



Directorate of
Intelligence

DDI Seminar: Analysis of International Financial Issues, 21–23 September 1983

Selected Readings

SCHEDULE

Seminar on the Analysis of International Financial Issues 21-23 September 1983 Headquarters Auditorium

Wednesday, 21 September

08:45-10:15 - The International Financial Crisis:
Evolving US Policy

Speaker: Martin Feldstein
Chairman
Council of Economic Advisors

10:15-10:30 - Break

10:30-11:45 - US Concerns In International Finance:
The Problems and Policy Responses

Speaker: Roger Robinson
Director
International Economic Affairs
National Security Council

11:45-13:15 - Lunch

13:15-14:45 - International Financial Issues:
Congressional Perspectives and
Policy Responses

Speaker: Casimir Yost
Professional Staff Member
Senate Foreign Relations
Committee

14:45-16:00 - Trade - Monetary Linkages: North-South
Trade and LDC Financial Prospects

Speaker: Mike Liikala
Special Assistant to the
Undersecretary for International
Trade Administration
Department of Commerce

International Banking

US Senate Banking Committee, February 1983

State of Paul A. Volcher

The Banker, July 1983

US Banks: New capital rules

US Senate Committee on Foreign Relations, January 1983

Statement of William R. Cline

Latin American External Debt, 1982

The Rate of Return to External Borrowing

Euromoney, May 1983

Where the Banks Put Their Bad Debts

US Senate Banking Committee, February 1983

Risks in International Bank Lending

The Rescheduling of Country Debt:
Is a More Formalized Process Necessary?

Fortune, July 1983

The War Among Brazil's Bankers

Forbes, June 1983

South American debt -- now look at the assets

Euromoney, June 1983

The Loan Drought Hits Africa

Eurocredit

US Senate Banking committee, February 1983

Trends in Eurocurrency Credit
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Euromoney, July 1983

From Brazil? Just a Minute, sir.

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US Senate Committee on Foreign Relations, February 1983

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You're the best judge of foreign risks

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STAT

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10:30-11:45 - Eximbank and the International
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Speaker: William Draper
President and Chairman
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Export-Import Bank of
the United States

11:45-13:15 - Lunch

13:15-16:00 - The International Financial Crisis:
Update on Commercial Bank Problems
and Prospects



STAT

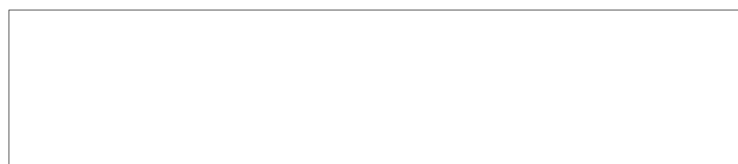
Friday, 23 September

08:45-10:15 - The International Financial System:
Lingering Problems and Prospective
Scenarios

Speaker: Maurice Ernst
NIO-Economics

10:15-10:30 - Break

10:30-11:45 - The International Financial System:
Lingering Problems and Prospective
Scenarios



STAT

Balance of Payments and Finance

THE WORLD ECONOMY/FINANCE/VIVIAN BROWNSTEIN

THE WORLD'S MISSING BILLIONS

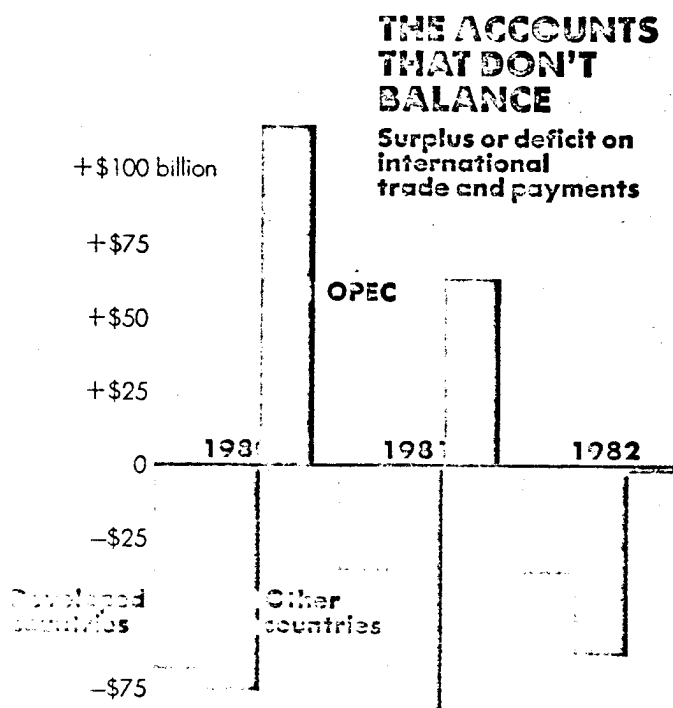
□ Find the missing \$100 billion. The rules are quite simple. At the end of every year economists around the world figure up how much each country has paid out to foreigners for goods and services, and as earnings on investments. They then compare this figure with how much the country received and calculate the country's current-account balance. One country's import being another country's export, if you add up all the surpluses and deficits around the globe, you would expect them to net out to a big zero. But here the plot thickens. They don't. When all the current accounts for 1982 were added up, the total came to a mysterious \$100-billion deficit.

The shortfall, known as the world current-account discrepancy, is no joke. Its size casts doubt on the current-account balance reported by every country. Those current accounts are the basis for many international economic forecasts and policies—who might need financial aid, whose exports or imports ought to be curbed, whose currency will be strong and whose weak. For example, the dollar is hanging high today despite a reported \$11-billion U.S. current-account deficit in 1982. The effect of a deficit that size, economists thought, would be to weaken the dollar.

AS RECENTLY AS 1980, the jigsaw puzzle of world accounts fitted together rather neatly. In a year when they sold nine billion barrels of oil for around \$31 a barrel, OPEC countries amassed a surplus of \$114 billion on current account, while the rest of the world reported deep deficits totaling \$144 billion. The result: a world current-account discrepancy of a mere \$30 billion.

By comparison, the picture for 1982 looks bizarre. The industrial nations were in better shape, with smaller deficits on average. The developing areas were still in trouble, however, and OPEC reported deficits too. As a glance at the chart at right shows, there were thus no surpluses to offset the minuses hanging below the zero line. It's no trick to figure out that something's wrong—the whole world can't be in deficit.

The world current-account numbers rarely balance out to zero, as the chart on the facing page indicates. Illegal imports don't usually find their way into the official accounts,



OPEC's once huge trade surplus vanished last year. No other group of countries reported...

one thing—no one expects a cocaine importer to stop off at his local customs office on the way from the airstrip. As long as the discrepancies were relatively small, though, few analysts got excited about them.

But \$100 billion is significant, even by the standards of global trade—well over \$1.5 trillion last year. Economists, who are used to second-guessing incomplete statistics, are in disarray on this one. They do agree that most of the 1982 discrepancy can be attributed to underrecorded or hidden receipts for services and investment income. So in searching for the missing funds, analysts start with the biggest service exporters, the industrial countries, and especially the Papa Bear of them all, the U.S.

According to the reported statistics, the U.S. bought \$294 billion in foreign merchandise and services in 1982; paid foreigners \$57 billion for rent on their U.S. real estate holdings, profits on U.S. businesses they owned, and income on other U.S. investments; and transferred \$8 billion in donations, government grants, and pensions to individuals living out of the country—a grand total of \$359 billion. Earnings from abroad came to \$348 billion, according to the best figures the government can come up with. Thus that \$11-billion U.S. deficit.

SUCH A DEFICIT calls for some tough economic policy choices. Extra dollars become available when the U.S. buys more abroad than it sells, and the value of the dollar should fall as foreigners become more reluctant to add to their dollar holdings. So a severe deficit might require the U.S. to hold interest rates high to attract foreign capital into dollars. This creates a dilemma for many economists who are advocating that Uncle Sam, in the person of Fed Chairman Paul Volcker, keep interest rates down to continue encouraging economic recovery and to ease the burdens of debtor countries. Lawrence A. Veit, Brown Brothers Harriman & Co.'s noted expert on international finance, complained recently, "Perhaps the strangest aspect of the discussions of the issues is the extent to which the debate has been knowingly based on misinformation."

Most observers think that the U.S. current-account deficit is overstated. According to Jack Bame, the Commerce Department's associate director of international economics, several billion dollars paid U.S. firms for consulting and engineering services to oil-exporting countries probably goes unreported. For one thing, budget limitations prevent government surveys from reaching most of the small and mid-size

ground economy. U.S. residents who park money offshore don't necessarily report their earnings to official data collectors.

The underground economy works both ways, however, and some payments from the U.S. are probably missing too. An estimated \$30 billion to \$35 billion of foreign capital poured into this country unreported last year. While capital flows are not included in the current accounts, income earned on the capital is. At least part of what's missing from U.S. current accounts is interest and dividends paid to foreigners on capital stashed here. At last year's interest rates, this could amount to as much as \$5 billion.

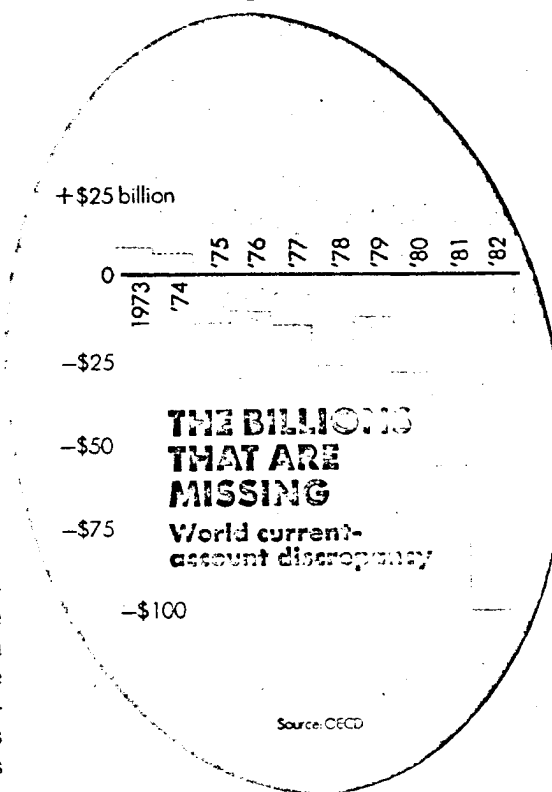
How far the U.S. accounts are off the track is hotly disputed. Morgan Guaranty's chief international economist, Rimmer de Vries, is convinced that about \$20 billion should be added to U.S. current-account receipts. Instead of a deficit last year, there would thus have been a surplus of about \$10 billion. Not likely, according to Bame at Commerce. Though he's the first to admit that the current-account numbers he has to work with have a lot of holes, he argues that there is no reason to assume that they've suddenly gotten a lot worse. All the pluses and minuses, Bame speculates, could reduce the U.S. deficit by \$5 billion to \$10 billion at most.

If the U.S. deficit is indeed overstated, that could partly explain the high-flying dollar. Currency traders are seeing a lot more demand for dollars than foreign exchange forecasters had led them to expect. Last January, Wharton Econometric Forecasting Associates, along with many others in the field, estimated that the dollar would drop by about 8% in value relative to foreign currencies between then and now. It has risen about 7%. Wharton says that foreigners' desire to keep investments in the safest of safe havens, the U.S., has overwhelmed the extra supply of dollars made available by the current-account deficit. But Wharton's analysts add that they wouldn't have forecast as much of a decline if they had suspected, as they now do, that the deficit was badly overstated. In its latest forecast, Wharton again expects that the dollar will drop, but not until next year. Whatever the U.S. deficit actually is, Wharton assumes that it's getting larger.

If the U.S.'s portion of the world's discrepancy comes to \$10 billion or even \$20 billion, there's a lot left to account for. Among other industrial countries, France is considered a likely candidate for a piece of the pie. Frenchmen, unhappy with the Socialist government, have probably contributed to the capital secretly flowing west, which makes for unreported income that should be showing up in France's current-account receipts.

ceipts should probably be ascribed to the debtor countries. Mexicans, for example, who hold an estimated \$30 billion of private assets abroad, don't bring home much of the income on that capital, so it's not recorded in Mexico's current account.

Attempts by individual countries and by international organizations such as the OECD to straighten out the statistical mess have made little headway. The U.S., for one, has been cutting back on money for collecting data on international accounts. But worries about the \$100-billion mystery are mounting. As the Bank for International Settlements says in its ponderous prose, "... to the extent that policies are influenced by countries' perceived current-account balances, overrecording of deficits or underrecording of surpluses may result in policy stances being more restrictive than they otherwise would have been." When government policies af-



... a surplus that could balance the world's account. The missing billions, once just a nuisance, now confound policymakers.

fecting a country's economy are too tight, people and businesses hurt.

■ Most businessmen understand that the figures economists give them are freighted with a bit of uncertainty. When these figures are off by \$100 billion, however, the discrepancy calls for a degree of caution greater even than that normally employed with the

INTERNATIONAL MONEY MANAGEMENT

THE IMF'S DILEMMA ON WORLD DEBT GETS WORSE

Brazilian workers struck a government-owned oil refinery outside São Paulo in July, joining thousands of others walking out of nearby Ford, General Motors, and other auto plants. The unions were protesting wage cuts ordered by President João Baptista de Figueiredo to satisfy demands by the International Monetary Fund to curb inflation in exchange for emergency loans.

In Argentina, workers threatened by similar conditions from the IMF are expected to vote the populist Peronists into power in upcoming elections. A strong group within the Peronists pledges to declare a moratorium on Argentina's \$19.6 billion debt to Western—mostly American—banks once the party takes office.

In Mexico, unemployment is soaring, crime is rising, and the exodus of illegal immigrants to the U.S. is up sharply as government measures to clamp down on the economy—again, demanded by the

will be paid back and that borrowers adopt stringent measures to shore up their economies and muddled finances.

