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SANDCASTLE: AN "ALTERNATIVE EMPHASIS" ANALYSIS OF THE STABILITY OF THE INTERNATIONAL BANKING SYSTEM

Previous issues of **International Strategic Issues** have assessed the geopolitical impact on key countries or areas of unconventional factors such as the political use of oil and terrorism, etc. This issue of **ISI** deals with international banking and the degree to which it could be rocked by a variety of economic and political factors discussed in other **International Strategic Issues** analyses (see assessments for Brazil, Mexico, and the Persian Gulf), and how the banking system, in turn, could be used as a devastating weapon against Western democratic political and economic stability.

The Conventional View: Stability Is Improbable But Not Impossible

International banking, the Eurodollar market, merchandise trade deficits, the "recycling" of "petrodollars," all are political issues which have long commanded attention in the press and occupied public debate. However, it was not until President Carter seized Iran's financial assets during the hostage crisis that international banking attained the same political headline status as terrorist attacks and military coups. Spokesmen for the financial community complained bitterly about Carter's transgression on the political neutrality of world banking. A great trust, we were told, had been broken. The more general response, however, has been essentially that the U.S. did no more than attach the bank accounts of a violater of international law. In the end, the action seems to have been instrumental in freeing the hostages, and nothing fundamental appears to have changed in world banking.

On the surface, this appears to be true. **The standard analysis** of international banking continues to see **no appreciable or substantial change in what has been the norm over the whole post-World War II period.** There has, of course, been growth and development but, on the whole, the picture is the same. International banking is viewed basically as an extension of the domestic banking systems of the major industrializaed nations. It has developed in order to facilitate the massive expansion of international trade which has developed as a result of GATT-directed tariff reductions. And it functions within a global framework provided by the International Monetary Fund, the Bank for International Settlements, and related institutions.

Domestically, banking has been a regulated industry for such a long time that, in many countries, it seems almost an extension of the government; in France and a few other countries, it actually is. Through central banks, these domestic banks are manipulated with the object of stabilizing the domestic economy, and maintaining the value of the country's currency internationally. Though obviously profit making institutions, the close involvement of the banks in the nation's total economic activity has made for a close alignment of interests between the banks and the government over the wellbeing of the nation's economy as a whole. Indeed, in their international advertising, banks are often the most enthusiastic of boosters for their home market.

Admittedly, the international banking system has faced **some serious shocks and setbacks over the last 35 years.** Originally built around a system of fixed exchange rates based on two reserve currencies, the British pound and the American dollar, international banking has survived a series of pound devaluations and its subsequent demise as a major reserve, the closing of the U.S. gold window, and the complete collapse of all pretense of fixed currency values. The system has also survived some notable bank failures, most recently Herstatt in Germany and Franklin National in the United States. In addition, there has developed a major market for "Eurodollars" which functions almost entirely outside the regulatory environment of the central banks. At first, this market was the subject of considerable concern but, as is so often the case with errant children, immense financial success has made the Eurodollar market an important element of the international banking community.

Perhaps the greatest challenge faced by this system came in 1974 when the increase in OPEC crude prices brought about the massive surpluses and deficits of the oil exporting and importing countries. The international banks and, most notably, the unregulated Eurodollar market rose to this challenge and provided the mechanism for "recycling" these "petrodollars." Once again, the banks were serving as the instruments for settling potentially disruptive political/economic problems. The latest shock came with the 1979–80 oil price increases. The immediate response was concern that the banks had done all that they could. However, the expected crisis did not come, and today the view is generally taken that, with some help from the IMF and the World Bank, as well as some direct involvement by the Arab banks themselves, this process of recycling the petrodollar surplus may continue.

This whole process does, of course, have its **critics.** The massive debt developed by the oil importing LDC's during the recycling process has revived interest in old fashioned financial panics. With some of the major U.S. banks earning as much as 50–60 percent of their income from international banking, with their loans to oil importing LDC's in some cases surpassing the banks' capitalization, with the LDC's paying ever larger portions of their export earnings on oil imports and debt service, the likelihood of default, insolvency, panic and financial collapse seems to grow daily. This impending crisis has, however, been with us for over five years. At this point, this long forecasted international banking disaster is beginning to worry people in much the same way as the long overdue California earthquake.

