States Congress, have a key role to play in that process, alongside international institutions and other countries.

A successful program must rest on action in several inter-related areas, involving a high degree of cooperation among countries and among lenders, coordinated in large part by the International Monetary Fund. The necessary approach falls under five main headings:

- (a) An indispensable first step is determined action by major borrowing countries to change their economic policies to cope with the realities of their situation -- that is to reduce internal and external imbalances. Typically, measures are required to cut down on very high rates of inflation and budget deficits, to establish realistic foreign exchange rates and domestic interest rates, to encourage greater economic efficiency, and, as a result, to aim for substantial reductions in external deficits. Working with the IMF in developing such programs, culminating in IMF approval of medium-term credit assistance, can be a critically important signal to other lenders that a country is committed to an effective adjustment program.

We are now seeing that process in action; Argentina, Brazil and Mexico -- the largest

international borrowers among the developing countries -- have reached agreement with the IMF on a set of economic policies that will satisfy the basic requirements for receiving financial support from that institution. A number of other countries have already established, or are in the process of developing, such programs.

- (b) Closely tied in with the adjustment programs worked out between the IMF and the borrowing countries are arrangements among the bank creditors to provide enough continuing credit to maintain continuity of payments and a financial environment in which orderly adjustment programs can be implemented. In important instances, current and future debt maturities have been "rolled over" or restructured, and agreement has been (or is being) reached on some extensions of new bank credit -- conditional on the performance of the borrower in meeting its IMF-agreed program. While the cases of Argentina, Brazil and Mexico have received the greatest attention, similar needs have arisen with other countries. The fact is that few countries are in a position rapidly to repay indebtedness built up over a number of years, just as, in a purely domestic context, many companies or individuals could not suddenly repay debt. Efforts by their creditors to withdraw from lending simultaneously can only be mutually self-defeating, precipitating a financial crisis even where sound adjustment programs are

- (c) In specific instances, short-term "bridging" credits by national monetary authorities, acting bilaterally or through the Bank for International Settlements, may be appropriate to meet minimum and immediate liquidity requirements while adjustment and borrowing programs are being arranged. The funds advanced are to be promptly repaid as commercial, IMF, or other credits become available. Both the Federal Reserve and the Exchange Stabilization Fund of the U.S. Treasury have participated in such credits, as reviewed in Appendix I to this statement. These credits have been limited to instances that present a clear threat to international financial stability and where there is adequate assurance of repayment. Monetary authorities have neither the capacity nor the mandate to substitute short-term central bank credit for medium or longer-term financing.
- (d) The earlier points emphasize the key coordinating and substantive role of the IMF, and there is a clear need for the resources of that institution to be enlarged so that it can, with assurance, meet the potential demands upon it. There is literally no other body in the world that can effectively combine the several ingredients necessary to encourage both sound adjustment and necessary financing:

- o It has legitimacy, as the agreed and politically neutral international vehicle for evaluating national economic programs;
- o It has financial capacity, as the organization through which 146 countries, large and small, have provided a pool of funds for meeting transitional, financial needs of its members;
- o It has ability, in terms of experience, expertise, and respect by other lenders and borrowers alike.

IMF funding may provide only a relatively small fraction of the funds required by borrowers in specific instances. However, the availability of those funds provides a base for attracting commercial bank and other financing to cover the bulk of the need. Indeed, in instances where countries have had access to international banking markets in the past, the success of IMF programs may require some prior assurance that adequate amounts of private financing will be available for a time. Current and prospective demands could well tax the present resources of the IMF, and sharply impair its ability to encourage orderly financing programs. Consequently, enlargement of quotas and other IMF

resources, a matter that has been under consideration in any event, needs to be speeded.

(e) Finally, the success of all these efforts over time in easing current financial strains and pressures will ultimately be dependent upon the elimination or substantial reduction of current account deficits by borrowing countries. That objective will require some combination of reduced imports and larger exports, but it is patently clear that not all countries can achieve those objectives together because we buy and sell from one another. In fact, the strong adjustment efforts by a significant fraction of the world economy will -- other things equal -- tend to damp growth of their trading partners, as well as internally. In the circumstances, an environment of sustained recovery and expansion in the industrialized world is critically important.

In all of this, the mutual dependency of the U. S. economy and the stability of the international financial system should be apparent. Failure to deal successfully with the immediate international financial pressures could only jeopardize prospects for our recovery -- for our jobs, for our export markets, and for our financial markets. Conversely, sustained, non-inflationary growth in the United States and elsewhere is needed to provide an economic environment in which borrowing countries can improve their balance of payments over time and in which debt burdens can be reduced.

The Background of Current Pressures

It is convenient to trace part of the present liquidity crises of some developing and Eastern European countries to the two massive oil price increases of 1973-74 and 1979-80. Since the first oil shock the oil import bill of the non-OPEC developing countries has escalated sharply, reaching more than \$20 billion in 1978, and then jumping to more than \$50 billion in 1980 and 1981. As a result, some oil importing countries have been burdened with chronically large and growing burdens on their current accounts. (See Table I.)

However, the direct impact of high oil prices on import bills does not provide a full and general explanation of the present difficulties; indeed, some of the most heavily indebted countries are oil exporters or are roughly in balance on oil account. While great differences can be found in specific causes of the resort to huge amounts of external borrowing by particular countries, and in the extent to which they tried to correct the situation, some general "environmental" factors seemed to affect them all.

The borrowing countries have all, understandably, wished to expand rapidly their industrial base to meet the needs of a growing population and increase national income and economic welfare. In fact, after the oil shock of 1973, as a group, they maintained much faster growth than the more mature economies. Some (with Mexico the leading example) benefited from oil development and rising oil exports, the volume of exports of manufactures increased sharply, and world inflation was accompanied by relatively

buoyant prices for commodity exports. But in addition, domestic expansion was frequently pressed by budget deficits and relatively low interest rates. As a result, internal inflation and rising current account deficits were common.

At the time oil prices first rose sharply, great concern had been expressed that industrialized and developing countries alike might be unable to finance the increased cost of oil imports. In fact, a rapid expansion of international bank lending, from a low base, helped greatly in "recycling" surpluses of OPEC countries to borrowers, including Eastern European nations and middle-income developing countries. While the debts of those countries rose rapidly, the view was increasingly taken by many banks and others both in the U.S. and elsewhere, that prospects for their future growth were reasonably good, and that on that base, increasing debt burdens in real terms would be manageable. During much of the 1970s, rising world inflation, and low or even negative "real" interest rates greatly moderated the rising debt ratios. Moreover, with credit in ample supply, most of the largest borrowers were able to add substantial amounts to their official reserve assets; taken together the non-OPEC developing countries added \$40 billion to their reserves in those years, tending to maintain confidence in their financial management and outlook.