At the same time, the disinflationary measures also help guarantee the payback of something much larger and more important—the hundreds of billions of dollars in private debt extended by American and other banks, which might otherwise have to be written off, with disastrous results for the U.S. economy and the international banking system. "Conditionality is essential because with a sovereign debtor, there is no other way of making it pay," says Federal Reserve Board Governor Henry C. Wallich. "You can't take it to court. If it continues with its policies, that will make it unable to pay."

The debt crisis is not limited to Latin America. Yugoslavia and Nigeria, among others, are in financial straits, and Poland's creditors, mostly European banks, are relending as trade credits

half the interest Poland pays on its \$25 billion debt. But nearly half the Third World's total debt of \$600 billion is concentrated in Latin America, and how far the IMF can push the region's fragile governments to tighten up on their economies is fast becoming a key international policy question.

UNABLE TO TRADE. The more heat politicians south of the Rio Grande feel, the greater the danger that one or more will walk away from their foreign debts altogether rather than face social upheaval. Yet if the IMF relaxes on setting conditions, it loses its only leverage for reform. "We are moving toward a catch-22 situation," says a high-level White House official. "If the conditions for a major debtor are unrealistic, then either the IMF eases off and loses credibility, or it insists and the debtor stops paying."

For debtor nations, the penalty for outright refusal to pay would be harsh. Borrowers who declare a moratorium,

If it eases loan terms,
it loses credibility. But
pushing too hard could
fire up social turmoil

IMF—lead to lower growth and the decline of the private sector.

The confrontation between social and financial demands reflected in these crises came to a head in mid-July when the Bank for International Settlements (BIS), headquartered in Basel, demanded that Brazil repay a \$400 million short-term credit. That heated up the pressure on Brazil to comply with IMF demands for tough economic austerity policies in return for \$4.5 billion in emergency loans. **'NO OTHER WAY.'** Everywhere in Latin America, the choice between social stability and economic restraint is becoming a heated political issue. Caught in the middle is the global lender and financial cop, the IMF, headed by Jacques de Larosière. By insisting on "conditionality," or severe restraints on domestic economies, the IMF tries to ensure that the emergency loans it extends to troubled nations



AFTER WORKERS TOOK TO THE STREETS TO PROTEST UNEMPLOYMENT AND WAGE CUTS, BRAZIL

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unless it is accepted by creditors, "would impose on themselves the worst recession they have ever seen," says a U.S. banker. Such an action would reduce the debtor country to little more than a barter economy and make its ships and aircraft vulnerable to seizure by the banks.

Nowhere is this conundrum more striking than in Brazil, which owes \$90 billion. Unless it reaches a surprise agreement with the IMF for more money or cuts a deal with the U.S. government for an emergency bridge loan by mid-July, the country may have little choice but to declare some kind of moratorium. It could be for a brief 90 days, following the example of Mexico last year, or it could be a demand for relief of all debt for five years or even longer. American banks could live with a 90-day halt in payments on principal if that led to an orderly rescheduling of debts but not with a long delay, which would force them to take massive write-downs of their assets.

The underlying fear, of course, is that if the IMF miscalculates and triggers a serious default, it could easily force the Federal Reserve to rush in and rescue the banks with massive injections of funds that might reignite inflation in the U.S. and unhinge the current economic recovery.

Like Samson, the debtor nations have grown so powerful by their accumulation of IOUs that they can bring the entire global financial temple down with



DE LAROSIÈRE: THE TOP FINANCIAL COP

them. Even if that does not occur, tightening up on all Third World debtor countries at once, as the IMF is doing, means lower economic growth, fewer imports from the U.S., and fewer jobs in American factories.

QUICK FIX. Just months ago, it appeared that Brazil had worked out a complicated rescheduling of its debt with Western bankers. Fed Chairman Paul A. Volcker began stitching together rescue packages last August when it appeared that Mexico was on the verge of defaulting on its \$80 billion debt.

The crisis resulted from the sharp 1981-82 global recession, which squeezed Latin American export markets and

from the huge runup in American interest rates, which hiked the region's already enormous debt repayments and devastated commodity prices. By getting the BIS and Washington to offer quick funds, persuading the IMF to provide medium-term money, and pressuring U.S. banks to keep lending, Volcker was able to prevent disaster.

The IMF's role in the bailout packages, as always, was that of tough guy. All the other moneylenders had premised their loans on debtor governments' following stringent economic and financial policies laid down by the fund.

For Brazil, it did not work. An agreement was reached in February on a program to prune state companies' capital expenditures by 20% in real terms, cut subsidies for gasoline and wheat, and start unlinking salaries and prices. Commercial banks agreed to chip in a further \$4.4 billion if Brasília went along with the IMF.

And the BIS, a central bank for central banks, committed \$1.2 billion in short-term loans to be doled out in four installments. But Brazilian workers took to the streets of São Paulo in April and again in July, protesting against unemployment and the deindexing of wages—a disaster to families in an economy where inflation is expected to hit 180% by year-end. After that, Brazil began to stall on implementing the IMF conditions.

In May the fund responded by stopping payment of the second portion of its loan. An IMF team looked at the country's books again and disagreed on just how big Brazil's public-sector debt really was and how fast to deindex wages and inflation. With the IMF delay, commercial bank money began drying up. The BIS agreed to roll over its bridge loan twice, but on July 11, BIS President Fritz Leutwiler announced that the bank would refuse a third time. "I still expect to receive the money by July 15," Leutwiler said. Eduardo Wiesner, head of the IMF's Brazilian mission, is in Brasília for a last-minute attempt to work out another deal.

SPLIT IN THE RANKS. Now the question is how tough the IMF can really get with Brazil. If it "goes soft" and offers money on easier terms, it will set a precedent for other debtor nations around the world. But if it does not modify its stringent terms, will it risk setting off political turmoil and possibly a declaration of default? Ulisses Guimarães of the opposition Brazilian Democratic Movement Party says that "by early August a party proposal for longer terms and lower interest rates plus a grace period will be presented in Congress."

The Reagan Administration has made a major shift on the issue of conditionality. When it first came into office, it rejected anything less than strict IMF



STARTED STALLING ON ITS IMPELLED TO IMPLEMENT STEEP ECONOMIC REFORMS

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terms for lending money, and it opposed expanding the fund's financial resources. Monetarists feared a renewed inflationary surge if great quantities of new money were created just to bolster flagging debtors.

But in August, 1982, faced with the imminent crisis in Mexico—a country critical to U.S. security—the Administration did an about-face. Secretary of

State George P. Shultz began working quietly behind the scenes to help debtor countries. "The combination of IMF management under de Larosière, with help from Tom Clausen [president of the World Bank], Paul Volcker, and Don Regan and their counterparts, plus the banks around the world, has done a terrific job," says Shultz.

Administration officials believe that

ARMS SALES TURN INTO GIFTS FOR STRUGGLING THIRD WORLD NATIONS

The world debt crisis threatens to put a serious crimp in the Pentagon's expanding role as arms supplier to the Third World. Washington has been lending billions of dollars to finance purchases of weapons by countries on which the U.S. relies heavily to wield geopolitical influence and military clout in world trouble spots. But now, "the LDCs most dependent on our loans are having a very bad time with their indebtedness," says a U.S. official involved in arms-sales policy. Adds another official: "It is increasingly likely that some countries will not be able to meet their [arms debt] payment schedules or will have to cancel or defer weapons orders."

To help prevent such a development, the U.S. has begun scaling down loans and stepping up outright grants, instead, to financially shaky arms customers. "Our policy of favoring loans over grants won't hold up much longer with respect to several countries we simply have to keep supplying," says a U.S. official.

The list of nations on the precipice makes U.S. military planners and foreign-policy makers shudder. Among 43 countries ordering \$23.5 billion worth of U.S. arms and military assistance this fiscal year, fewer than a dozen are in—or heading for—debt-repayment straits. But they include Egypt, Turkey, Pakistan, Morocco, Somalia, Sudan, Tunisia, Zaire, and even Israel—all viewed as crucial buffers against military or political encroachment by the Soviet Union or its surrogates.

COBALT SUPPLIER. Scheduled repayments of interest and principal on weapons loans to those debt-deluged nations will add up to nearly \$20 billion from the start of the current fiscal year through 1992. Israel accounts for half of that total, or \$9.8 billion, followed by Egypt at \$3.7 billion and Turkey at \$2.5 billion.

Turkey already has been forced to

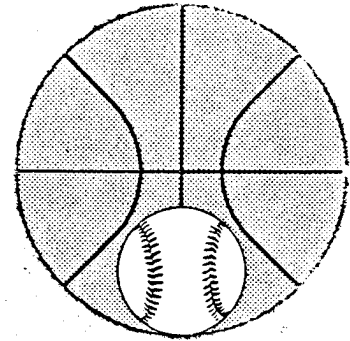
reschedule its repayments. And Zaire, in hock to the U.S. for \$170 million, has declared a moratorium on repayment. Under U.S. law, this action makes Zaire—important for its cobalt and its strategic location in Africa—ineligible for further arms credits. Instead, the U.S. has switched to outright grants to Zaire, totaling \$20 million over the past two years.

Arms gifts to other countries have also become more prevalent. Grants to Tunisia and Morocco will total a combined \$60 million this fiscal year, while Sudan will get \$75 million and Somalia \$40 million. For Turkey, proposed arms grants total \$230 million for fiscal 1984. And the Administration may have to decide whether to give Pakistan \$1.1 billion worth of F-16 fighter planes. Saudi Arabia had planned to finance the purchase, but it may back out of the deal because of the slump in oil revenues.

STOPGAP PAYMENTS. Israel and Egypt are also benefiting more and more from U.S. grants, thinly disguised as "forgiven loans." Since 1974, the U.S. has let Israel out of repaying \$5.5 billion of loans, and it now is doing Egypt the same favor. This year, Israel and Egypt are receiving \$750 million and \$400 million, respectively, from the U.S. under no-payback terms.

Congress far prefers to authorize loans instead of grants because it must appropriate funds for the latter. The loans are backed by the Defense Dept.'s Guaranty Reserve Fund, which contains about \$800 million. If a U.S. arms customer falls into arrears on a loan, Defense dips into its fund to make stopgap payments.

Now, with the world debt crisis threatening to swamp some U.S. arms customers and perhaps to spread, a senior Pentagon official warns that "our reserve fund could be depleted overnight." Gloomily, he adds: "We are getting very close to the margin."



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INTERNATIONAL MONEY MANAGEMENT

the U.S. recovery and slowly falling interest rates will rescue Third World debtors by boosting demand for their exports and lowering their interest costs. The White House now supports expanding the IMF's resources, and Congress is expected to vote on hiking the U.S. share by \$8.4 billion this summer. Yet divisions remain in the Administration. The Treasury, still under monetar-

ist influence, is more hardline than is the State Dept., which is concerned about political stability in Latin America, or the Fed, worried about the U.S. banking system. Beryl W. Sprinkel, Treasury Under Secretary for monetary affairs, insists that "it is very important that the IMF sticks to strict conditionality."

Other members of the Administration feel the White House and especially

Treasury Secretary Donald T. Regan should be doing a lot more to avert what they see as an explosive debt crisis. "You've got a Treasury Dept. that has a pretty conservative view on how to deal with all of this," says a senior Administration diplomat. Adds another: "Sooner or later, Brazil will have to declare a moratorium. The only question is whether it will be long- or short-term."

HOW THE DEBT CRISIS IS BATTERING MULTINATIONALS

For multinational corporations, the financial abstractions of world debt translate into decimated markets, blocked currencies, and a starvation diet of raw materials and essential parts for subsidiaries representing billions of dollars' worth of investments in less developed countries. "We're just pumping in cash to keep our subsidiaries alive," complains the harried treasurer of a major U.S. multinational.

By continuing to supply faltering subsidiaries in countries such as Brazil and Mexico—despite their inability to pay for

thing from demanding cash on the barrelhead from some customers to extending credit to others in order to sell products and maintain market share. A few, such as Sears Roebuck, Revlon, Gerber, and Campbell Soup in Brazil, have simply sold out. But others are scrambling for financing in local currency and struggling to find locally made substitutes for essential equipment and components that used to be imported and paid for with hard currency. Some are resorting to barter and nearly all are hustling exports to earn hard currency

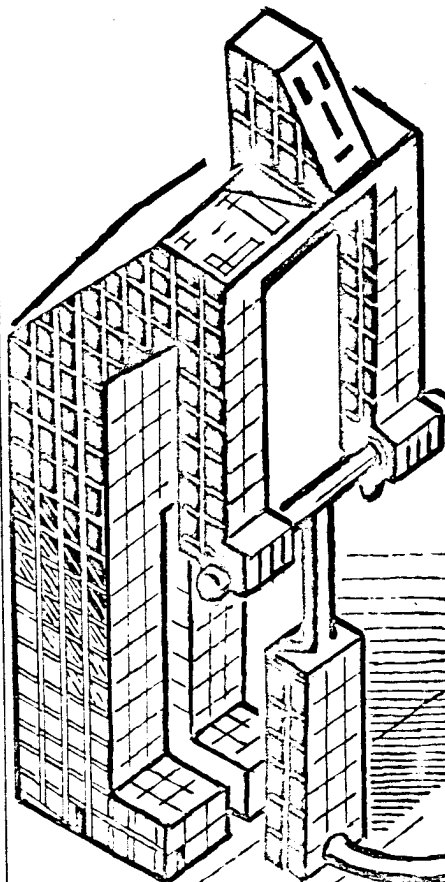
for subsidiary operations. Some are even stepping up their shareholdings in joint ventures, particularly in Mexico, by converting subsidiaries' debt to equity.