This attitude is best summed up by a senior economist at a major American bank recently quoted by the **Financial Times:** "If you just look at the macro numbers, at the vast OPEC surpluses and the correspondingly vast deficits of the oil-importing countries stretching on into the future, disaster looks inevitable. But if you pick it apart, and assume a bit of adjustment here, a bit of adaptation there, then the picture looks a lot less unmanageable. Disaster is still possible; but it is not inevitable."

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The hidden assumption in this type of analysis is that all the parties involved have the same incentives and will all work together to make that bit of adjustment here and the bit of adaptation there. This assumption is a sentiment based largely on the standard view of international banking discussed above. However, such a global commonality of interests is an increasingly rare thing in this world. Using the "alternative emphasis" approach, it can be shown that there are a number of possibilities and problems **which suggest that the various interests involved, both economic and political, may, in fact, be destabilizing to this delicate situation.**

LDC's: The Oil Bill is Bad, But the Debt is Worse

First and most obvious, there is the question of LDC debt to Western banks, estimated at $350–$400 billion, although the problem is **not just its size, but also its nature.** The bankers insist that this debt is not one big problem, but, rather, many unique individual country problems. Each, they claim, must be examined on its own terms. The bankers will also point out that debtor nations can't skip town and establish a new line of credit elsewhere. Any out and out default, they explain, would be pointless given the international financial community's willingness to "restructure" existing debt and the country's need for continuing credit to finance necessary foreign trade. Thus, the banks assure, there is **no problem,** despite the fact that, historically, loans to sovereigns being unenforceable in any court have often ended in default and ruin, and despite the fact that restructured loans, though carried on the books at face value, are in actuality significantly deteriorated assets, which in sufficient volume would have the same effect on a bank's capital structure as a major default.

The primary misconception in this whole approach is, however, the fact that, **in addition to a willingness to pay, there must also be the ability.** As noted above and shown in Table I, LDC debt service (i.e., principal repayment plus interest) has been growing relative to exports, and doing so quite rapidly. This is even true of the so-called high absorbing OPEC nations and the non-OPEC oil exporters such as Mexico.

TABLE I

Annual Rate of Growth in Debt Service Relative to Exports (1979/74)

Non-Oil Exporting LDC's	
Advanced Mediterranian	7.2%
Latin America	13.6%
North Africa & Middle East	10.0%
Sub-Saharan Africa	15.8%
Asia & Pacific	4.0%
Subtotal (weighted)	8.4%
Oil-Exporting LDC's	
OPEC	18.8%
Non-OPEC	26.9%
Subtotal (weighted)	25.1%
TOTAL all LDC's (wgtd)	13.9%

In addition to their debt payments growing faster than their export earnings, the oil-importing LDC's have also been facing oil import costs which have been rising relative to exports. It should be noted that this is not as widespread a problem as is the rising debt load. A few countries (e.g., Spain and Argentina) actually increased exports more rapidly than oil imports between 1974 and 1979. However, a number of countries (e.g., Brazil, Jamaica, Morocco, Sudan, and Turkey) are at or close to the point **where debt service and crude oil imports are about equal to exports.** Since all these countries are importing other necessities in addition to crude oil, a great number are in a position of having to borrow money in order to service their debts. As a result, debt service will continue to grow until radical measures are taken. To further underline the point that debt, rather than oil imports is the greater problem, Mexico, whose oil **exports** have been growing so rapidly, had by 1979 reached the point where its **debt service was larger than its merchandise exports and growing about 24 percent more rapidly per year.** In addition, a little over half of Mexico's crude oil production is "Mayan" crude which is both heavy and high in sulfur, a relatively unattractive crude. In the face of the world oil glut, Mexico has had to cut the price of this crude by $2.50 per barrel, and still one refiner, Ashland, has walked away from a 90,000 bpd contract. The potential loss is about $1.3 billion in exports, more than 10 percent of its 1979 debt service. More sales losses should be expected.