The second great increase in oil prices and other developments in the world economy at the end of the 1970s helped to call some of the favorable assumptions of borrowers and lenders into question. Export markets for manufactures weakened, prices of

commodity exports declined, and annual interest payments rose sharply as both the amount of indebtedness and world interest rates escalated. In the interest of prolonging and maximizing internal growth, adjustment measures were delayed or unconvincing, and budgetary imbalances, inflation, and current account deficits increased. Confidence at home was undermined in some cases, leading to capital flight.

In the case of Mexico, the current account deficit reached \$13 billion in 1981 in spite of petroleum exports of \$14 billion, and Mexicans moved large amounts of money abroad. Mexican external indebtedness rose by \$20 billion in a single year, with commercial banks increasing their exposure by nearly \$15 billion. Brazil found its oil import bill rising to \$9½ billion, and interest payments to \$12 billion last year. The result was a current account deficit of about \$15 billion, despite adjustment efforts.

Throughout this period, losses on foreign credits of commercial banks continued to be substantially lower than on domestic lending -- as they had been for many years. Foreign lending accounted for a rising share of the assets and the earnings of most large international banks, U.S. and foreign based. The bulk of the lending was undertaken by banks with established international concerns and expertise, and it was to a small group of rapidly growing countries deemed to have good prospects. The poorest countries continued to rely almost entirely on official financing.

As a result, developing country debts to commercial banks are relatively highly concentrated. (See Tables II and III.) Of the \$270 billion owed to banks by public and private sector borrowers in all developing countries at mid-1982, over half was accounted for by three countries (Argentina, Brazil and Mexico), and another 10 percent by Chile and South Korea. Eastern European countries owed another \$64 billion to banks abroad as of mid-1982, but the share of U.S. banks in total claims on those countries was only slightly more than 10 percent.

The relative participation by U.S. banks in lending to developing countries, while remaining large, tended to decline somewhat in the latter part of the 1970s, holding recently at about 35 percent of the total. The fact that interest margins had been driven to levels that provided little allowance for risk and capital growth seemed at times to moderate the enthusiasm of U.S. banks for foreign lending, and the share of our banks in providing new financing to the largest borrowers declined to less than one-third from 1979 to 1981. (See Table II.) But in absolute terms, the increases remained large, and exposure relative to capital and assets rose. (See Table IV.)

International lending has traditionally been pretty much the province of the largest banking institutions with a long history of experience with international business, extensive information networks through foreign branches, and a resource base capable of sustaining potential losses. During more recent years, more and more essentially domestic banks were drawn into

international lending. The amounts loaned, while typically involving less relative exposure, became significant in the aggregate. Nevertheless, of total U.S. bank claims on the developing countries in June, 1982, of about \$100 billion, the nine largest banks accounted for 60 percent, and the next fifteen banks for an additional 20 percent. (See Table IV.) These amounts represented a growing commitment of capital resources; for the nine largest banks, claims on all developing countries had grown to about twice their capital by last June, and about half of the claims of those banks were on Argentina, Brazil and Mexico. (See Table V.)

By that time, hundreds of regional and smaller banks around the world had participated to some degree in lending to developing countries through direct credits or as a result of syndications of credits by the large "lead" banks. The largest borrowing countries had well over a thousand bank lenders. Because the participations of smaller banks are, individually, limited in size, many of those banks no doubt assumed that their commitment to foreign lending could be handled quite flexibly, and reduced over short periods of time as their judgment dictated. That normal presumption is, however, called into question precisely at a time of financial crisis for the borrowing country when many banks may want to reduce exposure and other sources of financing are not available. Consequently, the refinancing programs underway have necessarily involved virtually all lending banks.

Supervisory Policies

The rapid development of international lending in recent years has received increased attention by the supervisory agencies here and abroad.

In international lending, several considerations arise beyond the usual "credit" risk -- that is, the ability of the borrower to generate funds in his own country for repayment. Banks are often dealing with sovereign rather than private borrowers. A sovereign borrower can usually generate resources in its own currency and need not meet a "market test" domestically, but the fact that the borrower is a sovereign political body also limits the recourse of the lender, when conditions deteriorate. Both sovereign and private foreign borrowers are subject to "currency" or "transfer" risk -- that is, conditions under which the country will be unable or unwilling to obtain enough foreign exchange to service external indebtedness.

Our traditional approach toward examining banks was not well suited to dealing with these kinds of risk. Individual bank examiners were not generally equipped to evaluate economic conditions and prospects of countries. There was a high degree of variability in the way country lending was handled in examination reports. The traditional criteria for formally "classifying" or "criticizing" loans were developed for private borrowers or local governments, and were not readily adaptable to consideration of "transfer risk" or evaluating sovereign entities. We were also aware that blanket "classifications" of a particular country --

classifications that would necessarily have arbitrary elements -- could have sudden and devastating effects on the availability of credit, sometimes defeating the possibility of orderly adjustment and inviting a misinterpretation that the U.S. Government might be making a political judgment.

In recognition of these problems, the three Federal bank regulatory agencies instituted in 1979 a new system for evaluating country risk. A detailed description of that system is contained in Appendix II to this statement.

In summary, the system has four elements. The first is a statistical report designed to identify the country exposures of each bank on a basis consistent with aggregate data, and to enable the regulators to monitor those exposures.

A second element is an evaluation of each bank's internal system for managing country risk, with the aim of encouraging more systematic internal review of, and judgments about, foreign lending.

As a third element, exposure to a particular country may be "classified," but only on the basis of collective judgment by the examining agencies and in instances where debt service is interrupted (or such interruption is imminent) and unlikely to be promptly resumed.

A fourth and critical element is country-by-country appraisal of each bank's large exposures. The principle underlying that appraisal is that adequate diversification should be the cardinal rule in banks' management of their international portfolios. Neither banks nor their supervisors can expect to

anticipate all significant political changes and economic developments. Diversification of a portfolio provides a degree of protection against events in a few countries seriously undermining the earnings and condition of an individual bank.

These appraisals draw upon the findings of an Interagency Country Exposure Review Committee charged with reviewing conditions in borrowing countries. The Committee evaluates conditions in individual countries; with its guidance, examiners review and comment on country exposures which exceed a certain portion of bank's capital.

The overall purpose is to call significant exposures to the attention of senior management and boards of directors of the banks, to raise questions, and to force careful consideration.