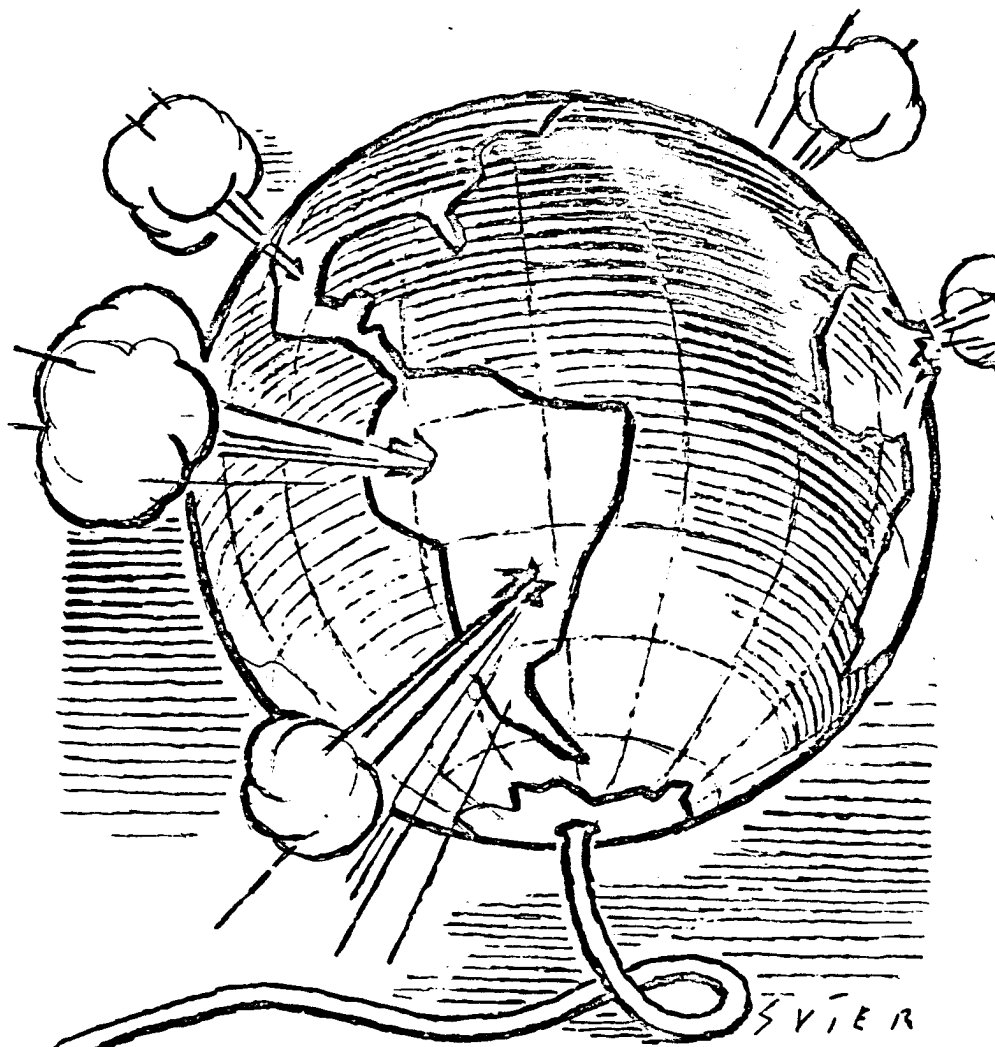
Paradoxically, most multinationals are more sanguine than the bankers about prospects for the debtor countries, particularly in Latin America, where North American and European investors have been building up productive assets for a half-century or more. "I believe in Brazil. They have a wealth of resources equal to anywhere in the world, and that's real money," says Robert P. Si-

If they don't keep pumping in cash, their Third World subsidiaries could go under

imports—and by pushing those countries' products in world markets, the multinationals are helping debtor nations stave off defaults to creditors in the U.S., Europe, and Japan. But most LDCs give top priority to repaying banks while stinting on hard currency for foreign corporate investors and suppliers. **COPING OR SELLING OUT.** Says a U.S. official: "We are the dominant supplier to [Latin America], and we are bearing the brunt of the adjustment. Here we are endorsing IMF rescue packages that in effect call for substantial cutbacks in imports to achieve trade surpluses, and that is coming out of our own hides." Brazil's stunning \$3 billion trade surplus so far this year has been achieved largely by slashing imports, while Mexico cut imports, mostly from the U.S., by one-third in the first four months from the corresponding 1982 level.

To cope with the harsh new conditions, multinationals are doing every-





mon, treasurer of Brascan Ltd. in Toronto. "In the final analysis, money is something you print. You don't print gold, iron ore, and forests. Those are real. And you don't print productive people."

Such faith is sorely needed to sustain multinationals through their current tribulations. In markets that once held out the promise of booming expansion and fat profits, multinational executives relate tales of woe. To the chagrin of Detroit's Big Three auto makers, car sales in Mexico, where all have plants, are off 33% this year, while truck sales have fallen 50%. Volkswagenwerk Chairman Carl H. Hahn concedes: "In 1983 we will be unable to break even in Mexico." Despite layoffs and other cost-cutting measures, Japan's Komatsu Ltd. reports that its operations in Mexico—where it has a 40% stake in a government-controlled joint venture—will lose money this year because of the construction market's collapse, with bulldozer sales to private contractors running two-thirds behind last year's. In Brazil, Italy's Fiat is fighting desperately to turn its joint venture around after losing \$40 million there in 1982. Together with its 45% in-

nior partner, Fiat injected an additional \$300 million in 1982 and expects to drop \$100 million more before the year is out.

The depressing news reaches across the product spectrum. "We expect Mexican consumer spending to be down 3% in real terms this year with some recovery in sight next year and private investment to be off 25%," says John A. Urquhart, executive vice-president and head of the international sector at General Electric Co. in Fairfield, Conn. As a result, refrigerator manufacturing is off 50% in Mexico—to balance inventories—and the company has temporarily shut down its clothes-washer and water-cooler production.

ARM-TWISTING. Compounding the sales slump that has engulfed Latin nations from Argentina to Mexico are severe corporate financial problems. In subsidiaries' local markets, consumer credit is in short supply, collections often require ugly arm-twisting, price controls restrict the ability of managers to keep prices abreast of rampant inflation, and capital equipment is so expensive that customers demand a long time to pay. Payments that "used to come in like clock-

work" now arrive six weeks late or more, treasurers complain.

For parent companies, the story is much the same. An executive at Frankfurt chemical giant Hoechst reports: "We're seeing more payment defaults on deliveries, particularly in Brazil and Venezuela, but we haven't gone out to any customers to get back goods we delivered." Rival BASF is less patient with what it euphemistically calls "negative export sales"—goods delivered to customers who cannot pay. "In a few cases we have gone out to customers and retrieved goods, hoping to find someone else who could take them right away," concedes a BASF executive.

Other corporations feel they cannot afford to play so tough. "Multinationals are lending money to customers to keep markets and long-standing relationships, especially if they're in up to their eyeballs in receivables," says a U.S. banker. "You have to make sure the guy you have receivables from stays afloat." This is particularly true for equipment such as agricultural machinery sold on a consignment basis, with the seller repaid out of crop sales.

TODAY'S BIG STICK. For subsidiaries in Latin America, many parent multinationals face the Hobson's choice of letting their offspring go out of business or shelling out more cash for debt service and for imports of needed materials and equipment. In Mexico, for example, an important subsidiary of Becton, Dickinson & Co. manufactures health care products. "On intercompany accounts, we are letting [the subsidiary] run up arrears. We have also gotten cooperation from some of our suppliers, who are willing to wait for payments from Mexico," says Willard D. Andrews, president of the Latin American Div. of Becton Dickinson, in Paramus, N.J. "We carry a big stick because we buy a lot of supplies around the world."

A major financial headache for multinationals is complex currency-exchange controls, coupled with massive devaluations that make it nearly impossible for companies to repatriate monetary assets. Many corporations had become lulled by the common Latin American practice of maintaining an overvalued exchange rate. While most multinationals had adjusted to Brazil's periodic cruzeiro devaluations, Mexico's three successive devaluations—dropping the peso 82% against the U.S. dollar since mid-February, 1982—caught many short. "We had always had a practice of financing [Mexican] operations with dollar debt because it was cheaper," regrets the senior financial officer for a major Midwestern manufacturing company.

Likewise, exchange restrictions compound multinationals' financing problems. Litton Industries Inc., for example,

INTERNATIONAL MONEY MANAGEMENT

suddenly discovered last summer that the Mexican government had converted about \$1 million it had on deposit in Mexican banks into pesos. The maneuver amounted to "a little private-enterprise subsidy for the economy of Mexico," says Fred M. Sullivan, Litton assistant controller in Los Angeles.

'SPECTACULAR TERMS.' Stung by such measures, nearly all multinationals now try to borrow locally. But it is costly: While Brazilian inflation is high at 130%, the going rate on cruzeiro loans is a staggering 205%. Such differentials, says a Canadian executive, "give rise to the most lovely opportunities. People will pay through the nose for cruzeiros; you get some spectacular terms."

The crisis for some multinationals has developed into a bonanza, in fact, for others whose treasuries are overflowing with local currency. Italian tiremaker Pirelli, for example, lends out its Brazilian profits locally instead of repatriating all the dividends it is entitled to. "A cruzeiro loan could kill you," says Andrea Travelli, Pirelli's worldwide financial director in Milan.

To avoid costly borrowing, Tenneco Inc. arranged for its subsidiary, Marlin Drilling Co., to lend \$10 million worth of cruzeiros from its Brazilian operations to the Brazilian subsidiary of JI Case Co., Tenneco's construction equipment manufacturer. "Luckily we had another division in a profitable situation in Brazil," says Robert T. Blakely, Tenneco's chief financial officer in Houston.

Without hard currency for imports, many multinationals are cutting production. Nissan Motor Co., for one, imports 40% of the parts for the trucks and cars it assembles in Mexico. "We cannot make as many vehicles as we want," complains a Nissan executive. Thus, many subsidiaries are scrambling for locally manufactured substitutes, even though they are often inferior in quality. "Indirect government pressure is creating substitute suppliers in Brazil, which is exactly [Brazil's] game plan," says the chief Latin expert for one U.S. company. "The question is how much substitution is a structural change in trade patterns," he adds. He wonders whether the multinationals will ever regain their lost markets—and whether the new local suppliers will grow to become global competitors.

PAYING BANKS FIRST. A few companies have managed to pry hard currency out of Latin central banks by threatening to close plants and lay off workers. But local authorities usually favor paying off foreign bank creditors first. Because of a need for massive infusions of fresh capital and debt reschedulings, debtor nations are particularly dependent on

the commercial banking community. After Mexico's near-default in August, 1982, "bankers were creating the impression that it was official U.S. and IMF policy that banks be paid first," complains a lawyer for a U.S. multinational. Adds a U.S. government official: "The companies say: 'When push came to shove and we went in to get money we needed for spare parts to keep our plant running, the government told us it was fresh out of money. Yet Chase got paid off on a loan that was due.'"

There is considerable resentment among multinational corporate executives over the speed with which the



VOLKSWAGEN EXPORTS BEETLES FROM BRAZIL TO EARN MORE HARD CURRENCY

banks took care of themselves. "There's a perception that there's a lot of weeping while counting money in the back room" at the banks, says one U.S. executive. Adds a Canadian, referring to the increasing bank practice of insisting that multinationals guarantee loans to subsidiaries: "Banks like to have it both ways: a parent-company guarantee on one side and pricing that reflects a Brazilian risk on the other."

Despite their huge stake in the outcome of the debt crisis, U.S. multinationals have been slow to organize a response. Only now, under the auspices of the New York-based Council of the Americas, have they begun to collect information about the impact of the crisis on multinational corporate finances. "Bankers by practice know each other

well and organized more quickly," says the lawyer for the multinational. "They all participate in jumbo syndications and have each other's phone numbers." He adds: "The day after [Mexico's August crisis], the chairman of Chase knew the damage." By contrast, "in many cases it took six to nine months for a multinational's chairman to get an assessment of the damage."

One way around the hard-currency shortage and exchange controls, for some multinationals, is to increase equity in their LDC subsidiaries. Last year, instead of waiting an unknown length of time for a \$20 million payment from its Mexican diesel-engine joint venture, Cummins Engine Co. increased its share to 40%, with the government's Diesel Nacional retaining 60% ownership. Despite Mexican policy of encouraging or forcing foreign investors to take on majority Mexican partners in most businesses in recent years, the administration of President Miguel de la Madrid says it is willing to be more flexible in permitting majority foreign control.

A goal of the Council of the Americas is to push Washington to persuade Latin nations that they would benefit by increased foreign equity in their industries. And in a July 8 speech in Geneva, International Monetary Fund Managing Director Jacques de Larosière noted: "Given their large needs for external resources, the developing countries would be well advised to place greater emphasis on policies to attract foreign direct investment as part of their development strategy."

'STAY LOOSE.' Multinationals are turning in the meantime to other techniques for coping with the crisis. One is to push exports from LDCs as hard as they can, knowing that the more they export, the higher they will move on government waiting lines for hard currency. Volkswagen exports Beetle cars from Brazil and operates a cattle ranch there, shipping frozen beef back to Germany. And in Mexico, the company recently took coffee in payment for local auto sales, then sold the coffee in Germany. GE, on the other hand, found LDC markets for locomotives and hydraulic turbines so depressed it switched to making boat hulls at its Campinas plant in Brazil.

Despite the problems, most multinationals insist they are in Latin America and other debt-ridden LDCs for the long haul. "It requires a very dynamic approach," says John F. Beck, General Motors Corp. vice-president for North American vehicle operations. "You can't make a decision now and sleep with it for the next two years." Beck's advice to others doing business in Latin America: "Stay loose." □

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Where should the Fund go from here?