There Are Difficult Cures ... With Serious Side Effects

For an LDC facing this sort of debt problem, the standard remedies are on the surface quite simple: **reduce imports and/or increase exports.** For most of these countries, however, reducing imports and, especially, reducing petroleum imports means slowing down the domestic economy. To increase exports on top of this may mean even further reduction in the goods available domestically. The export problem is further aggravated at this time by the fact that the industrialized economies are in the middle of a serious and apparently protracted slump, resulting in generally depressed markets for exports. Further, more protectionism in subtle forms is on the rise. The United States has recently announced that its generalized system of trade preferences (known as GSP's) which, since 1976, have provided easy access to the U.S. market for LDC goods will no longer be granted to **Hong Kong, South Korea, Taiwan, Brazil and Mexico.** These countries will now face the same tariffs and restrictions as do the industrialized countries. The European community is in the process of making similar reclassifications. In the face of these rising barriers, any excessive price cutting to spur LDC exports of manufactured goods would quickly lead to charges of dumping and even more protectionist policies. As for the commodities and raw materials exported by many LDC's, the current economic clump is already having its typical downward impact on prices, along with the usual weak demand response to such price cutting. Nothing new is happening here—only the debt load which must be serviced is larger.

The one thing that is new is the **high interest rate facing the LDC's.** Usually the interest rate comes down during a major economic slump. This time, however, world interest rates, which were well below world inflation rates throughout the pre-1979 recycling period, have now risen to record levels in an attempt by central bankers everywhere to once and for all halt the rising tide of inflation. Much of the LDC debt is either at floating interest rates or is relatively short-term with frequent rollovers. As a result, LDC interest payments and debt service have been rising more rapidly than its debt load: in 1979, total debt rose about 17 percent, while debt service increased 34 percent.

Historically, periods of credit expansion followed by periods of extremely tight credit generally result in **bankruptcies.** Such failures are not due to bad faith, but rather due to an inability to pay. Sometimes this inability is due to illiquidity. Often it is due to insolvency: cyclically low operating income is overwhelmed by heavy debt service and the resulting losses cannot be covered by a small and highly leveraged capital base. The general antagonism in Third World countries toward foreign ownership and repatriation of profits has brought about extensive reliance on debt financing as opposed to equity. This tendency has resulted in what amounts to **extremely leveraged LDC capital structures.**

Another reason for frequent failures following periods of excessively rapid economic growth is the overly optimistic expectations such periods breed. Such expectations usually lead to ill-conceived ventures and often result in outright fraud. It is a hard act of faith to maintain that the Brazils and Mexicos of this world are free from such typically human failings. The recent failures of Argentine banks and a major South Korean trading company bear witness to this fact.

There Are Also Alternative Cures ... None too Palatable

The potential for default in relatively good faith is not, however, the only problem. The LDC's also have their fair share of **political leaders only too willing to seek power through promises to rid their**

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nations of the scourge of foreign bankers. The world was, in fact, genuinely, surprised when the government of the Ayatollah Khomeini insisted that it intended to pay off the excessive debts incurred by the hated Shah. But Iran is oil-rich, while Brazil, Argentina, South Korea, Poland, and no many more, are not. Since radical politics often have their greatest appeal when a period of rising expectations meets disappointment and frustration, the **standard remedies of tightening up on the domestic economy could prove self-defeating and result in politically-inspired repudiation.** Such possibilities are usually downplayed on the grounds of LDC dependency on international trade and their need to maintain god relations with the international financial community. The more radical the political change, the less weight such arguments carry. And in general, the strategy of export-led economic development through integration with the world's economy is a realtively recent idea. Throughout the 1950's and 1960's, the goal for most LDC's was import substitution. This is still India's objective and, given its recent agricultural successes, the country is closer now than at any time in the past. India's economy is, admittedly, quite inefficient, but it does rely on few imports, about seven percent of GDP, while its debt, though largely to public institutions, is quite large ($15+ billion). Even the highly successful Brazilian economy has imports running only about 9.5 percent of GDP, though about a third of it is crude oil. Should their hydroelectric and biomass energy schemes prove only moderately successful, that massive foreign debt of some $60+ billion would become an easy domestic political target. After all, Brazilian foreign debt has been repudiated three times in the past forty years.