This approach obviously involves striking a difficult balance. I am aware, for instance, that in reviewing these procedures, the GAO questioned whether comments were sufficiently pointed, or bank managements adequately sensitized, to influence lending policies appropriately. At the same time, in our system of banking and supervision, the supervisor should not take responsibility for the lending decision, beyond assuring ourselves to the extent feasible that relevant factors are weighed and appropriate procedures followed by those responsible for the management and direction of the banks.

In the light of recent developments, we have in process a re-evaluation of our current approach toward supervision. My own

preliminary judgment is that the basic framework of the system introduced in 1979 is constructive and sound, but important questions arise about implementation.

Between mid-1980 and mid-1982, the claims on Mexico of the nine largest U.S. banks grew from 32 to 50 percent of capital funds, with lending terms tightening only toward the end of that period. (See Table V.) Less dramatic but significant increases in these banks' exposures to Argentina and Brazil also occurred. The comments made in examination reports during this period did reflect growing supervisory concerns about the situation in these countries and the potential for payment difficulties. However, questions naturally arise as to whether those comments were stated forcefully or early enough, whether they were considered carefully enough by the banks -- or, indeed, whether that kind of approach to the problem, involving the most difficult kind of judgment by banks and supervisors alike, needs to be supplemented by other techniques.

There are several possibilities for consideration. One approach would be to consider setting formal limits, by law or regulation, on bank exposures in different countries. In effect "single country" limits analogous to "single borrower" limits would be imposed. Such limits, while capable of enforcing diversification, have inherent difficulties. They would inevitably be arbitrary, unable to distinguish among the capabilities of different banks, the size and conditions of different countries, or different types of borrowers -- the government, public agencies, financial institutions, and non-bank private entities -- within a

country. (See Table VI.) If applied judgmentally and changed from time to time, they would imply inherently controversial economic political judgments about other countries by the U.S. Government.

I would note the present system already uses various ratios of exposure to capital as a threshold point for commenting on exposures in certain countries. We will want to examine whether we can build on that approach while retaining important elements of flexibility.

Looking to the future, another possible approach would be to promote, through accounting and reserving practices, appropriate financial incentives. For instance, practices in accounting for "front end" fees in large syndicated credits appear to differ, and a conservative and uniform approach could be encouraged. There has been some discussion here and abroad about the possibility of more formal rules, based on rather specific criteria, for setting up specific prudential reserves against severely troubled country credits. That approach would build upon and supplement the existing practice of establishing loan loss reserves in relation to the risk in particular loans and the unforeseen risk in the total portfolio. Provision for reserves of that kind would impact on current earnings, and in some instances there may have been reluctance to "penalize" earnings, particularly with respect to sovereign credits where the argument may plausibly be made that the borrower will not "disappear" or go "bankrupt" in the sense of a private borrower, and interest or principal arrears should ultimately be recovered. Another

approach would be to supplement general reserves or strengthen capital ratios for institutions with relatively high concentrations of foreign risk. Experience does demonstrate that countries are not insulated from protracted difficulties, and such provisions would recognize that, all other risks equal, lending abroad has the additional dimension of country risk and should be supported by adequate capital. Seen in this light, it is clear that such an approach would need to be integrated into the analysis of capital adequacy of the banking organization taken on a consolidated basis.

A different approach would be to rely more fully upon public disclosure of large concentrations to promote market discipline. There has already been movement in that direction, but a balance must be struck. When lending is fashionable, there may be little discipline and even incentives to "follow the leader." When sentiment shifts, markets may react abruptly, undermining confidence by simplistic or naive interpretations of the data. Considerations of customer confidentiality and competition impose limits.

There is an additional complication in supervision of international lending. Competitive pressures are heavily conditioned by the behavior of lenders in other countries. To the extent feasible, our approaches should be coordinated with those of banking supervisors abroad, guarding, of course, against tendencies to retreat to the "least common denominator." Recent experience also suggests a need for some re-examination of the scope of,

and supervisory approaches to, the operations of banks outside their home country markets, reinforcing the need for a multi-lateral approach to address considerations of safety and soundness and of competitive equity among banks from different countries.

In sum, there is no easy and obvious answer; banking, by its nature has risks, and none of us can fully protect against the unknown. Moreover, excessive caution can be as damaging as excessive risk. International lending has made an immense contribution to the growth of the world economy and to cushioning the oil price and other shocks. Actual losses have been limited, and the present difficulties are themselves a powerful disciplinary force. We do not want to substitute government credit judgments for those of the banks, and we don't want to curtail the necessary and legitimate flow of bank credit. A sudden excess of caution would be damaging to the world economy, and to the United States, and our supervisory policies should not feed such over-reaction. It is within those parameters that we are examining our own approaches, and will need to review our thinking further with our colleagues here and abroad. I would like to report to you further as that process is completed.

Bank Lending as Part of Adjustment Programs

The situation of the large borrowers among the developing countries has frequently been characterized as a "liquidity" -- rather than a "credit" or "solvency" -- problem. To be sure, events last year unfolded with a speed disconcerting to many lenders, but that is characteristic of liquidity problems when the balance of confidence shifts. The fact remains that each

of the major borrowers, given time, can bring large resources to bear on the need to correct their external payments problem and to service their debts.

Many of these nations have already demonstrated a considerable capacity to adjust. Non-OPEC developing countries cut almost \$20 billion from their combined trade deficits last year, and Argentina, Brazil and Mexico all had trade surpluses. (See Table I.) Those borrowers have attached the highest priority to that effort in their economic policy making, recognizing their future growth and stability is dependent on access to credit. In a growing world economy, their current account deficits can be reduced to sustainable levels, or for a time eliminated.

In some of the countries, adjustment efforts had begun some time ago. In Argentina, for example, attempts were made to reduce an explosive rate of inflation and correct an overvalued peso, but the war in the South Atlantic undermined those efforts. In Brazil, monetary policy was tightened in 1981 to counter soaring inflation and efforts were made to hold down the current account deficit, which was pushed up by sharply increased interest payments and larger payments for imported oil. In Mexico, the external situation weakened rapidly in 1981 and little had been done to counter that tendency, perhaps in part because oil revenues gave an undue sense of comfort. In all these cases, the effects of the recession in the world economy, and high real interest rates, had not been anticipated, leaving little or no room for maneuver.

Now, each of those countries is putting in place a strong adjustment program. The aim is massive curtailment of large budgetary deficits -- programs that imply changes in taxation

and expenditures far beyond anything that, for instance, has been discussed in relation to our own budgetary problem. Money growth is being cut back, and interest rates are in some instances sharply higher. In Mexico and Brazil, growth will be curtailed for a time, and Argentina is expected to recover only part of last year's losses in output.