Alena Wels
New York

Various ideas are being canvassed for reforming the international financial system but no consensus has yet emerged. Improvements, IMF managing director Jacques de Larosière argues, should be preceded by a period for 'maturation and gestation'

The severe international liquidity crisis has cast the spotlight on the International Monetary Fund and the slim, dapper and logical Frenchman, Jacques de Larosière, who is the Fund's sixth managing director. He began his second five-year term, with the unanimous support of the Fund's members, this month. For the 53 year-old Mr de Larosière — the quintessential French bureaucrat who spent four years at the head of the French treasury, had been chairman of the deputies of the Group of 10, participated in the work of the Committee of 20 and served as *chef du cabinet* of former French President Valéry Giscard d'Estaing when he was finance minister — the spotlight is by no means unwelcome.

As Mr de Larosière put it recently, 'increasingly the eyes of the international financial community have turned toward the Fund as the central element in the search for a constructive solution to the current international financing and indebtedness difficulties'. Mr de Larosière, said C. Fred Bergsten, who heads the Institute for International Economics, stepped into the breach in a very decisive and effective way. 'He and Fed chairman Paul Volcker are the heroes of the story'.

Another long-time American observer of the Fund's operations observed that the managing director 'has done quite well in building a global awareness of the Fund. He has done a great deal to strengthen the separate image of the Fund from the US and any other single country'. The perception that the Fund is a tool of the US, which has always played a leading role in the organisation, has proved a major handicap in dealing with developing countries in the past.

On the other hand, the US remains the strength of the Fund, and Mr de Larosière, as an impeccable civil servant, must see himself as the instrument of its 'most important minister'. The US administration wanted him in the spotlight. Will he remain there when the current debt crisis is resolved and how will

the role of the IMF evolve?

The French treasury official attracted the attention and won the respect of the Americans when he and the then US undersecretary of the treasury, Edwin H. Yeo III, worked out a compromise between the French and the American positions on the role of gold, the exchange rate regime and surveillance that was embodied in Article IV of the amended articles of the Fund. He retains that respect still.

While his immediate predecessor H. Johannes Witteveen, a former Dutch finance minister, had no trouble with the Americans, Pierre-Paul Schweitzer, who held the post for a decade before him, was barely tolerated. Deeply pessimistic about his ability to stop the collapse of the Bretton Woods system and stem the disorder in monetary affairs that followed, Mr Schweitzer angered the Americans by urging them to devalue. He was told unceremoniously that he could not expect a third term. His predecessor, Per Jacobsson, an adviser to the Bank for International Settlements, was a crusader for the free enterprise system.

Main input

If Mr de Larosière's public positions would appear to have swung from a more liberal approach during the Carter years to a more conservative one currently, he vehemently denies it. He says now that his first action when he came to the Fund in 1978 was to insist on the importance of adjustment. He made a very strong plea to stop the sort of trust funds, oil facilities and other unconditional recycling mechanisms that had been developed in the wake of the first oil shock. There was to be no more sales of gold to buy the international community out of its problems, no more oil facilities.

The abundance of money stemming from the surpluses of the oil producing countries between 1978 and 1981 did, however, postpone adjustment by the deficit countries. If the adjustment had been taken

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earlier, he now believes, it would have been less painful and more acceptable. Payments deficits would not have soared to \$100 billion for the non-oil developing countries in 1981 and external debt would not have mounted to \$600 billion at the end of 1982, a whopping 132% of their exports. The easy habits of financing would not have caught on.

He is said to view the main input of the Fund in the system as getting minds as well as countries to adjust. He wants to dispel the notion that a debt conversion scheme, similar to those under discussion in academic and other circles, would pave the way for a return to what he likes to call 'the old, old game'. If member countries have unanimously given him the opportunity for a second five-year term, they presumably agree with having a managing director of that persuasion. He, in any event, thinks so.

Another American close to the Fund says simply that the managing director has taken a 'sensible view of the financing problem. He has, moreover, got the support of the right people'. Mr Witteveen, this observer comments, was well suited to the kind of philosophical and analytical problems that engaged the Fund during his tenure. Mr de Larosière may be better suited to dealing with the practical problems now facing him.

Surveillance

It is particularly significant that it would have been on the US initiative that the managing director would have been invited to participate in the meetings of the inner group of industrial countries that now consult on the implications of their economic policies on the international system, an idea that emerged from the Versailles summit.

The five countries, whose currencies make up the SDR, the US, Germany, Japan, Britain and France, have a major impact on the world economy. The five are joined in their discussions by Canada and Italy, the other two partners in the summit meetings. Better compatibility and consistency of policy among the major actors is viewed both at the Fund and within the US government as an important element in the recovery of the world economy and the establishment of a better economic environment.

The concept of surveillance among a small group of industrial countries has not had time to mature and serious doubts have been expressed over the ability of the international community to influence the policies of the US, the most flamboyant player on the world stage. It has been said also that there is an absence of a mutually accepted economic framework, making it difficult to consult on economic matters much less seek some degree of economic collaboration.

Mr de Larosière's position is that it is essential that the modest but gradual recovery now anticipated in the industrial world be realised and sustained. The central objective of economic policy, he said in a recent speech at Neuchatel, Switzerland, is achievement of sustainable growth. He continues to



Jacques de Larosière: no return to the old game

say that a durable recovery depends on the continuing credibility of anti-inflation policies. He is particularly concerned that budget deficits in the US be brought down so that prospective deficits do not 'cast their shadow' in the form of high interest rates that would hinder the process of recovery.

Mr Bergsten and others worry that Mr de Larosière may be 'sticking with deflation longer than is needed and this could turn out to be very costly'. But the managing director said at Neuchatel that there is no satisfactory alternative to the general strategy of bringing down inflation and tackling structural rigidities and imbalances as the right course for a lasting recovery.

He remains apparently unmoved by the calls for coordinated economic stimulation even when they come from his mentor, Valéry Giscard d'Estaing. The former French president told a meeting of the Council on Foreign Relations that Europe should be prepared to take up the gauntlet next year when the economic stimulus in the US begins to weaken as it surely will if real interest rates are not brought down appreciably.

No short cut

Mr de Larosière asserts that it is still imperative to continue the fight against inflation despite considerable progress in that area because, if the message now were changed, policy-makers would be doing an enormous disservice to the chance for recovery and growth. The flexibility of the world economies have been so weakened by more than a decade of uncontrolled inflation that it is an illusion to think that a little bit more stimulation, a little more reform and a little more liquidity will solve the world's economic problems.

He is convinced that the chance for economic recovery will be enhanced and the problems of the

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indebted countries ameliorated if there is a more constant set of economic policies in the world. But it requires great skill to promote changes in the economic policies of major industrial countries that will conform to a model of multilateral consistency. He is apparently ready to try his hand. He believes that the IMF has been successful in setting the general tone of anti-inflation efforts. He is also convinced that IMF surveillance had discouraged members from manipulating their exchange rates in order to get competitive advantages.

However there is a general dissatisfaction with the exchange rate regime and its inability to reflect underlying economic conditions. Mr Bergsten believes the Fund has been unable to push hard enough to correct exchange rate imbalances largely because of US indifference. In his New York speech, Giscard d'Estaing was impatient with loose talk about the need to return to more stable exchange rates. He believes that the time has come for the major industrial countries to decide whether they want to return to fixed exchange rate parities. If they do agree to this objective, they must decide whether to pursue a theoretical or empirical approach.

The latter approach, which Giscard d'Estaing clearly favours, would involve 'the convergence of mutually reinforcing actions'. These would include the strengthening of the European Monetary System, the strengthening of the European Currency Unit and the establishment of target zones for the ECU, dollar

and yen with wide margins that would gradually be reduced. This would involve some coordination of monetary policies and mutually agreed intervention in the foreign exchange markets. If the answer is negative or mildly positive, Giscard d'Estaing continued, there would still be a need for better management of exchange rates. That necessitates adequate intervention in which the Federal Reserve participates.

Approach to reform

Mr de Larosière senses that there is a desire in the US administration as well to explore ways and means to stabilise the monetary system. The time may have come to overhaul the system but the managing director is said to agree that there is a need for an understanding and agreement on the basic objectives to be pursued. The founders of the IMF understood that they wanted to restore an open trading system and that they needed an international organisation to facilitate financing. The question that Mr de Larosière will be facing in his next five years is the nature of the system that is needed for the 1980s. Reforms and improvements in the system, he explains to associates, have to be preceded by a period of maturation and gestation.

An academic conference held at the IMF in March weighed the benefits and drawbacks of the floating rate system. The general conclusion was that floating rates have not worked well, having contributed to



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excessive movements in real exchange rates, inefficient adjustment and misallocation of resources. On the other hand, the participants saw little prospect of an early return to fixed exchange rates. Nor did they see an enhanced role for the SDR in the system unless the unit is made more attractive and usable in the private market. This would involve the same kind of government and institutional support that the Europeans are giving to the ECU. Nor did the academics present view the IMF as an incipient world central bank.

Warning against excessive ambition, Federal Reserve chairman Paul Volcker told more than 10,000 foreign exchange traders at a dinner in April, that 'we can constructively do something to help stabilise exchange rates within the general framework of the floating system . . . nations should be in a position to accept in the formulation and execution of monetary policy and, in the fiscal-monetary mix, a degree of discipline implicit in the desirability of greater exchange rate stability'. In this context, he concluded, intervention might have a modest subsidiary role to play.

Irving Friedman, a consultant to First Boston with extensive experience at the IMF and World Bank, insists that there is a major need for a more precise definition of where the Fund ought to be going and what basic principles should guide it. The Fund must have a clear mandate from its members on the areas members would like to see considered and decided. He believes that it is important that the members decide whether currency stabilisation, for example, should be the objective of a global body or of a smaller group of industrial countries like the Group of 5. There will be tension and ambiguity in this area until this is resolved and it will make management of the Fund very difficult, he says.

Contacts with banks

A decision must also be taken as to whether the increasing contacts between the commercial banks and the Fund, which has sprung from the debt crisis, should be institutionalised in some way. Mr de Larosière's trip to New York to address the major multinational banks at a rapidly convened meeting at the New York Federal Reserve bank last November was a milestone in this relationship. As he recalls it, he did nothing more than explain the problems facing Mexico and Argentina and that it would be impossible to solve their liquidity problems without the cooperation of the banks. He made clear that the banks were perfectly free to make their own decisions but he left the impression that the IMF adjustment programmes would fail unless the banks put up substantially more in new funds.

Current IMF projections suggest that the non-oil developing countries will have a current account deficit this year of \$70 billion, down from \$90 billion in 1982. The Fund expects the banks to increase their net contribution by 7-8% over the last year to about

\$20 billion to help finance that deficit. Some \$50 billion will come from grants, direct investments and long-term official lending. The IMF will provide a further \$12 billion.

Mr de Larosière said in Neuchâtel that the assumptions concerning commercial financing flows were 'both critical and uncertain'. He said further that the projections for bank financing will depend on a 'reassurance that sound adjustment policies are underway in the borrowing countries. . . . If confidence in Fund-supported programmes were to diminish because of a weakening of conditionality, an abrupt curtailment of bank lending would seem to be inevitable'.

Projected capital flows, he contends, would be broadly consistent with an increase in the volume of imports by these countries of 2½%. Mr de Larosière is very sensitive to charges that the conditionality of the Fund programmes may be too harsh and that it may be detrimental to the world economy as a whole to sharply curtail demand in the developing countries which are major markets for the industrial world.

Conditionality works

The IMF has reviewed the overall performance of developing countries that entered into upper tranche stand-by arrangements in the period between 1971 and 1980 and found that they achieved significant improvement in their balance of payments while broadly maintaining their real economic growth. To be sure, the past few years have seen a deterioration in the world economic environment with growth rates declining in industrial and developing countries alike. But real growth rates may actually improve, even during the first year of the Fund programme, for most of the 23 countries that have recently approved and the three that have proposed standby and extended arrangements with the Fund.

Mr de Larosière contends that the Fund's adjustment programmes are designed to be 'outward oriented'. Of the most recent 26 programmes, 19 assume an increase in imports in the first programme year as compared with the previous two years. Mr Bergsten believes it is important for the Fund to 'calibrate' conditionality to take account of the world economic situation. In reality, Mr de Larosière has countered, Fund programmes have protected the chances of recovery in the major developing countries. Actions that do not make sense for individual economies should not be taken simply for the sake of international recovery.

The managing director continues to point out at every opportunity that he cannot guarantee the effectiveness of the Fund's adjustment programmes or the quality of their implementation. Thus banks must continue to lend at their own risk. He refused to consider the provision of any sort of guarantee to the banks nor does he have any interest in the numerous schemes that are being proposed to consolidate the debt of the developing countries. Even Giscard

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d'Estaing raised the possibility that a market for bank claims be established with some official support. Some partial guarantees might be provided by a multinational organisation, he said. Mr de Larosière, on the other hand, is impatient with what he believes to be easy answers, noting that a bad debt will not disappear with the wave of a magic wand. It is noteworthy that most bankers do not like these ideas, either, because they generally involve the discounting of their developing country assets.

Mr de Larosière has said publicly that it may be desirable for the Fund to issue explicit warnings where external financing problems seem likely to emerge. But the Fund remains cautious about requests to increase the flow of confidential information to the banks. Nor is the IMF noticeably anxious to develop a closer relationship with the US regulatory authorities.

The pressure, however, is building up. Anthony Solomon, the president of the Federal Reserve Bank of New York, told an audience in Geneva that bank regulators in creditor countries should be able to consult with the IMF so as to avoid an excessive build-up of credit in the future. Some cooperative approach, he believes, would avoid the competitive inequities and convince borrowers that the authorities are serious about moderating the amount of bank lending in the future.

The American regulators made a series of proposals to accompany the legislation for an \$8.4 billion expansion in the US contribution to increased IMF quotas and the enlarged general arrangements to borrow. These urged the Fund, in its consultations with member governments on their economic policies, to intensify its examination of the trend and volume of external indebtedness of private and public borrowers in the member country. The regulators want the Fund to report to the executive board on such borrowing from the viewpoint of its contribution to the economic stability of the borrower.