As for the problems of re-establishing a nation's credit worthiness in the world market, recent experience suggests that the problem may not be all that great. Following Mao's triumph over the Nationalists in Mainland China, there was a general default by both sides. Thirty years later, when the PRC amicably sought to re-establish China's credit in order to purchase vase quantities of goodies from the West, the previous debts were settled quickly and quietly (at about $.50 on the dollar). Massive new lines of credit were then extended to finance that ever-tempting China trade. Such lessons are remembered well by all national leaders contemplating default.

As has been pointed out in numerous previous issues of **ISI**, foreign debt is not the only reason for possible violent disruptions in the political economies of the world's LDC's. In many cases, if the problems are not just below the surface, they are just beyond the border. Again, Mexico is a prime example of a country which is generally considered a low-risk situation, politically, easily justifying the $30+ billion in outstanding loans. Yet, Mexico is facing all the ingredients traditionally associated with massive internal disorder and populist, if not radical, political uprising: large scale urban and rural underemployment (40–50 percent), rapidly rising expectation due to sudden and excessive oil wealth, widespread institutionalized corruption again aggravated by sudden wealth, a vocal and organized revolutionary intellectual tradition, plus active and externally financed guerrillas on its sourthern borders. Even Mexico's much heralded oil wealth is vulnerable, being located as it is in a region which is potentially most unstable.

Finally, there is the potential, as pointed out in previous ISI's, for a general LDC default brought about by a "precipitating" Brazil, Mexico, or India under a hail of anti-bank leftist or ultra-nationalist rhetoric, building cumulatively throughout the LDC's and Eastern Bloc. Widespread economic fagility, brought about by rising energy costs, makes such a catastrophe increasingly possible.

Eastern Europe: Problems and Objectives All Its Own

The Third World is not, however, the only area where large amounts of international debt may be vulnerable to politically inspired default. One of the fruits of detente in the 1970's has been a marked increase in East/West trade, most of it financed by a ten-fold increase in Western credit extended to the East. Poland has international hard currency debts in excess of $20 billion (CIA estimate): its domestic economy is near collapse and the Soviet army is circling about its borders. As a result, Poland has had its financial officers nervously touring Western financial centers trying to restructure its debt. The equally nervous Western bankers, having no other options open, seem to have agreed. To date, the East European countries have been considered good credit risks, mainly because they have always paid their bills, but also because trade and detente have been central to Western foreign policy. Today, obviously, the policies have changed and detente has withered. There has been a growing use of trade restrictions and threats of embargos in retaliation to Soviet moves in Afghanistan and, potentially, in Poland. As a result, it is now a growing possibility that a Soviet response to all this might come in the form of an embargo on debt service, that is, a default. Given the havoc a major panic would play with Western economies, an Eastern European default somewhere in excess of $65 billion dollars, calculated to have maximum impact on the financial markets involved, is a distinct political possibility and a powerful potential weapon.

The Arabs: The Largest Money Weapon

The politicalization of the world banking system does not, however, end with the Soviet Union. The OPEC petrodollar surplus itself may turn out to be as politically useful as the much discussed oil weapon. The major surplus nations, (Kuwait, Qatar, Saudia Arabia, and the United Arab Emirates), have, since 1974, been in the position of literally making more money than they knew what to do with. Their initial response was to loan it out short-term on the Eurodollar market. This was almost the equivalent of keeping their money in a passbook savings account. By 1978, however, the initial 1974 annual surplus of $60 billion dollars had fallen to $5 billion, with even conservative Saudi Arabia finding extravagant projects to squander its wealth upon. The subsequent 1979–80 price increase ran the annual surplus back up to record levels, nearly $70 billion in 1979, and an estimated $120 billion last year. It should be noted that one year's surplus just adds onto the surpluses of the preceeding years with the cumulative total to date somewhere in excess of $350 billion.

Being basically suspicious of infidels and badly burned by interest rates which failed to compensate for the ravages of inflation, these nations have made a major effort to develop entirely Arab banks to replace their dependence on Western institutions. These banks should be expected to become significant factors in international banking. They are already handling much of the Middle Eastern regional banking, most of which was previously done by Western institutions. Given the leveraged nature of banking in which one dollar of capitalization often serves to support as much as $15 in loans, the potential impact of **Arab surpluses invested in Arab** banks should not be underestimated. After all, the combined capitalization of Bankamerica Corporation, Citicorp, and Chase Manhattan is only about $13 billion.