All of that involves immense economic and political difficulties. The difficulties are justified by the prospect that the austerity programs should also cut external borrowing needs, permit servicing of existing debt, and lay the base for resuming growth on a solid foundation. The programs cannot be successful, however, without liquidity support for an interim period, and the necessary support has required the organized effort of virtually all lending banks.

The first reaction of many banks to the critical situation that emerged for Mexico last year was to reduce or stop new lending; given the size of Mexico's need, the inevitable result was to deplete reserves and jeopardize its ability to service its debt. The more cautious lending attitudes quickly spread to other developing countries, especially those in Latin America. As fears of currency depreciation and capital controls intensified, capital flight helped to aggravate the resulting problems.

There have been a number of occasions in recent years when it was necessary for banks to restructure or renegotiate loans to particular countries. The situation that emerged last year was unique in its scope and potential effects. It involved

several major debtors at the same time, and threatened to spread to others, weak and strong alike. It is this potential for cascading liquidity pressures, undermining the stability of the financial system, that has demanded prompt and forceful action by governments, as well as by private institutions, to protect the stability of the financial system as a whole and our own economy. Fortunately, institutions and facilities designed to cope with problems of this kind were in place and can be adapted as necessary to cope with the present circumstances.

It is in this context that organized programs have been needed to combine and coordinate the efforts of the debtors, the commercial banks, the authorities of the major industrial countries, and the International Monetary Fund (IMF).

The issue has not been whether the debtors will have to close the gap in their external payments -- when the supply of credit is curtailed, there is simply no alternative. Nor can private creditors abstain from participation -- limited available official funds, whether short or medium term, could be marshalled to ease the adjustment in some cases, but they should not be dissipated by repayment of private creditors.

The need has been to recognize these imperatives and reconcile them in a way that would promote needed adjustment without intolerable burdens on the debtor countries and the world economy. The aim is to forestall potential threats to the financial system and to economic recovery in a way consistent with future stability.

One element in that solution has had to be organized efforts by banks worldwide to restructure existing loans and to provide enough new credit to satisfy reduced needs as the adjustment programs take hold. Supervisory authorities both here and abroad have recognized that these efforts are necessary to the success of the program. We cannot, of course, abandon our concern for prudence in lending. But we can and do recognize that sound adjustment programs, carefully monitored by the IMF, can contribute to the credit-worthiness of individual countries, as well as to the stability of the financial system as a whole.

In cases like these where moderate amounts of new bank credit and some restructuring of existing debt are required as part of effective adjustment programs and the loans can be serviced, supervisory objectives do not require criticism of the restructured and new loans. Indeed, refusal of banks to participate in such programs could undermine their common interest in maintaining the servicing and the ultimate collectibility of existing credits.

Enlarged IMF Resources

Member countries of the IMF appear close to agreement -- subject to legislative approval -- to expand the effective resources of that institution, and to do so promptly. The decision has not been reached in haste -- discussions about the potential demands on the IMF have been in progress for many months in connection with the Eighth General Review of quotas. Throughout the negotiating process, the United States has emphasized the need to avoid excessively large additions to resources for fear that those resources might be used too freely, or might encourage laxity or delay in adjustment

actions where they are necessary. Those concerns, of course, remain relevant, and have been taken into account. But events also conclusively demonstrate that a substantial increase in resources is indeed required to meet potential needs. The amount to be agreed by U.S. negotiators, I feel sure, will not exceed the basic requirements of the IMF if it is to discharge its large responsibilities with confidence and effectiveness.

Recent discussions among the leading countries have focused on an increase in quotas in the neighborhood of 50 percent, or by about \$30-\$35 billion. The Group of Ten has decided upon an enlargement and broadening of the General Arrangements to Borrow (GAB) from SDR 6.4 billion to SDR 17 billion (or from \$7.1 billion to about \$19 billion). For the first time, money available through that arrangement could be used for lending to any member country, but only when the borrower has agreed to a major adjustment program and when there is deemed to be a threat to the stability of the international monetary system.

Both the quotas and the GAB essentially provide a commitment to contribute to a pool of funds that can be drawn upon for loans to IMF member countries in time of need. As more funds are borrowed by a country, stricter conditions are required. The aim is to provide assurance that there is adequate, temporary multilateral financial support available for well-designed and executed economic and financial programs.

As I have indicated, in the case of major borrowers like Argentina, Brazil and Mexico, the actual financing that can be committed by the IMF within its resources and under its procedures is only a fraction of the total financial flows that must be organized and maintained. The IMF programs and financing are, of course, in the interests of banks and other lenders, because they have a large stake in the stability and creditworthiness of the countries involved and in the functioning of the system as a whole. But as I have emphasized, the programs and IMF participation do not contemplate banks can "bail out" of existing loans, and they are, in fact, called upon to play a responsible part in the lending process.

The precise share of the United States in the proposed quota increase is not yet finally agreed, but is likely to be less than 20 percent. Our share of the enlarged GAB is contemplated at 25 percent, involving about \$4.7 billion at current exchange rates for the dollar. About \$2 billion of that amount will be covered by our current \$2 billion commitment to the present GAB, an amount that has been unchanged for more than 20 years.

These are standby commitments. They will involve cash advances only when and if demands on the IMF exceed amounts that can be provided from current resources. IMF facilities are reciprocal; in case of need, the United States can draw on resources provided to the IMF by other countries.

Commitments for increases in IMF quotas and for an enlarged GAB require budget authority and appropriation for the full amount. They do not, however, lead to a net budget outlay, in recognition of their monetary and reciprocal character. Should the IMF call upon the U.S. commitment, there is an equal and offsetting debit and credit to the appropriation account, as the cash transferred to the IMF is reflected in an increased U.S. reserve position in the Fund. That reserve position is freely available to us in time of foreign exchange need.

Transfer of cash to the IMF does add to the borrowing requirements of the Treasury; there is a corresponding reduction in borrowing requirements when dollars are received by the Treasury from the Fund as a result of repayments to the IMF or U.S. drawings. To the extent that the IMF's lending activity is apt to increase during periods of global economic recession, and decline during periods of prosperity, any marginal effects on credit markets are ameliorated. Relative to the totality of U.S. financial markets, these flows will be relatively modest; for long periods, the funds may not be used at all. To the extent funds are drawn, interest is paid at levels related to average short-term interest rates in major countries.