Of even more significance, however, is the request that the IMF consider the extent or form that these comments might be made available to the international banking community and the public. Further, as part of any member's stabilisation programme, the

regulators want the Fund to place limits on public sector external short and long-term borrowing and publish information on the trend and volume of international lending in the aggregate as it affects the economic situation of lenders, borrowers and the smooth functioning of the international financial system.

For its part, the IMF has generally held the view that there is a limit to the amount of information that the Fund, on its own initiative, could make available that bears on the economic and financial performance of a member. The danger is that the Fund's relationships with the members would be harmed if the IMF were to publish its reports and evaluations of member countries economic policies and prospects. Some bankers contend that the Fund protests too much since any enterprising banker with good contacts can learn of the Fund's assessments.

Early warning system?

Many bankers believe that the Fund should develop its symbolic relationship with the private market, evolve objective criteria for appropriate levels of borrowing and act as an early warning system. Is this possible? Irving Friedman thinks not. The IMF's concerns, he explained, are of a macroeconomic nature, ranging from balance of payments, inflation, fiscal policy and the establishment of realistic exchange rates. Bankers are interested in all these things, but for them country risk is less of an abstraction. They have their own exposures, balance sheets and responsibilities to their shareholders to consider. Therefore, they must be well informed about the social and political environment in the country in which they hope to lend. Those are questions that the Fund cannot explicitly consider.

Can you conceive, Mr Friedman asks, of a situation in which the Fund, having become aware of the heavy short-term exposure of the Mexicans in early 1982, were to have told the banks not to lend. Mr Friedman cannot. That would have meant that the IMF was prepared to take the responsibility for the level and composition of international lending. It has neither the authority given it by its members nor the expertise to do so, he asserts. Said another observer,

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'the borrowing countries would be very troubled if the world banking community were to coalesce around the Fund and the institution were to be able to turn credit on and off like a faucet'.

While there is a growing recognition that closer cooperation between the Fund and the banks might help to keep credit flowing in the short term, people are very sceptical as to how far this cooperation should be allowed to go. The new Institute for International Finance, established in Washington by the major international banks, might provide one channel for such cooperation. But it is not very clear yet to most observers what the institute intends to do. To this observer, the institute is still an 'abstraction'.

Meanwhile, the staff of the Fund is severely strained in attempting to put together plausible adjustment programmes and to monitor the performance of the borrowing countries. They find Mr de Larosière demanding and sometimes capricious. They must often face hostility and deviousness in the borrowing country.

Their calculations might be severely disrupted by a further decline in oil prices, the failure of US interest rates to decline or the dollar to fall from present levels. But events that would harm one country would benefit another. The Eastern European countries, for example, would benefit if the dollar remains strong because the bulk of their debts are in Swiss francs and German marks.

Primary objective

Mr de Larosière's primary objective, he tells those around him, is to introduce more rationality into economic decisions. He views the world dispassionately as a hard one, where resources are scarce and often over-extended. The challenge is to sit down with debtor countries, examine their future and the resources available and decide what must be done to return them to creditworthiness.

The path is a narrow one. On the one side are the debtor countries that are increasing their sacrifices and reducing their growth paths while, on the other, are the banks which are often over-extended on a number of key countries. But it is the considered opinion of the staff and the managing director that the type of adjustment that will be required to meet the 30% debt service burden envisaged for 1983 is politically and socially acceptable and does not ask for impossible sacrifices. It is the nature of the situation that some, especially in the developing countries, would not agree.

The creditworthiness of the banks will also improve if the programmes are successful, the IMF contends. As Mr de Larosière has been explaining to the banks, it is better to have a restructured or rescheduled debt on major borrowing countries with the prospect of recovery, even if it is in the medium term, than for the banks to slip away in a disorderly fashion and let the situation deteriorate further.

Mr de Larosière has been saying in recent months

that the current crisis is manageable if three basic conditions exist. If the borrowing countries 'stick to their guns', if the bankers live up to their responsibilities, and if the mix of policies in the major countries allow for a durable recovery in the world economy. It will be extremely difficult for the heavily indebted countries to continue servicing their debts if world trade does not pick up.

The Fund's responsibility in assuring that this will happen is also three-fold. It must devise with the borrowing countries stabilisation programmes that are workable and convincing, it must develop an understanding with the banks and it must continue its surveillance of the major countries to assure that their economic policies are correct for a sustained recovery.

Fund resources

It also goes without saying that the IMF must have adequate funds to meet the unprecedented demands on its resources. It was agreed at the Interim Committee meeting in Washington in February that the Fund's quotas should be increased by 47.5% to SDR 90 billion or just short of \$100 billion. There has also been a pledge to increase the resources of the general arrangements to borrow to SDR 17 billion or \$19 billion and make these funds available to all members of the IMF. This would roughly double the IMF's available resources.

However, the legislation to approve the \$8.4 billion US contribution could get bogged down into a widescale debate on how banking regulations should be amended to assure that debtors and their banks do not become over-extended in the future. Despite Mr de Larosière's assurances that his intention is to 'bail-in' the banks, some in Congress persist in viewing the IMF bill as some sort of 'bail-out' for the banks.

The IMF will be short of funds this year, whether or not the quotas are approved quickly. It has only \$8 billion uncommitted and expects outlays in the \$9 billion to \$10 billion range. More funds will be forthcoming from the Saudis but other sources of financing may also be necessary.

The Group of 30 has argued that international confidence would be enhanced if the IMF were to be allowed to borrow from the private market. The Japanese and Germans are very sceptical about a market approach, much more so than the Americans. There are those in the US who feel that such an approach would drastically change the character of the institution and they are not yet ready to see that happen. That may mean that the Germans and the Japanese will be approached for more funds. Since such borrowing would also be at market rates, sources within the IMF see little difference between that and borrowing from the private market. In any event, the major sources of funds will have to continue to be subscriptions from the member countries. And, as usual, increases in these subscriptions will continue to be hostage to the US Congress' suspicion of foreign aid.

GLOBAL ECONOMIC OUTLOOK

TUESDAY, FEBRUARY 15, 1983

UNITED STATES SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C.

The committee met, pursuant to notice, at 10:30 a.m., in room SD-419, Dirksen Senate Office Building, Hon. Charles H. Percy (chairman of the committee) presiding.

Present: Senators Percy, Lugar, Mathias, Boschwitz, Pressler, Pell, Biden, Sarbanes, and Dodd.

The CHAIRMAN. The committee apologizes to all of you. There was a Cabinet session called by the President so that the Secretary of State could report to the leadership of the Senate and members of the Cabinet. We were delayed getting over here.

Secretary Shultz, we very warmly welcome you not only back to the United States but for your first public appearance before this committee in 1983. We are particularly pleased that you will be focusing your attention on the range of international economic issues which affect the conduct of U.S. foreign policy today.

No one in this room need be reminded that you bring to these issues a wealth of experience and expertise absolutely unique for a Secretary of State, coming at a crucial time in American history when international economic affairs are of greatest concern to all countries throughout the world. It will be our good fortune to have the benefit of your thinking in this area.

Senator Mathias conducted a series of hearings in January and early February in the International Economic Policy Subcommittee on the stresses and strains in the international financial system. Today we continue the hearings at the full committee level. The subcommittee received testimony from 15 witnesses including three former Secretaries of the Treasury, the former Chairman of the Council of Economic Advisers and the former Comptroller of the Currency.

I wish to particularly commend Senator Mathias for the great leadership and creativity that he and his staff have offered in focusing attention on the critically important economic factors which so influence our Nation's security, and certainly, the timing of it now, as the President this week sends forward his recommendations on IMF.

In these hearings we do not have to start the work, then, of determining what the nature of the problem is, what the burden is going to be. If the crushing debt incurred by these nations all come together, will it lead to a world collapse of the economic system?

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We now have 2 solid months of hearings anticipating this action and recommendation by the President and action by the IMF.

The subcommittee hearings, together with the testimony we will receive today from you, Mr. Secretary, and the testimony of Secretary of the Treasury, Don Regan, who comes before this committee next week, will form the basis for our consideration of authorizing legislation for an additional U.S. contribution to the International Monetary Fund.

We welcome your views, Secretary Shultz, on the need for additional resources for the IMF. In addition, this committee is charged with authorizing the expenditure of U.S. dollars for foreign military and economic assistance. We want to hear from you on how such assistance is in the national interest of the United States.

We have, in short, a full plate of issues before us. I can assure you that this committee will move with great dispatch in getting these issues forward so we stay on schedule. We have already scheduled a discussion with Howard Baker so we can move right along on them, and we look forward to hearing from you today.

Senator Pell?

Senator PELL. Thank you, Mr. Chairman, and welcome. Today's hearing before our committee on the state of the international economy is, I think, symbolic of the importance which international economic issues have come to play in the formulation of our policy.

It is particularly fitting that our Secretary of State, George Shultz, himself a distinguished economist, should appear here today to provide us with his assessment on the state of the world economy and his recommendation for coping with the stresses of the economic system brought on by the severe recession in the industrial West.

I am sure you are aware, Mr. Secretary, that a number of individuals have raised questions about the \$8 billion-plus contribution to the International Monetary Fund at a time when 12 million Americans are jobless, and expenditures on domestic programs have been cut to the bone.

I think it is necessary for the administration to articulate a strong and credible case as to why it is in our interest to greatly increase the resources of the IMF and provide funds for foreign assistance programs in these difficult times.

When I was on the hustings these past weeks, this question came up more often than anything else: Why should we send all this money abroad when our people at home need employment, shelter, food, and fuel? I think it would help us, the American people, if you could give specific reasons why it is to the advantage of the United States for these expenditures to be made. Why is it a good investment for the taxpayer? Why is it a good idea that the aid request from the administration will go from \$5 million to \$6.3 billion; that the contribution to IMF will go from \$16 billion to \$24 billion.

I think these are tough questions, ones that I find are very difficult to answer to my constituents when they press me in my State of Rhode Island, and I hope that today you could give us some specific reasons as to why it is to the advantage of the taxpayers of the United States to move ahead with these expenditures.

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Thank you, Mr. Chairman.

The CHAIRMAN. I wonder, Senator Mathias, having conducted these subcommittee hearings, whether you would care to make a comment.

Senator MATHIAS. Mr. Chairman, I would rather hear from the Secretary, but I would take the opportunity to thank the extraordinary roster of witnesses that we had come to this committee with very deep preparation, who brought us an enormous amount of information so that we have a record, as you say. I think it will withstand challenge on this subject.

It is impossible to summarize all those hours of testimony in one sentence, but the message they brought us very clearly is that we live in an interdependent world economy in which unemployment in the United States is very definitely tied to the lower levels of trade with the developing world. The availability of capital is tied to the whole question of the world debt and how we manage it. We are going to have to proceed with great prudence and with a great deal of determination to resolve these problems.

I think the answers to Senator Pell's questions lie in the kind of program that the President alluded to in his state of the Union message, so I am anxious to hear what Secretary Shultz has to say on the subject.

The CHAIRMAN. We will try to adjourn close to 12 o'clock. The Secretary has an appointment at 12:30, but because he dealt with agriculture and just met briefly for a few minutes as he came into the building with some agricultural leaders, if you have any opening comment you would like to make, Senator Boschwitz and Senator Dodd, we would be happy to hear from you.

Senator BOSCHWITZ. I am sorry I missed Senator Mathias' hearings. I understand they were among the better hearings that have been held in quite some time. And I share Senator Pell's concern.

I hope you will deal, Mr. Secretary, with the differences between the budget authority and the outlays that, as I understand it, are involved in contributions to the International Monetary Fund. From the way I understand it these contributions would not increase the deficit, though they would increase borrowing.

Are you going to cover that aspect of it?

Secretary SHULTZ. Yes, sir.

Senator BOSCHWITZ. Good. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. Senator Dodd, do you have any comments?

Senator DODD. Not at this time.

The CHAIRMAN. Secretary Shultz, we would be happy to hear from you.

STATEMENT OF HON. GEORGE P. SHULTZ, SECRETARY OF STATE

Secretary SHULTZ. Mr. Chairman and distinguished members of this committee, I am very pleased to have a chance to respond to your invitation to testify on the international economic system and the ramifications of it for the United States. So my testimony responsive to your invitation and the questions is focused on this subject.

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I would like to say at the outset, however, that you should not infer from that that I think this is the only subject of interest in foreign policy matters, and in particular, I would like to say that the general program of security assistance and economic assistance is of great importance to us in our foreign policy.

I am delighted to learn that you are going to push ahead rapidly on your markup in this area, and I know that Under Secretary Schneider is due to testify, I think, on Thursday. I simply want to lend my support to what he will be telling you.

Restoring prosperity and stability in the world economy is one of the fundamental goals of the President's foreign policy. Progress toward that goal reinforces our other fundamental objectives—safeguarding peace and security and expanding the benefits of democracy and freedom.

I am going to divide my remarks on the international economic system into three sections. First, a discussion of the U.S. stake in the international economy—where do we come in. Second, an examination of the antecedents of the current situation and the challenges that it presents; and finally, a description of some of the actions that the administration is taking and my thoughts about them, to re-invigorate the world economy.

This country began as a trading nation. The legend of the Yankee Trader has faded with time, but no matter how remote the image, there are still plenty of Yankee traders among us, and I think partly as a result, foreign trade is now more important than ever to the vitality of our country.

In 1981, the United States represented about 25 percent of the world gross national product. One out of five U.S. jobs depends in some way on trade, and 40 percent of our cropland is devoted to production for exports.

In the last decade, U.S. merchandise exports, as a percent of our GNP, have doubled from 4 percent to over 8 percent. Much of this increase is attributable to the growing interdependence of the world's market economies in the 1970's.

Non-OPEC—leave the oil out of it—non-OPEC developing nations, for example, accounted for roughly 20 percent of U.S. exports in 1970. The same nations now account for nearly 30 percent of U.S. exports, which happens to be more than either the European community or Japan.