These Arab banks, however, differ in many ways from the Western banks with which they are competing. First of all, they generally lack a domestic market base of any significance and, lacking such, they are not under the constraints of domestic macro economic and balance of trade policies which constrain the Western banking environment. Next, their relationship with their respective banks and, indeed, the governments themselves, if far from the slightly subordinate, and definitely arm's length, relationship that characterizes Western banking. Instead, a blurred distinction exists with the political and economic interests of the banks and the governments intertwined. Finally, instead of being facilitators of trade, the new Arab banks are being set up as a means of protecting and advancing the wealth and well-being of the nations involved. These institutions may best be understood as instruments in the foreign policy arsenal of a group of extremely rich, but militarily vulnerable, authoritarian nations. The fact that some of these countries are potentially unstable domestically or eccentrically radical (e.g., Libya, which is also moving into Arab banking) only further strengthens the view that their banking policies are likely to be guided by political goals which may supercede a coldly utilitarian profit motive.

The Western Banks: Things Ain't What They Used To Be

Finally, the Western banks themselves need to be re-examined. The last decade has worked substantial changes on these institutions: financial, legal, and technological. To begin with, the major banks are no longer domestic institutions with overseas interests. In 1970, the ten largest U.S. banks received only about 17.5 percent of their earnings from international investments; by 1979, such investments accounted for 42.6 percent. Back in 1975, when the U.S. was in

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recession and the first recycling wave was at its peak, this figure was 52.5 percent. For a few of these banks, it has been as high as 80 percent. These are now international banks with an interest in the U.S. market that is roughly proportional to the U.S. importance in the world's economy as a whole, and at times even less so. Such a significant shift in the financial interests of these institutions must eventually alter their perspective and subsequent behavior.

Over this same period, the major banks have also significantly increased their degree of financial leverage. In 1970, each dollar of invested capital supported about $11 in loans; by 1979, this figure had risen to $16. Given the reported growth in foreign earnings, one may roughly conclude that this 45 percent increase in leverage was mainly due to the increase in foreign investments. Now all these loans are obviously not to LDC's, however, it has been estimated that about a third of them are to non-oil exporting LDC's. In terms of exposure, this works out to about $2.25 in loans for every dollar of capitalization. Ten years ago, all international banking activity was leveraged at less than $2 in loans per dollar of capitalization. Even without the problems discussed above, this shift would have to be seen as a move to a higher risk position.

This shift away from the conservative banking practices of the past may be seen elsewhere as well. There has been a growing trend not just in the U.S., but generally throughout Western banking to expand the financial range of banking activity, as well as the geographical range. Directly or indirectly, banks have been seeking footholds in every possible type of money management, investment and monetary service activity they can fit within their legal constraints, while, at the same time, they have been lobbying to expand or eliminate those constraints. Much of this diversification has been justified on the grounds of portfolio theory: i.e., by spreading their investments into a greater range of activities, they reduce their exposure to loss in any individual area. However, what the banks have, in fact, been doing is a somewhat different variant of the same theory. They have been moving into increasingly higher risk activities in order to increase the average rate of return on their total portfolio. In general, banks have replaced the former goal of a "quality" portfolio with the objective of attaining one that "performs."

Another aspect of this emphasis on "performance" is the expanding use of computers and communications technology aimed at ever tighter management of bank assets. System float is tracked and forecast on a continuous basis in order to squeeze out a few more dollars of loanable funds. Reserves required for day-to-day banking in the U.S. are, after hours, loaned out overnight in Hong Kong, or some similar foreign banking center to be repaid before opening time the next morning. From a technological point of view, global banking has become as impressive as the Houston Manned Space Flight Center with operators all over the world seated before their CRT's trading currencies, loaning, and borrowing on fractional spreads, squeezing that last decimal of reserves for all it's worth. Such systems allow any and every participant to make maximum use of the liquid assets available and, by opening up instantaneous credit, they also reduce the prudent safety margin in terms of buffer stocks or reserves an institution needs to meet operating contingencies. As a result, the whole system runs far tighter, and much faster, than it did ten years ago. On the other hand, the system as a whole tends to have lower reserves and, thus, it probably has a decreased ability to sustain a large shock affecting all the participants without recourse to some lender of last resort.