Questions have been raised about the impact of IMF lending programs on our economy relative to domestic credit programs. That is a difficult comparison to make. As noted,

our commitments to the IMF are standby and reciprocal, and drawings on those commitments are likely to be short term and reversible. The operations are not aimed at a particular part of the economy, nor are subsidies to one sector of the U.S. economy or another involved. To be sure, some of the IMF advances to borrowing countries, whether or not the United States is the immediate source of the funds, are likely, directly or indirectly, to be spent on U.S. exports. Some of the funds may promptly find their way back into the U.S. banking system or credit markets.

But those technical comparisons should not obscure the basic point of the IMF commitment. The strengthening of the IMF is an integral part of the overall effort to defend the stability of the international financial system. The success of that effort will not be measured by the amount of dollars drawn, but by its contribution to confidence that governments can and will work together to assure that the financial system can and will withstand strains and pressures, continuing to function effectively in the interest of every country.

That concern is not abstract or altruistic. The international financial system is not separable from our domestic banking and credit system. The same institutions are involved in both markets. A shock to one would be a shock to the other. In that very real sense, we are not considering esoteric matters of international finance, or primarily what is in the interest of heavily indebted developing countries, although that is involved. We are talking about dealing with a threat to the recovery, the jobs, and the prosperity of our own country, a threat essentially without parallel in the postwar period.

Conclusion

I do not minimize the pressures on the international financial system, and the implicit risks. Those risks in the most immediate sense are financial and economic, but they could potentially be broader than that, affecting the cohesion and political relationships of the Western world.

At the same time, I can only be encouraged by the understanding and cooperation that have marked the response to the difficult circumstances -- by governments and central banks, by private financial institutions, and not least, by the borrowing countries themselves that carry the most difficult burden. The IMF stands at the center of the process, and has responded with force and leadership.

We -- the United States and other countries, lenders and borrowers, banking supervisors and those supervised -- have much to learn from this experience. No single action -- no magic wand -- is available to assure success.

What is sure is that, working together, solutions can be found and are being found. That effort does, and will continue to, demand the active participation of the United States. As the largest economy, increasingly dependent on world trade and finance ourselves, we cannot escape that responsibility.

The benefits of the total effort, which many countries are sharing, will be broadly felt. Our own direct stake is large, for we are dealing with a potential obstacle to our objective of

moving from recession into a period of long-sustained growth. And, as we do so, we will have made an enormous contribution to a world economic environment in which the acute debt problems of today will recede and the international financial system can support growth in investment, trade and economic activity.

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TABLE I

Selected Data for Non-OPEC Developing Countries

	<u>Growth Rate OECD (percent)</u>	<u>Growth Rate Developing Countries (percent)</u>	<u>of which: Western Hemisphere (percent)</u>	<u>Gross External Debt (millions of dollars)</u>	<u>Debt to Foreign Banks (millions of dollars)</u>	<u>Total Reserves minus gold (millions of dollars)</u>
1973	6.1	6.7	8.4	110 ^{1/}	35 ^{1/}	25.9
1974	0.7	5.6	6.9	135 ^{1/}	50 ^{1/}	28.1
1975	-0.2	4.2	3.2	165	62.7	27.1
1976	4.8	6.6	5.5	200	80.9	38.2
1977	3.8	5.4	5.0	250	94.3	52.1
1978	4.0	5.6	4.5	310	131.3	66.0
1979	3.1	5.0	6.7	365	171.0	76.7
1980	1.2	4.7	5.9	430	210.2	76.8
1981	1.5	2.5	0.5	505	253.5	74.7
1982	-0.8 ^e	1.2 ^e	-0.7 ^e	550 ^e	268.3(June)	69.3(Oct.)

^{1/} The estimates for these years were done without the benefit of BIS-reported bank lending data, which are only available beginning in 1975.

e = estimate.

TABLE I - continued

Selected Data for Non-OPEC Developing Countries

	Debt Service % of Exports	Change in Commod- ity prices (percent)	Gross Oil Imports ^{2/} (billions of dollars)	Trade Balance (billions of dollars)	Gross Interest Payments (billions of dollars)	Current Account Balance (billions of dollars)
1973	n.a.	53.2	4	-7	n.a.	-6
1974	15.9	28.0	15	-24	9	-24
1975	17.9	-18.2	14	-30	10	-32
1976	16.8	13.2	16	-16	11	-19
1977	17.4	20.7	19	-13	14	-14
1978	21.9	-4.7	20	-24	20	-26
1979	21.9	16.5	31	-35	28	-41
1980	20.0	9.7	50	-56	40	-64
1981	22.9	-14.8	53	-59	55	-74
1982	28.0 ^e	-12.1 ^e	47 ^e	-40 ^e	58 ^e	-60 ^e

1/ IMF index, 1968-70=100 (does not include oil).

2/ Net of oil refined and re-exported.

e = estimate.

TABLE II

Bank Claims on Developing Countries
(billions of dollars, end of period)

	<u>Total</u>	<u>U.S. Banks</u>	<u>Non-U.S. Banks</u> ^{2/}	<u>U.S. Share of Total (%)</u>	<u>U.S. Share of Annual Increase (%)</u>	<u>Weighted-average Spread on Medium-term Credits</u> ^{3/}
1975 ^{1/}	62.7	34.3	28.5	54.5	n.a.	1.65 ^{4/}
1976 ^{1/}	80.9	43.1	37.8	53.3	48.4	1.87 ^{4/}
1977	94.3	46.9	47.4	49.7	28.4	1.75
1978	131.3	52.2	79.1	39.8	14.3	1.31
1979	171.0	61.8	109.2	36.1	24.2	0.82
1980	210.2	75.4	134.8	35.9	34.7	0.85
1981	253.5	92.8	160.7	36.6	40.2	1.05
1982 (June)	268.3	98.6	169.7	36.7	39.2	1.20 ^{5/}

Bank Claims on Argentina, Brazil and Mexico

1975	31.5	18.7	12.8	59.4	n.a.
1976	42.5	24.7	17.8	58.1	54.5
1977	50.2	25.8	24.4	51.3	14.3
1978	63.2	26.8	36.4	42.4	7.7
1979	83.0	29.9	53.1	36.0	15.7
1980	108.1	37.0	71.1	34.2	28.3
1981	134.5	46.7	87.8	34.7	36.7
1982 (June)	145.0	52.4	92.6	36.1	54.3

^{1/} Data for 1975-76 are not fully comparable with those for later years.

^{2/} In recent years, the dollar value of claims of non-U.S. banks has been reduced as a consequence of the dollar's appreciation.

^{3/} Federal Reserve staff sample.

^{4/} Fourth quarter.

^{5/} First three quarters.

n.a. Not available.