On the other side of the trade ledger, the non-OPEC developing countries supply about 25 percent of the goods we import for use by our factories and consumers. Since the counterpart to interdependence is dependence, it is not surprising that the Third World supplies more than half the bauxite, tin, and cobalt used in American industry, and virtually all the natural rubber, coffee, coca, and hard fibers used by American consumers.

The North-South trade connection is important but it should not be overstated. We should remember that Japan is our second largest trading partner, and our neighbors, Canada and Mexico, are first and third, respectively. Moreover, in the aggregate, the European Community is our single largest trading partner. Indeed, in 1982, U.S. trade with the EC totaled \$46 billion as compared with \$32 billion with Canada.

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On the financial side, the United States has traditionally been a large investor abroad, and conversely, has attracted a great deal of foreign investment. In the 1950's and 1960's, returns to investment were higher abroad than at home, and the United States was a heavy net foreign investor.

The counterpart to this foreign investment was a persistent surplus in our merchandise trade. By the 1970's, the demand for new capital abroad had decreased, as had the U.S. supply of savings. Thus, the United States ceased to be a net capital exporter and usually incurred a deficit in merchandise trade.

This history is described in greater and more informative detail in the "Economic Report of the President," so I will not develop it further here. There is a very interesting chapter in the "Economic Report on the United States and World Economy" that I think is very well worth reading. There are a number of points in there that they develop well.

The United States is also a significant factor in international financial institutions, as you all referred to. Our support of the World Bank and the International Development Association helps mobilize capital for vital projects in the developing world. In addition, we are a major factor in the International Monetary Fund. The IMF is an instrument of collective action and although we are not a borrower, we still benefit when it supplements global liquidity and provides members with temporary balance-of-payments financing.

In sum, whether looked at from the trade side or the financial side, the U.S. stake in the international economic system is significant—significant in terms of jobs, income, and opportunities. Specifically, we can infer from this brief overview that the United States has a clear stake in the promotion of trade, in the vitality of the international financial system, and in economic stability in developed and developing countries alike.

Beyond pure economics, however, we also have a stake that is more political in character. The demonstration of the strength and viability of market-oriented economies and the democratic form of government with which they are associated. We should seize this moment to prove the potential of the open market mentality that inspired the Yankee traders.

In so doing, however, our own system will be put on trial. Therefore, if we urge other countries to adopt market-oriented policies, we should be sure to adhere to those policies ourselves.

The world is now coming through a period of painful decompression from the severe inflationary surge of the 1970's. That period has left us with serious problems: High unemployment in the industrial countries, large public sector deficits that constrain recovery, and the heavy debt burden of some developing nations that now strains the international financial system. These problems had their origin in the decade of the seventies. An analysis of that period reveals that they may have a common solution—economic expansion in the 1980's.

The level of developing countries' total debt, which now stands at nearly \$700 billion, increased more than sevenfold from 1972 to 1982. In the same 10-year period, debt to private lenders jumped from 40 to 60 percent of outstanding LDC debt. The conclusion

Secretary SHULTZ
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to stimulating that growth lies in the interdependence forged in the 1970's of the world's economies.

Today, for example, the economic linkage between the industrialized West and the developing world is tighter than ever. Indeed, it has been estimated that if OECD GNP were to grow by 4 percent in 1983 rather than the projected 1.8 percent, the nonoil developing countries would earn an additional \$15 billion on exports to the West, a figure equal to 14 percent of their estimated 1983 debt service payments.

The industrialized countries in my opinion are now poised to lead an expansion of the world economy. In particular, the United States is on the road to recovery. It appears to me personally—this is just a personal opinion—that the growth projections in the President's fiscal year 1984 budget will be exceeded. Interest rates are down, inflation is down, inventories are depleted. Basically, a very expansionary set of policies are in place. In short, the United States and other industrialized nations that have reduced inflation are positioned to play a vital role in world economic expansion.

The recent drop in oil prices may also stimulate expansion. Of course, an oil price decline is not unambiguously good, for any sudden unanticipated change in the world economy causes disruptions. An oil price decline may, for example, harm individual countries, especially net oil exporting LDCs such as Mexico and Venezuela.

But assume for the sake of illustration, as distinct from prediction—I underline that—but I want an illustration, and I take a big enough case so we can really kind of get an idea of the orders of magnitude involved here: a decline, say, to \$20 a barrel which is a 40-percent drop. It has been estimated that such a price decline would, in the aggregate, have the following catalytic impact over a 2-year period:

Real growth rates in industrial countries would increase 1 to 1½ percent, and developing country rates 2 to 2½ percent. Inflation in the United States and elsewhere would decline 1½ to 2½ percent; the 1983 oil-import bill for industrial countries would drop by \$90 billion, and that for LDCs by \$9 billion. The OECD current account balance would swing from a deficit of \$18 billion to a surplus of \$17 billion. Simultaneously, LDC exports would rise 3 percent, cutting their current account deficit by \$18 billion. A less significant oil-price decline would have similar positive effects, roughly proportional to the reduction from current prices.

Now, I say this not as a prediction but just to point up that with all of the handwringing you sometimes hear of about the possibility of oil-price declines, there is a very positive side if that should happen. And this just gives some notion of the orders of magnitude involved in the direction and the effect.

Senator BOSCHWITZ. Are you going to make a prediction later on in your testimony?

Secretary SHULTZ. No, sir; I have one, but I am not talking.

The salutary effects of the world economic expansion will not come about automatically. The United States, together with other nations, must work to insure that the opportunities for growth are seized. In turn, this means that we must concentrate our efforts on four objectives. First, insuring sufficient liquidity in the interna-

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tional financial system; second, preserving open markets; third, improving the international monetary system; and, fourth, insuring political stability in the developing world.

In working toward each of these objectives, which I shall address in turn, cooperation will be essential. Cooperation between the public and private sectors, between the developed and developing worlds, between business and Government, and between the executive branch and the Congress.

The basic elements for successfully dealing with the liquidity problems of the high debt developing countries are known and in place. The so-called debt bomb can be defused through emergency, short-term bridge financing, leading to adjustment programs implemented in conjunction with the IMF and with the cooperation of commercial banks.

Private banks, however, are now reducing their rate of new lending to the developing world. Net new bank lending was flat between the first half of 1981 and the first half of 1982. Estimates for the second half of 1982 show a precipitous drop in new lending, which we have to say it is not surprising that that should happen under the circumstances.

Such an abrupt contraction in new lending obviously would imperil the recovery of the debtor countries. Moreover, reduced lending in the face of increased debt-service costs would also retard our own recovery by contracting LDC imports from the West. Indeed, as Rimmer de Vries recently testified, a Morgan Guaranty Trust Co. study estimates that if capital flows into the LDCs were cut by \$25 billion, OECD growth would drop at least a half a percentage point. With OECD growth in 1983 expected to be only 1.8 percent, half of a percentage point represents a significant cut in growth.

The Morgan Guaranty study is hypothetical. But import cuts are already a reality. A dramatic case in point is Mexico whose 1982 imports from the United States dropped 36 percent from the 1981 level. Consequently, in the course of a single year, the U.S. balance on merchandise trade with Mexico swung from a \$3.7 billion surplus to a \$4.5 billion deficit.

The international economy is too vulnerable to this kind of contradiction to permit a continued decline in lending to the Third World. Private banks have a collective interest in extending sufficient new money to permit the developing countries to service their debts. Western governments, including our own, have a similar stake in seeing that the LDCs have sufficient capital to pay for imports of goods and services that will enhance LDC productivity and contribute to world economic expansion.

The United States, I believe, stands ready to do its part in this effort. Where appropriate, we will provide funds, as was the case with Mexico, through bridge financing, CCC credits, Eximbank loans or swap facilities.

This administration will also be seeking congressional support for the expansion of IMF resources, coming directly to Senator Pell's question. In just-concluded negotiations last Friday, member countries agreed upon a quota increase of 47.5 percent. The U.S. share of this increase will be approximately \$5.8 billion. I might note that the quota increase is not a U.S. budget item—this, I think, is going to be responsive to your point, Senator Boschwitz—

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More importantly, our quota represents an investment in international financial well-being. The purpose of the IMF is not to pay off old debts, but to encourage sound policies. Indeed, indications are that a borrowing country's creditworthiness tends to improve with the successful implementation of an IMF program, and private lending then generally increases rather than declines. A quota increase is thus an inherent component of any program to encourage world economic growth.

Another component of such a program is the expansion of the general agreements to borrow. A GAB was initially established by 10 industrialized nations as a backup line of credit to be drawn upon solely by the 10 contributing countries.

However, late last month in Paris, the United States, together with the other nations of the group of 10, agreed to almost triple the GAB from \$7 billion to \$19 billion. Our share of this expansion is \$2.6 billion. I think, incidentally, the number that is being quoted is the sum of the \$5.8 and the \$2.6 billion. That is where that \$8.4 billion figure comes from.

Unlike the traditional GAB, access to this expanded fund will not be limited to the G-10 alone, but will be accessible to any country whose liquidity problems threaten the financial system as a whole.

Our share of the IMF quota increase and the GAB expansion totals \$8.4 billion. This is the amount we will be asking Congress to approve before the end of 1983. And Secretary Regan, of course, is the pointman in presenting that to you, but I want to say here that I fully support what he is doing, and I think the combination of Don Regan's efforts and Paul Volcker's efforts with other finance ministers, and central bankers, and Jacques de La Roussiere, an outstanding international civil servant, has been very important here and effective.

Let me turn to the trading system. Even if the sustained bank lending and increased IMF resources prevent a sharp contraction in LDC liquidity, the success of our financial efforts will ultimately depend on adjustments in the trade accounts of developed and developing countries alike. Import cuts can provide only so much; export growth must lead the way in the recovery of the LDC's. Therefore, we must resist protectionist pressures and seek to preserve the system of open trade we helped to build.

The recession and high rates of unemployment in the West understandably have increased protectionist pressures. The 98th Congress will probably confront local content legislation, agricultural and other subsidies and a host of protectionist proposals directed at hard-hit sectors such as steel and autos.

These protectionist moves threaten to impede our own recovery and economic expansion generally. Quotas, tariffs, and other trade barriers raise costs to us and deny borrowing countries the hard-currency earnings needed to service their debts and buy our exports. Conversely, open trade speeds resources to their most productive uses and creates more jobs than it destroys.

That does not mean, however, that we should acquiesce in other nations' trade-distorting practices, especially those imposed on sec-

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tors such as agriculture and services, in which we enjoy a comparative advantage.

This is what we were discussing just before coming here, Mr. Chairman.

Subsidized agricultural exports from the EC, for example, have enabled European farmers to expand their share of third country markets at the expense of U.S. farmers. In response, we recently sold subsidized wheat flour to Egypt.

Temporary, trade-distorting measures such as the wheat flour transaction can be justified on the ground that "when all the world is mad, 'tis folly to be sane." But we should remember these are insane things to be doing.

Temporary measures tend to become permanent; and retaliation has an inherent tendency to escalate. Constructive negotiations—in which we meet unreason with reason—present the only lasting solution to protectionist problems such as export subsidies.

We have a situation emerging where, for example, through this competitive subsidy program various countries in the world will be producing butter, and as the butter gets sold in the world market and winds up in the Soviet Union, through this insane system of subsidies butter will be produced and sold to the Soviet housewife at about one-quarter the price the American housewife pays for it.

Can anyone explain why that makes sense? I do not see it.

We will, therefore, work within the GATT to remove barriers to the export of U.S. services and agricultural products. In addition, we will work on a bilateral basis, as I did on my trip to Japan, to roll back trade barriers. Difficult but important negotiations with the EC on agricultural trade subsidies are now in process. Finally, we will seek concrete ways of implementing the open trade pledges made by the major industrialized countries at the Versailles Summit and the GATT Ministerial.

Turning to the monetary system, trade is encouraged by stability in exchange markets—something we have not had in recent years. The instability of relative currency values over the last decade is basically a reflection of turbulent economic conditions. But several developments have created recent problems for the trading position of U.S. producers.

Financial flows, for example, are having a powerful effect on exchange rate movements. This presents difficulties from the standpoint of trade. During 1982 financial flows into the United States led to the greatest appreciation of the dollar since the beginning of floating rates in 1973. The strong dollar increased the price of U.S. exports and decreased the cost competitiveness of U.S. industry. Consequently, the U.S. trade deficit in 1983 is expected to widen.

Moreover, if large outyear budget deficits are not reduced, they will consume U.S. national savings, which already accumulate at the lowest annual rate in the industrial world. A shortage of savings would drive up both real interest rates and the dollar, thereby further widening our trade deficit.

In other words, what is happening to us here is we suddenly find ourselves in a kind of Switzerland position where big financial flows are having an effect on the value of the dollar. The market is behaving just right. I mean it is reflecting what is happening. However, when you look at trade, that strong dollar is making our

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goods much less competitive in third markets, thereby presenting a real trade problem to us.

An additional problem we face in the international monetary system is the great volatility in exchange rates. For example, between May and November of 1982, the yen depreciated from about 230 yen to the dollar to 276, raising the price of U.S. exports in Japan and third country markets, and reducing the price of Japanese imports in the United States. By the end of the year, however, the yen had swung back to its previous level of 230.

This point was made very vividly to me by Lee Morgan, the head of Caterpillar Tractor. And the effect of the big swing was basically to knock Caterpillar out of a whole set of third-country markets. It is not because something was wrong with management or they did not know how to sell in third markets or whatever. It was the tremendous impact on them of the swing in exchange rates.

The solution to such excessive exchange rate volatility is not clear. What is clear, however, is that the problem warrants close study by the major currency countries.