As the minimum loan period in this global banking system has shrunk from months to weeks to days to a matter of hours the response time of the system to external events has similarly accelerated. Thus, where financial panics once took weeks to work themselves out and sometimes spread from banking center to banking center over a period of months, such panics now have the potential of global scope in a matter of hours or minutes. Needless to say this greatly reduces the time available to monetary authorities in which they may plan and implement their response, if any, to a sudden or unanticipated shock. Admittedly, the magnitude of a shock necessary to destabilize a system of this size is significantly larger than what was required in the past. But then the magnitude of the LDC or the Eastern European debt outstanding is extremely high as are the liquid assets of the Arab states.

One last note on Western banking has to do with a somewhat intangible quality, call it "financial statesmanship": that cool, longer term, self-assured character trait that resists panic when severe financial loss threatens. It is this almost detached objectivity on the part of central bankers, and the largest financial institutions which has often assured investors that all valid claims would be honored and thus maintained general confidence in the total system. It is in this context that it is worth noting the following fact: at the time of the Iranian freeze, Citibank as lead managing bank of certain internationally syndicated loans to Iran "moved quickly to protect its outstanding claims. So fast did Citibank move, in fact, that it completely tore to shreds all conventional methods of lending common throughout the international banking system and, in the process, perhaps seriously threatened the petrodollar recycling process so crucial to both industrial and developing nations. . . . Citibank, followed by Chase, Bankers Trust, and Manufacturers Hanover . . . grabbed the assets fast, leaving the rest of their syndicate members—including both foreign and regional domestic banks—out in the cold." (Business Week, December 3, 1979). There was much complaining and explaining at the time but the lesson was clear: at the highest levels of international banking it's every man for himself. Financial statesmanship has been replaced now; next time around no one is likely to take the long view of play by the rules.

Panic: The Great "What If"

If a major shock (take your pick from the options) were to hit the international banking system, and should the system respond with an every man for himself panic the conventional wisdom is that the central banks and most specifically the Federal Reserve would step in and act as lender of last resort, thereby providing the liquidity which the system would need. This expected response, it must be pointed out, is a matter of faith, rather than stated policy, because any statement of intention in this area, it is generally agreed, would only encourage even greater risk taking on the part of the unregulated Eurodollar banks. But even within this article of faith, there is ambiguity over the hypothetical lines of responsiblity: a Hong Kong bank affiliated with a German or Swiss bank making loans in dollars or yen? Given the response time which will probably be required the most likely resolution will be: "I don't know, do whatever you think is best!"

Another problem area has to do with out and out insolvency. The classic rule of thumb for lenders of last resort is to lend all that is needed to those who are solvent and to merge whatever is insolvent as quickly as possible. The partner in such mergers must be someone strong enough to support whatever is left, protecting depositors at all cost. Thus, the liquidity of the central banks requires support by independent institutions with sufficient resources of their own to instill confidence that the obligations of the insolvent will be honored. It was in this way that Franklin National, for example, became European American. Given the highly leveraged and exposed positions of many of the major American banks, some of whom might not even be able to support their own overseas affiliates in the face of such a panic, the authorities could be hard pressed to find institutions with sufficient resources to play this difficult role.

The Geopolitical Scenario

This issue of **International Strategic Issues** has analyzed the increasingly fragile nature of the international banking system, and outlined several scenarios for collapse, including a cumulative LDC default. Other geopolitical possibilities exist.

The Soviet Union has been exceptionally effective in clandestine manipulation of Western commodity and financial markets. It could use such manipulation, as well as selective Eastern Bloc defualts and pressure on fragile countries (such as Mexico), to stimulate a Western bank disaster. The Soviets are only likely to use such a weapon, however, in the context of a larger geopolitical strategy, and such action probably would not be appropriate for several years. The problem at present is that the practices of Western banks, combined with their lack of understanding of the international political climate in the LDC's within which they deal, may well lead to devastating financial disaster for the West long before opponents of the West are ready to use the money weapon.

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