TABLE III

U.S. and Non-U.S. Bank Claims on Major Borrowers, June 1982
(billions of dollars)

<u>Country</u>	<u>Total</u>	<u>U.S.</u>	<u>Non-U.S.</u>	<u>U.S. % share</u>
1. Mexico	64.4	24.3	40.1	37.7
2. Brazil	55.3	20.7	34.6	37.4
3. Venezuela	27.2	11.1	16.1	40.8
4. South Korea	20.0	8.7	11.3	43.5
5. Argentina	25.3	8.6	16.7	34.0
6. Chile	11.8	6.3	5.5	53.4
7. Spain	23.7	5.7	18.0	24.1
8. Philippines	11.4	4.8	6.6	42.1
9. Taiwan	6.4	4.4	2.0	68.8
10. Colombia	5.5	2.7	2.8	49.1
11. Greece	9.7	2.7	7.0	27.8
12. Yugoslavia	10.0	2.5	7.5	25.0

Source: (1) BIS semi-annual maturity survey; (2) U.S. Country Exposure Lending Survey (data adjusted to a BIS basis).

TABLE IV

Claims on Non-Oil Developing Countries:
Country Exposure Lending Survey Data for Nine Largest Banks
 (billions of dollars)

	Claims on Non-Oil De- veloping Countries	Reporting Banks' Total Assets	Reporting Banks' Total Capital	Claims on Non-Oil Developing Countries as a percent of:	
				Total Assets	Total Capital
1977 December	30.0	372.5	18.4	8.1	163
1978 June	31.0	390.2	19.0	8.0	164
December	33.4	422.5	20.0	7.9	176
1979 June	35.0	449.8	21.1	7.8	166
December	39.9	486.1	21.9	8.2	182
1980 June	41.9	508.4	23.0	8.2	182
December	47.9	531.0	24.0	9.0	199
1981 June	51.6	553.7	25.0	9.3	206
December	57.6	564.6	26.1	10.2	220
1982 June	60.3	566.3	27.1	10.6	222

TABLE IV - continued

Claims on Non-Oil Developing Countries:
Country Exposure Lending Survey Data for All Reporters
 (billions of dollars)

	Claims on Non-Oil De- veloping Countries	Reporting Banks ' Total Assets	Reporting Banks ' Total Capital	Claims on Non-Oil Developing Countries as a percent of:	
				Total Assets	Total Capital
1977 December	46.9	717.1	40.9	6.5	115
1978 June	48.7	747.9	42.5	6.5	115
December	52.2	823.6	45.0	6.3	116
1979 June	54.4	867.8	47.4	6.3	115
December	61.8	941.3	49.9	6.6	124
1980 June	66.2	999.1	53.9	6.6	123
December	75.4	1,066.3	57.0	7.1	132
1981 June	82.3	1,119.3	59.9	7.4	137
December	92.8	1,164.5	62.7	8.0	148
1982 June	98.6	1,192.4	66.2	8.3	149

TABLE IV - continued

Claims on Non-Oil Developing Countries:
Country Exposure Lending Survey Data for Next Fifteen Largest Banks
 (billions of dollars)

	Claims on Non-Oil De- veloping Countries	Reporting Banks' Total Assets	Reporting Banks' Total Capital	Claims on Non-Oil Developing Countries as a percent of:	
				Total Assets	Total Capital
1977 December	8.8	145.0	8.3	6.1	106
1978 June	9.3	150.7	8.7	6.2	107
December	9.9	166.0	9.0	6.0	110
1979 June	10.3	175.2	9.5	5.9	108
December	11.3	188.1	10.1	6.0	112
1980 June	12.5	196.6	11.0	6.4	114
December	14.2	207.1	11.4	6.9	125
1981 June	15.4	221.5	11.5	7.0	134
December	17.4	233.8	12.2	7.4	143
1982 June	19.0	241.1	12.7	7.9	150

TABLE V

Claims on Selected Developing Countries
for Nine Large U.S. Banks

<u>Date</u>	<u>Claims (billions of dollars)</u>			<u>Total 3 Countries</u>
	<u>Argentina</u>	<u>Brazil</u>	<u>Mexico</u>	
1977	1.8	7.7	6.1	15.6
1978 June	1.9	8.0	5.9	15.8
December	1.8	8.5	6.1	16.4
1979 June	2.1	8.8	5.8	16.7
December	2.9	8.8	6.5	18.2
1980 June	3.3	9.1	7.3	19.7
December	4.2	9.4	9.1	22.7
1981 June	4.6	9.7	10.2	24.5
December	5.2	10.6	11.6	27.4
1982 June	5.3	11.8	13.4	30.5

<u>Date</u>	<u>Claims as Percent of Capital</u>			<u>Total 3 Countries</u>
	<u>Argentina</u>	<u>Brazil</u>	<u>Mexico</u>	
1977 December	9.8	41.8	33.2	84.8
1978 June	10.0	42.1	31.1	83.2
December	9.0	42.5	30.5	82.0
1979 June	10.0	41.7	27.5	79.1
December	13.2	40.2	29.7	83.1
1980 June	14.3	39.6	31.7	85.7
December	17.5	39.2	37.9	94.6
1981 June	18.4	38.8	40.8	98.0
December	19.9	40.6	44.4	105.0
1982 June	19.6	43.5	49.4	112.5

TABLE V - continued

Claims on Selected Developing Countries
for Next Fifteen Largest Banks

<u>Date</u>	<u>Claims (billions of dollars)</u>			<u>Total 3 Countries</u>
	<u>Argentina</u>	<u>Brazil</u>	<u>Mexico</u>	
1977	0.5	2.3	2.5	5.3
1978 June	0.6	2.4	2.3	5.3
December	0.5	2.6	2.2	5.3
1979 June	0.7	2.6	2.2	5.5
December	1.0	2.4	2.4	5.8
1980 June	1.3	2.6	2.4	6.3
December	1.4	2.6	3.2	7.2
1981 June	1.6	2.8	3.4	7.8
December	1.7	3.0	4.3	9.0
1982 June	1.8	3.6	4.9	10.3

<u>Date</u>	<u>Claims as Percent of Capital</u>			<u>Total 3 Countries</u>
	<u>Argentina</u>	<u>Brazil</u>	<u>Mexico</u>	
1977 December	6.0	27.7	30.1	63.9
1978 June	6.9	27.6	26.4	60.9
December	5.6	28.9	24.4	58.9
1979 June	7.4	27.4	23.2	57.9
December	9.9	23.8	23.8	57.4
1980 June	11.8	23.6	21.8	57.3
December	12.3	22.8	28.1	63.2
1981 June	13.9	24.3	29.6	67.8
December	13.9	24.6	35.2	73.8
1982 June	14.2	28.3	38.6	81.1