Finally, even if we succeed in increasing LDC liquidity, preserving relatively open trade and decreasing volatility in the exchange markets, adjustment for many developing countries still will be difficult—in some cases, testing what the social fabric will bear. Developing countries have had to accommodate the recession in the West and their own financial problems by cutting imports and curbing economic growth. Aggregate real LDC growth this year will be about 1 to 1.5 percent—the lowest since 1950. African countries have been especially hard hit because of their dependence on exports of primary commodities. Increasingly desperate, they are tempted by repressive strategies and radical panaceas.

LDC austerity can, if excessive, risk political instability that endangers U.S. strategic interests. In this hemisphere, economic difficulties threaten to increase illegal immigration into the United States. Economic troubles were a factor in the recent expulsion of hundreds of thousands of Ghanians from Nigeria. And economic difficulties in the Sudan could, for example, threaten the U.S. interest in Middle East stability.

In short, our own strategic interests dictate the following rule: While LDC adjustment is necessary, such adjustment must take place within the limits of the politically possible, and with sufficient financial support to maintain stability and spark renewed growth.

This analysis has, by necessity, been quite general. Yet I think its implications are straightforward. The problems currently burdening the international economy—recession, high unemployment, LDC debt—all have a common solution: economic expansion. If growth in the world economy resumes and real interest rates fall, the debt burden of even the most heavily indebted countries will become manageable.

The key to recovery from the debt problems, however, lies in increased exports from developing countries. That increase is in turn dependent on an expansion of our own economy and those of other industrialized countries. Economic expansion anywhere can help everywhere—but not necessarily.

For if we expand, while simultaneously erecting protectionist barriers, neither the LDC's nor the industrialized countries will benefit from that mutually reinforcing boost to recovery provided by open trade. In shutting out goods from the rest of the world, we will incur not only the usual costs of protection—higher prices to consumers and jobs lost in the export sector—but retard our own recovery and threaten the world economic system as well.

Our challenge, therefore, is to revitalize the international financial system; preserve and extend the benefits of open trade; improve the monetary system; and insure political stability in the developing world. This administration is working hard to achieve these four objectives, all of which contribute to world economic expansion. Our own economy will play a leading role in that expansion. As a result, we have an opportunity to demonstrate the continued viability of our market-oriented economy, and the democratic institutions it supports.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Secretary Shultz.

Because of the number of Senators here this morning and the time constraints we are working on, without objection we will go on a 7-minute rule.

Mr. Secretary, just before we came in here we met with farm leaders, and they put the question to you of the problem of the United States being a stable supplier and supported strongly actions taken by the administration in contract sanctity.

There was a position taken on those pipeline sanctions, which we appreciate, a position of leadership that you and the President took. Could you say something about long-term contracts with the People's Republic of China, and longer than a 1-year extension that has been already committed with the Soviet Union? Are we working toward a longer term agreement so we can destroy this image that we are not a reliable supplier?

Secretary SHULTZ. First I think it is very important for any trader to be viewed as reliable, so that when we say we will do something or I as a private businessman or farmer or whatever say I will do something and I sign up to that, that the person I am signing with can count on it. That is an essential ingredient in trade, so we have to cultivate that idea, and sometimes, unfortunately, things happen that make it necessary to break a contract. But I think that we should view that as something that happens as a last resort and under the most extreme circumstances. Otherwise, we lost our position in the trading world.

As far as agricultural sales in China and the Soviet Union are concerned, of course, those represent both large potential markets for our farmers. Both from the standpoint of our farmers' role in our own markets and from the standpoint of the attitude of people to whom we are selling, reliability is an important ingredient.

Other things reasonably equal, long-term agreements are desirable because they tend to give information about what is happening to the marketplace and provide a level of assurance to both suppliers and consumers about what can happen. So as a general proposition I think they are desirable.

In order to move forward on them I think we need an atmosphere that is congenial to the expectations implied by long-term

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agreements; so it is an important part of our diplomacy to try to upgrade that atmosphere. Obviously it takes two to do that, and it is a great big broad problem, and I hope we can make headway with it. But it is a difficult situation to predict.

The CHAIRMAN. Will consideration be given to not only increasing the limits at the bottom—6 million tons now—but also increasing the maximums?

Secretary SHULTZ. All of these things would be part of any negotiation, and just where one would come out would remain to be seen. Right now there seems to be an atmosphere of surpluses in the agricultural field. It isn't always that way, as we can all remember, and nature tends to have a way of imposing some variability. And so you have to be ready for both types of situations.

The CHAIRMAN. In your statement you touch briefly on a problem that the strong dollar creates for the competitiveness of U.S. exports. We hear not only from farmers but manufacturers on this. From your view or our view the overvalued dollar is a critical impediment to increased exports.

From your own perspective as an ex-budget director should we first be doing more to reduce the future budget deficits; what else could be done? Second, do you think with respect to the yen that the yens value as against the dollar is entirely set by the free market, or there are things that Japan could do to bring the yen in closer parity to the dollar?

Secretary SHULTZ. Two different questions there, one having to do with the monetary system and the other the budget. Let me take the first and then the second.

I did not say that the dollar was overvalued or that the yen was undervalued. The market has made an evaluation. What is happening is that we have tended historically to think of the dollar or currencies as reflecting sort of trade flows and relative inflation rates, and then the values sort out to bring about some stability there.

A few countries have had a rather different problem, Switzerland being the outstanding one, because it has in a sense as much the characteristics of a bank as it does of a country. Financial flows have been very big there for a couple of reasons. Particularly in the last couple of years there have been very big financial flows into the United States, and they have tended to become very important in setting the value of the dollar.

The market has correctly reflected these flows, so in that sense you cannot say it is overvalued or undervalued or anything. The market has been reflecting these facts: That money has come to the interest rates here and, I believe, seeking a safe haven. The fact that money keeps coming even though interest rates are going down is a measure of that fact. But it poses problems for our merchandise trade, and that is something that we have to scratch our heads pretty hard about.

There is no evidence that the Japanese have been maneuvering the value of the yen; and that has been looked at very hard by the Treasury, and they see no evidence for that whatever. It is more along the lines of what I suggested.

I would point out also in the President's Economic Report there is a very interesting chart that shows the cross rates with the dollar of the yen, of the Deutsche mark, of some other currencies,

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but the yen and Deutsche mark are the two principal ones there. The track is rather parallel, so you have a broad influence here.

On the budget side, I think the outyear deficits are the thing to focus on. Personally, I think that the deficits in the current fiscal year and 1984, while it would be desirable to compress them somewhat, are nevertheless ones we can live with. It is the outyear deficits that are frightening to financial markets.

Just what they will turn out to be, of course, remains to be seen, and I do not have total confidence in our ability to project exactly what our economy will look like 5 years from now; but people have done the best they can, and we see that there is a substantial deficit. The President's contingent tax proposal I think is a good one and a way of addressing that, and of course, the spending side needs to be worked on continuously and hard.

The CHAIRMAN. Thank you, Mr. Secretary, and congratulations to you on a much-needed and I think an outstanding trip to the Far East.

Senator Pell.

Senator PELL. Thank you, Mr. Chairman.

In connection with the exclusive economic zone, under which you know, we would have the exclusive right to all living and mineral resources within a 200-mile area on a line from our shores, what are the plans of the administration? Do you plan to move ahead with a unilateral declaration on that, or would you be willing to wait until we have had a hearing on the matter?

Secretary SHULTZ. You catch me unprepared, Senator Pell. I have thought about the Law of the Sea Treaty a lot, and that is a point that I have not registered on. I know that we feel that the 200-mile limit that is established in the Law of the Sea Treaty is something that we would claim for ourselves and do claim for ourselves. Certainly a hearing is fine, but I am not sure what the juxtaposition of a formal declaration in a hearing is. I would have to get back to you on that.

Senator PELL. Let me submit that in writing, if I may, sir.

Secretary SHULTZ. Certainly.

Senator PELL. I thought your statement was excellent. I found that even though I am no economist myself, I understood it and its thrust. But I speak to you as a representative of an administration which is terrific in communication, headed up by a great communicator, and in this regard I want you to imagine yourself not having a group of friendly Senators here but having as I had a couple of weeks ago, 500 very angry individuals without enough fuel, cold, not enough food, some of them depending on soup kitchens, some of them looking for lodging.

Many people are very upset at the foreign aid program and its corollary, the IMF. When you add these figures up, they really are tremendous. How would you in very simple terms explain to people who have no college degrees, half of them no high school degrees, what the advantages to the American poor and unemployed and cold and hungry Americans are of the aid program?

Secretary SHULTZ. There is a lot of variety in the programs being spoken of. There is the support for the IMF and the General Arrangements to Borrow. There we essentially have asset trades in

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the interest of maintaining the health of the system and keeping it from breaking down.

Senator PELL. To these people the system has broken down.

Secretary SHULTZ. Well, it has broken down but not irreparably. The question is to keep things together so that as our economy expands, that can take place with as much flourish as possible; and people will be able to get their jobs back or get other jobs, so the process of job creation can proceed.

I think the evidence for the importance of the international trading system and financial system to that is overwhelming. The expansion of trade has been accompanying one of the greatest booms in history, not only for ourselves but for our trading partners. So everyone has benefited from that. Their standards of living have risen. That is the line along which I would try to make the explanation.

It is also true that if our trading partners suffer too badly—and the developing country examples I gave, such as Mexico, are dramatic, we see what that has done to us in many ways. So we have a stake in keeping other people healthy, just as we have a stake if we are a member of a community in keeping the whole community healthy, not just ourselves alone.

Senator PELL. When it comes to explaining to our people the question of jobs or the lack of jobs here and the difference in competitive ability that we face—automobiles, for example, where the Japanese are producing cars with fewer work people, where the salaries, when you check into it, the benefits of permanent lifetime employment and the side benefits are not that much different in wages from the scale that we have here—it is very hard to explain to them that we are losing our competitive edge. And I think it takes more than a theoretical explanation.

What I am really groping for here are for some specific arguments that can be used as to why the aid program and free trading, fair trading, is a good idea; because the protectionist sentiment, as you know, is building up very hot and heavy.

Secretary SHULTZ. I think you have to point, if you are a farmer, in the fact that 40 percent of our cropland is devoted to exports. Those exports have to go somewhere, and the people who till those lands are depended on that trade. Similarly, there are many industries that export heavily. There are other industries being affected by imports, to be sure, and some balance there is important and some sense of pace as imports increase is important.

In the textile case, for example, there has been a determination that imports should not increase faster than the rate at which the market itself grows, at least for now. And the result of that has been a negotiation to try to bring that into some kind of balance.

At the same time you mentioned the case of automobiles. There we have an industry where wages rose much faster during the 1970's than in manufacturing generally, which accounts for part of the problem. I think the auto union and industry has confronted this very courageously in the last couple of years. But at the same time I think we have to take note of the fact that the cars being produced off the U.S. assembly lines now are definitely superior to the ones of 3 or 4 years ago, in my opinion. They are more suited to the times, they are smaller, they are lighter. I think the quality

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has been improved greatly, so the U.S. consumer is getting something better.

One of the reasons is that our manufacturers saw that if they are going to stay around, they have to compete, and they have to make a product better; so we are getting benefits from that kind of competition. We have to keep remembering that. And thinking about the consumer, too.

Senator PELL. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Lugar.

Senator LUGAR. Thank you, Mr. Chairman.

Mr. Secretary, in the debate that is shaping up on the IMF, suggestions were made that restrictions ought to be placed on U.S. banks with regard to amount of foreign lending or other guidelines by our own banking system. It has also been suggested that there ought to be some rediscount window or facility created in which U.S. banks might discount some of the paper that they have abroad, get out of the international lending business, take a loss and write down uncollectible loans so that we are not jeopardized continuously by this overhang of \$500 or \$600 billion.

What comments do you have on either the guideline issue—that is, whether we ought to be having guidelines on our banks—and whether the banks should either simply mark down these loans or we should create a facility to handle some rediscount of its paper?

Secretary SHULTZ. Well, on the guidelines, probably that is a good idea if the enactment is not too specific. When you start new regulations, you generally wind up sorry 5 years later, because there are all sorts of unanticipated results, if you give too little opportunity for those who are going to administer them to adjust them to the circumstances.

Basically, however, I would have to say this is a subject on which I would defer to the Treasury. They have thought about it a lot more than I have had the opportunity to do.

As far as creating some sort of governmental discount window through which our private banks can unload their debt, I am very dubious about that. I think that it is desirable for our banks to be in the international lending business. It is a good business for them, and they should take their part in financing the international economy.

I think it is a problem that there is a retreat going on now. We need liquidity in the current situation. The answer to these debt problems, as I tried to develop in my testimony, is to get the system healthy and expanding; and while I do not want to be advocating price increases, certainly there are many primary commodities right now that are very depressed in their prices. So if we saw some comeback in those prices and we saw world expansion coming along, I think a lot of these debts would look different and could be handled. I would rather see them worked out that way.

Senator LUGAR. Mr. Secretary, in your testimony you stressed this thought: that as opposed to a debt repayment problem we ought to be thinking in terms of income earnings for many countries that are growing. But is this not primarily a political problem in the sense that even if IMF or other loans are made is not the

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problem of growth within those countries essentially the nature of their economic systems? In other words, what kind of encouragement could we give to private enterprise in those countries whose centralized economies have rather poorly used their assets and come up with horrendous debts. Poland is a good example of this: No amount of IMF lending or private lending would apparently turn this around at this point.

Could you address yourself to the political dimensions of what we might be able to do?

Secretary SHULTZ. One of the advantages of the IMF, I think, is that the IMF is able to develop conditions for loans with the Government better than we ourselves or any other single government can do—and certainly far better than private lenders can do. So the idea of so-called conditionality with IMF loans I think is an important idea to preserve and enhance.

Now, then, you have to come to the question of what are the conditions and how much sense do they make. Broadly speaking, I think the IMF has tried to develop conditions that will help the economy involved regain its momentum and its capacity to deal with its debt. However, the IMF just cannot dictate things to people, and different countries have their own ideas about what they want to do with their tax system. Many have prices of basic commodities that are controlled at a very low level—energy and food being two big examples—and it is difficult to let up on those prices.