TABLE V - continued

Claims on Selected Developing Countries
for All Reporting Banks

<u>Date</u>	<u>Claims (billions of dollars)</u>			<u>Total 3 Countries</u>
	<u>Argentina</u>	<u>Brazil</u>	<u>Mexico</u>	
1977	2.6	12.0	11.2	25.8
1978 June	3.0	12.4	10.8	26.2
December	2.8	13.4	10.7	26.9
1979 June	3.4	13.6	10.4	27.4
December	4.8	13.6	11.5	29.9
1980 June	5.6	14.0	12.8	32.4
December	6.9	14.5	15.7	37.1
1981 June	7.5	15.2	18.1	40.8
December	8.4	16.8	21.5	46.7
1982 June	8.6	18.9	24.9	52.4

<u>Date</u>	<u>Claims as Percent of Capital</u>			<u>Total 3 Countries</u>
	<u>Argentina</u>	<u>Brazil</u>	<u>Mexico</u>	
1977 December	6.4	29.3	27.4	63.1
1978 June	7.1	29.2	25.4	61.6
December	6.1	29.4	23.5	59.0
1979 June	7.2	28.8	22.0	57.9
December	9.6	27.3	23.1	60.0
1980 June	10.4	26.0	23.8	60.2
December	12.1	25.4	27.5	65.1
1981 June	12.5	25.4	30.2	68.1
December	14.0	28.0	35.9	78.0
1982 June	13.7	30.1	39.7	83.6

TABLE VI

Amounts Owed to U.S. Banks by Foreign Borrowers, June 1982
(billions of dollars)

	<u>Total Claims</u>	<u>Portion Owed by</u>		
		<u>Banks</u>	<u>Public Borrowers</u>	<u>Private non-Bank Borrowers</u>
<u>To nine largest banks</u>				
<u>Non-OPEC developing countries</u>	60.3	15.9	22.7	21.7
Argentina	5.3	1.1	1.9	2.4
Brazil	11.8	3.6	4.1	4.1
Mexico	13.4	2.2	5.6	5.6
<u>To next fifteen largest banks</u>				
<u>Non-OPEC developing countries</u>	19.0	8.2	4.3	6.5
Argentina	1.8	0.7	0.5	0.6
Brazil	3.6	2.0	0.8	0.8
Mexico	4.9	0.7	1.2	2.7
<u>To all reporting banks</u>				
<u>Non-OPEC developing countries</u>	98.6	33.0	31.6	34.0
Argentina	8.6	2.5	2.7	3.4
Brazil	18.9	7.9	5.5	5.5
Mexico	24.9	4.4	8.8	11.7

Appendix I

Participation in Bridging Credits by U. S. Monetary Authorities

During the past year, the U. S. monetary authorities have provided, or participated in the provision of, short-term, bridging credits to Mexico, Brazil, and Argentina to help these countries meet their minimum and immediate liquidity requirements while adjustment and borrowing programs were arranged. These credits have sometimes been provided in cooperation with the Bank for International Settlements (BIS) and monetary authorities in other industrial countries. A bridging credit was also provided to Hungary in 1982 in which the United States did not participate, and a bridging credit for Yugoslavia, in which it is proposed that the United States might participate, is under active discussion. This appendix summarizes the arrangements for Mexico, Brazil and Argentina.

Mexico

The Federal Reserve has had a swap arrangement with the Bank of Mexico since 1967. That arrangement is for a total of \$700 million. The Bank of Mexico drew \$600 million on that arrangement on April 30, 1982 and repaid on May 1, drew \$200 million on June 30 and repaid on July 1, drew \$700 on July 31 and repaid on August 1. Finally, the Bank of Mexico drew \$700 million on August 4. A portion of that drawing has now been repaid and the remainder is expected to be repaid within the next month.

The Exchange Stabilization Fund (ESF) of the U. S. Treasury has had swap arrangements with the Bank of Mexico since the 1930s. On August 14, 1982, the ESF entered into a \$1 billion short-term swap arrangement with the Bank of Mexico. Drawings under the arrangement were repaid on August 24 with the proceeds from an advance payment on oil purchases for the Strategic Petroleum Reserve by the Department of Energy.

The ESF and the Federal Reserve both participated in a \$1.85 billion bridging facility provided to the Bank of Mexico under the aegis of the BIS on August 30, 1982. The U. S. monetary authorities provided half the total amount through parallel swap arrangements -- the ESF \$600 million and the Federal Reserve \$325 million. The Bank of Mexico has drawn on these facilities in the past five months to meet its urgent financing requirements while Mexico has put into place its IMF-approved economic stabilization program and arranged a financing package with the commercial banks. These drawings are expected to be repaid by the end of August 1983.

Brazil

In October and November of last year, the ESF entered into swap arrangements with the Central Bank of Brazil to provide a total of \$1.23 billion in short-term, bridging credit to Brazil. On December 28, the Central Bank of Brazil

repaid \$500 million, and on February 1 another \$280 million was repaid. The remainder is expected to be repaid within the next month as additional IMF and commercial bank credits become available.

The BIS, acting with the support of the ESF and monetary authorities in other industrial countries, provided the Central Bank of Brazil with a \$1.2 billion credit facility on December 23, 1982. The ESF on December 13 provided through a swap arrangement an advance of \$250 million on the BIS facility which has been repaid. On January 17, 1983, the Saudi Arabian Monetary Authority agreed to support an addition of \$250 million to this facility. The BIS expects to be fully repaid by November 1983. As part of the liquidity support arrangements for the BIS provided by the participating monetary authorities, the ESF has agreed to be substituted for the BIS for \$500 million of the total credit facility in the unlikely event of delayed repayment by the Central Bank of Brazil.

Argentina

Last week the BIS announced that it is providing a \$500 million bridging loan to the Central Bank of Argentina with the support of a group of its member central banks and the U. S. monetary authorities, which is expected to be repaid by the end of May as other funds become available to Argentina.

In this case, the Federal Reserve has agreed to provide liquidity support to the BIS as may be necessary in connection with the credit facility including being substituted for the BIS at its request for \$300 million of the total credit facility in the unlikely event that the credit remains outstanding for a longer period of time than is now contemplated.

Appendix II

Examination of Country Risk in U.S. Banks

United States bank regulatory authorities are responsible for evaluating the financial condition of U.S. banks and for encouraging the conduct of their operations in a safe and prudent manner. As a matter of general approach and philosophy, U.S. bank supervisors consider a bank as a consolidated entity and seek to apply the same criteria to a bank's domestic and international activities. Some special procedures are required, however, with regard to the international side to take account of the dimension of "country risk," i.e., the possibility that adverse economic, social, or political circumstances may prevent a country's borrowers from making timely repayment of interest or principal. Due to the growth in international lending, especially in the last decade, an analysis of country risk exposure is now an essential element of evaluation of the financial condition of the largest U.S. banks. Country risk, however, is only one of a number of factors affecting a bank's condition and must be analyzed in relation to each bank's overall condition.

In 1979, the three Federal bank regulatory agencies (the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation) adopted a new uniform system for the examination of country risk in bank portfolios. This system replaced various procedures that had attempted to treat country risk in the same format as commercial risk in banks. The new system assures basic uniformity among the agencies, analyzes the lending bank's own capabilities for country risk management,

provides for standard criteria for determining when credits should be "classified" due to country risk, and focuses attention on concentrations of lending. Definition and statistical analysis used in the examination process are integrated with the collection of aggregate data on bank foreign lending, greatly facilitating appraisals of individual bank positions relative to the whole and improving the quality of the available data. U.S. bank exposures are evaluated on the basis of their world-wide operations.

The new system has four parts: (1) a listing of significant country exposures, designed in a manner to bring large exposures, relative to capital or other lenders, to the attention of management; (2) comments on large exposures to individual countries (for this purpose, countries are divided into three broad groups depending upon cross classification of risk factors in the country and degree of exposure by the bank); (3) classification of exposures when necessary; and (4) a discussion of the bank's procedures and controls for managing country risk.

The System is administered by an Interagency Country Exposure Review Committee composed of three members from bank supervision staffs of each agency, including at least six senior bank examiners. The primary functions of the Committee are to evaluate "transfer risk" (i.e., the possibility that the borrower may not be able to maintain debt servicing in the currency in which the debt is denominated because of lack of availability of foreign exchange); to place countries into one of three groups for purposes of evaluating and commenting upon bank exposure

relative to capital; to provide "country summaries" to be used in the examination report where warranted; and, if necessary, to prepare classification on the basis of transfer risk. (Private foreign credits may be classified by individual examiners on the basis of normal credit analysis.)

"Listing"

The "listing" section of an examination report sets out aggregate exposure country-by-country, subdivided by the nature of the loan or other exposure (i.e., deposits, letter of credit, etc.). The array of data reflects both risk categories determined by the ICERC and the amount of the exposure relative to a bank's capital funds. Exposures are listed when they exceed 5 percent of capital funds for a country where risks are considered potentially greater, 20 percent for a middle group of countries, and 25 percent for countries in the strongest group. Listing an exposure does not in itself imply criticism; rather, the purpose is to draw attention to those exposures that the bank should more closely monitor because of size and risk characteristics.

Comments on Concentrations of Exposure

As noted in the preceding paragraph, the ICERC places borrowing countries into one of three groups. In making its decision, the Committee relies primarily on: (1) a statistically generated "ratio" screen of risk factors; (2) country studies prepared by the Federal Reserve Bank of New York and the Federal Reserve Board's International Finance Division; (3) oral briefings from the Treasury Department; and (4) information obtained from

banks by examiners prior to the meeting. Judgment of a country's standing relative to those three groups is by majority vote of the members of the Committee.

An exposure is subject to mandatory comment in a bank examination report if the amount of credit extended to a country in the "bottom" group exceeds 10 percent of a bank's total capital or if exposure exceeds 15 percent of capital funds to a country in the middle group. In addition, the examiner has the discretion to comment on exposures down to 5 percent for countries in the bottom group and down to 10 percent for the middle group. There are ordinarily no comments on exposures to countries in the top group.

A comment consists of two paragraphs. One paragraph contains a brief statement on conditions prevailing in the country. This paragraph is prepared by the ICERC and cannot be altered by examiners. The comment typically takes into account the presence of an IMF-approved adjustment program in relevant cases. The other paragraph is prepared by the individual examiner on site. It describes the nature of the bank's exposure (e.g., maturities, type of borrower) and trends in that exposure. In relevant cases, the examiner may indicate how the bank's exposure compares to exposure levels in other banks and discuss the bank's future plans for lending in the country.

Classifications Due to Country Risk

A major task of bank examination is to evaluate bank assets. Credits having serious deficiencies are classified in one of three

categories: substandard, doubtful or loss. Historically, classification has resulted from perceived deterioration in the financial position of individual commercial borrowers. However, foreign credits may in exceptional cases also be classified due to "transfer" risk. All credits to both public and private borrowers for which repayment is dependent on a flow of foreign exchange would be included in a transfer risk classification. Amounts classified due to "country" risk are added to those classified due to commercial risk, whether domestic or foreign, in determining a bank's asset quality rating.

Since 1979, all transfer risk classifications have been determined through the procedures of the ICERC. Interagency guidelines instruct ICERC to review a country's credits for possible classification only when there has been an actual interruption in external payments or when such an interruption appears imminent. ICERC reviews the reasons for actual or prospective non-payment, sources of external financing available to a country, and measures being taken to restore debt servicing to a sound basis. The presence or absence of an IMF-approved adjustment program would be a relevant factor. Classification is by majority vote of the Committee members.

Once a classification is imposed, it is not removed until a country has demonstrated, on a sustained basis, that it is able to service its debts (which have usually been restructured) in an orderly manner. A country should also demonstrate an improvement in its economic position, especially as it affects the country's external accounts.

Evaluation of a Bank's System for Monitoring Country Exposure

Another function of the examination system is to ascertain that banks are properly supervising their country exposure. Examiners are instructed to review three major aspects of banks' systems: (1) the measurement and monitoring of country risk; (2) the procedures for establishing and changing country limits; and (3) the procedures for evaluating countries. Examiners are expected to criticize any deficiencies in these areas.

General Comment

The primary purpose of these examination procedures is to assure that the most senior policy-makers in the bank are aware of the need to follow sound banking policies with regard to the bank's international exposure and, in particular, to encourage diversifying exposure and avoiding large concentration of credit in potential problem areas. Consistent with the approach to bank supervision in the United States, placing a comment in the examination report should force officials of the bank responsible for its international activities to justify the exposure to senior management and, where appropriate, to the bank's board of directors. In such circumstances, management may reconsider the approach toward lending in that particular country.

If an examiner determines that the level of an exposure (relative to risk factors) is particularly high, or major problems exist elsewhere in international risk management, he may call

attention to these findings in the summary of the examination and reference may be included in the letter transmitting the examination report. A bank's board of directors is required to review carefully all summary and transmittal comments.