So I do not think that a standard of perfection by our lights is something that we can see imposed everywhere; but I think we should like to see things moving in the right direction. And on the whole, I think the IMF is trying to do that.

Senator LUGAR. Let me just add a comment to that. Senator Pell certainly has had an experience similar to those of each one of us at home during the recess. I would say on behalf of my constituents in Indiana that we appreciate that 2 out of every 5 acres being planted in our State will be exported, and we hope that someone will have the money to pay for it.

Secretary SHULTZ. Well, that is what we are talking about here.

Senator LUGAR. One out of every eight manufacturing jobs presently is for export—goods and services, machinery, mechanisms, parts and so forth. Without export we are dead in the water.

On the employment side—and I think this is the point we were attempting to make—I would say simply that it is clear in my State that we will have to have export financing facilities available or we will have higher unemployment.

Secretary SHULTZ. I think export financing facilities is one point, and providing some funds to the IMF is another point; but basically what we are trying to do, it seems to me, or should be trying to do is different. We should be trying to help provide an expanding and healthy world economy so it is that fundamental expansion that is providing the market into which we are selling, as distinct from the particular stimulative devices that are talked about.

Senator LUGAR. Thank you very much.

The CHAIRMAN. Thank you very much.

Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

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Mr. Secretary, I am a little concerned about a possible implication of your statement. You are not asserting, I hope, that no loans were made to countries now in difficulty at a time when careful and prudent analysis of their situation would have argued against making the loans.

I understand your point about the assumptions under which people were proceeding in the mid-1970's with respect to export growth and low-interest rates, which you outline in your statement, but are you suggesting that all of a sudden one morning we woke up to discover, to our great surprise, that we had a difficult problem which no one could have seen coming if he had taken a more careful look?

Secretary SHULTZ. No, sir. I think I say that many bad judgments were made.

Senator SARBANES. If that is the case, should not the request for an increase in the IMF quotas involve some process to assure that we will not again find ourselves in the situation we now face, otherwise, won't we be back for another increase in IMF quotas sometime in the future because in having gone down this path without some way to raise early warning flags?

Secretary SHULTZ. Well, of course, the market has provided a kind of censure to people, and there have been a lot of bad loans that people have had to record. Quota increases are now associated dramatically with this problem, but of course historically as the world economy expands and the need for world liquidity expands, you would expect there to be a larger IMF facility. So it isn't all simply related to this particular problem.

I do think the assumptions that turned out to be wrong were very widely held. It is true that some people were saying watch out, this is not going to go on this way and so on. And probably most of us could find some statement that we made somewhere that said that. So with hindsight and second-guessing, you can look much wiser than a lot of loan officers look right now.

That does not mean they should be taken off the hook. That is their job to make those judgments, and when they make bad ones, they have to pay for it.

Senator SARBANES. They invariably will be taken off the hook, will they not? The consequences that would normally flow from such judgments will not be allowed to happen when the debtor is a country and when the size of the debt is so large that if we followed the normal course, we would give a major shock to the international financial system.

Is that not simply a given?

Secretary SHULTZ. I think what we are saying is something like this: We have a choice. We can say that all you countries around the world, including our own, and banks, including our own, made some mistakes, so that you are going to have to live with those mistakes, and we are not going to do anything about it. Let the world system go down the drain. We would rather have it go down the drain and then pay for their mistakes than to try to help work the situation around so that we do not go down the drain.

Senator SARBANES. That is right. You are not advocating the first approach, I assume.

Secretary SHULTZ. I am advocating the exact opposite.

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Senator SARBANES. No one does advocate the first approach, be-
cause its consequences are too heavy to bear.

Secretary SHULTZ. Right.

Senator SARBANES. In the course of trying to work this out,
should we not set up procedures to help assure that we will not go
down that path again?

For instance, what would be wrong with requiring that all pri-
vate loans to governments be submitted to the IMF for review and
comment—let us leave aside approval—so that we know what is
happening and have some sense of how much in private lending is
accumulating?

Secretary SHULTZ. Well, we have through bank regulation, in
this country anyway an ability to know what the banking system is
doing. We do not have a lack of that kind of information.

Senator SARBANES. Other countries do not require that, and they
make these loans. And in a great many instances, a good part of
the private debt is owed not to American bank's but to foreign
banks. But the international banking system is interrelated, as the
whole financial system is, as you point out.

Secretary SHULTZ. It is interrelated, and at the same time I, per-
sonally, would not be ready to put into the hands of a kind of world
central bank a regulatory authority over the flow of loans. I do not
think the evidence is strong at all, granted that some bad judg-
ments have been made, that on the whole, government judgments
are better than the sum total of private judgments. I think it is the
other way around.

Senator SARBANES. When you use the word "regulatory authori-
ty," how do you define that?

Secretary SHULTZ. I suppose you are saying that you would—and
I am just taking your suggestion, which I thought it to be—any
time a private loan is made outside the country of the lending in-
stitution, that loan should be registered or somehow run through
the IMF for comment. Presumably you mean that that should be
true for U.S. private loans and also for those originating in other
countries.

Now, that sets the IMF up as a central functioning, virtually a
regulatory agency. It is not at all clear that other countries would
accept that. I do not know what our country's attitude toward that
would be. But I think it is something that I would personally be
rather reluctant about.

Senator SARBANES. What assurance can we give the people we
represent, as we are now confronted with the question of expand-
ing the IMF quotas, that some safeguards have been put into place
to assure that this situation will not reoccur, that we will not be
back again seeking another increase in the IMF quotas because
once again a number of loans were made that everyone now agrees
should not have been made?

Secretary SHULTZ. We can hope there is some learning from ex-
perience. We can see that some people were caused to lose some
money. I think myself that the private banks have been drawing
back as a matter of fact from international lending faster than is
desirable and that if it goes on too far and too fast will be damag-
ing to the general interests of the private banks.

But at any rate, it suggests that there has been caution imposed. Senator Lugar has raised the question of some guidelines insofar as our own banks are concerned. And no doubt, that will be considered and should be. But I do not see that anyone can give an assurance that governments will never engage in the excesses that bring about and encourage the sorts of problems that we have had.

If you come right down to it, where did this originate? Government is responsible for the inflation. The Government of the United States put on wage and price controls. I was there kicking and screaming, but I was there. It was a catastrophe.

We kept the price of oil down. It was only when President Reagan came in that finally the controls were taken off. And we see how healthy that result is. So governments made mistakes all through this process that have helped create an environment where lots of other people made mistakes, too. I do not know that we can lay down a guarantee that Government will never make a mistake again.

Senator SARBANES. Mr. Chairman, my time is up. I just want to make an observation. I think the administration ought to be giving some constructive thought to coupling their request for an increase in the IMF quotas with some procedures to provide assurances that we will not go down this path again.

In saying that, I am not using the debater's device juxtaposing extremes, either that we should assure that governments will never make a mistake in the future as they have in the past, or that the alternative is to suggest that the system should just be allowed to collapse, et cetera, et cetera.

But it does seem to me that there is a range where we can work toward some constructive proposals to link this request for an increase in the IMF quotas to some process—whether it is a review process, and how it involves other countries, are questions to be worked out—that will provide assurances in the future that if we start down the same path, there will be some early-warning flags raised. Otherwise, we are just leaving it open for a repeat of the current performance.

The CHAIRMAN. Thank you.

Senator Mathias.

Senator MATHIAS. Mr. Chairman, I would like to pursue the theme that has been raised by Senator Sarbanes and Senator Lugar of the private sector banks' involvement in this process, because I think that it is very close to the heart of the whole remedy.

Senator Sarbanes says that the banks will escape the consequences of their poor judgment. During the course of the hearings that issue was dealt with at some length, and one of the witnesses said, we are not bailing out the banks, we are bailing them in. And this, of course, is the fact.

The President's request and the IMF increase of quotas by 47.5 percent is not going to do this job. If that is it, in my judgment, we have a failure on our hands. Another necessary ingredient is that the commercial banks stay in and live with the consequences of their prior judgments. And more than that, that the banks increase their lending on an annual rate of something like 7 percent until we get through this very shaky period. And it is going to require

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we would like to pursue the Sarbanes and Senator in this process, but of the whole remedy. Will escape the consequences of the hearings and one of the witnesses bailing them in. And

base of quotas by 47.5 percent, in my judgment, we have an ingredient is that the consequences of that the banks increase by like 7 percent until it is going to require

this joint action of the private sector and the public sector to get us through a rocky time in the world's financial condition.

Secretary SHULTZ. I agree with that entirely, Senator. I think you are absolutely right.

Senator MATHIAS. The question, of course, Mr. Secretary, is this. The commercial banks in the United States consider themselves in some cases overextended on foreign loans. Maybe in the judgment of objective observers, they are overextended. But they have to stay in. Are we asking too much of the banks, not too little but too much? Many of the regional banks I think would like to get out.

Secretary SHULTZ. I think it is very much in the interest of the private banking system as a whole to stay in and to provide new money, as you suggested. When there is difficulty, of course, an individual bank may want to get out, and particularly regional banks, which many feel they really do not understand what is going on very well and have become part of the syndicate.

Senator MATHIAS. And that is a big group. There are 1,500 regional banks.

Secretary SHULTZ. And they do not have the capacity to get out and work around the world. They have to rely on the larger banks that take the lead in the syndicate. So when there is trouble, they like to retreat. But it is very hard to manage this, because if one is let out, then everybody wants out and all of a sudden you have a kind of a run on the bank, in effect.

So I think that it is important to hold these groups together, and it is not asking too much. It is asking the private banking system to measure up to its responsibilities and its interests. And so far, particularly the big banks have been doing a pretty good job of holding people together.

Senator MATHIAS. I concur with that. And the regional banks seem to be willing to stay and seem to be willing to go forward for the time being. I agree with you that it is in their self-interest as well as their general interest to do. But you take a rather optimistic view of where we are going economically, and I hope you are right.

Secretary SHULTZ. I do not want to be a pollyanna about it. There are plenty of problems, and I have tried to identify them. But I do not think that we can just sit and wring our hands about the problems. We have to say, well, there they are, now what can we do about them?

Senator MATHIAS. You have to go forward.

Secretary SHULTZ. There are things to do about it, and no doubt, in the whole picture the most important thing to do about it is to have the conditions created in the United States whereby our own economy will expand. That is the key. We are 25 percent of the world economy.

Senator MATHIAS. The question was asked, will you have to come back again for another quota increase? And I would think that if the projections of growth are accurate, if they are realized, that we may get through on this quota increase for the foreseeable future. But you would not suggest, would you, that if the world economy does continue to stagnate, that there may not have to be another review of IMF capacities?

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Secretary SHULTZ. I would not say that, nor would I say that if things work out well, there would never be another review of IMF capacity, because that capacity has to reflect the general scope and size of the world economy. So if 10 years from now or 5 years from now things have worked out well, we will have a much bigger enterprise, in effect, to try to manage.

Senator MATHIAS. I think clearly the consensus agrees with you that we have to have growth, No. 1. That is the essential ingredient. And if we have it, we have a fair chance of avoiding further immediate difficulties.

One thing that you mention in your statement about which there is not yet a consensus is the question of exchange rate stability. Clearly, the poor relationship between the dollar and the yen, as you have described it very vividly, is the root of many of our trade problems with Japan. It has swung wildly in the recent past. When our inflation rate should have been pushing it one way, it went the other way.

Should we have some kind of international arrangement that at least controls the far end of the swing, perhaps not the day-to-day fluctuation, but the wild swinging of currency rates, something like the European "snake," which I do not pretend to fully understand but which seemed to work.

Secretary SHULTZ. Some very exotic terminology. Back in the early 1970's we had the tunnel and then we had the snake in the tunnel and a lot of jargon like that. It was great.

Senator MATHIAS. But do we need something of that kind?

Secretary SHULTZ. Well, this is a question that is raised a lot, and I would not lay down an answer. I think that it is important.

Senator MATHIAS. You have a lot of company in not being willing to lay down an answer.

Secretary SHULTZ. I think it is important that the system be flexible. The par value system of the 1960's basically broke down because there was no way for the dollar to get itself adjusted to what was happening. Other currencies all could play off against the dollar, but the dollar was frozen. The floating system now opens that up. The extremes of volatility I think have reflected the fact that we have had a tremendous amount of turbulence connected in considerable part to the big swings in oil prices. And if the situation becomes less turbulent, there will be more stability.

So in that sense, the exchange market is more a thermometer registering the heat than it is a producer of the heat itself. Whether or not now there should be some effort to give the system some additional constraints is a question that I am sure is being considered. And I would not want to leave it at that. I would think the way to approach it is to think in terms of just a few currencies rather than the whole world currency system.

The currencies that are in the SDR basket are the main currencies. And if the relationship among them or even among, say, the dollar, the yen, the Deutsche mark, the French franc and the pound were a little more stable, then everything else kind of relates itself to that, and it may be that something can be done to bring that about.

There has been a study of the effects of intervention that is about completed. And I do not know what the results of that are.

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Secretary Regan will be testifying, and he will be in a position to tell you about those results. I would be surprised if the study shows that intervention can really affect basic values. It does not figure that it is able to do that.

The CHAIRMAN. Thank you, Senator Mathias.
Senator Biden.

Senator BIDEN. Thank you very much.

Mr. Secretary, what we need is a mongoose in that tunnel. The fact that has been mentioned time and again in the discussion that has gone on here about imprudent bankers making decisions raises the questions whether the Government makes decisions that are equally as imprudent or maybe even more imprudent and who is the cause. One of the problems that folks like us on the committee have in doing what I think has to be done—and that is, acceding to the request you are making—is a purely political one. Not in the Democratic-Republican sense, but in terms of explaining it to our constituencies and explaining it to some of our colleagues on the floor of the U.S. Senate.

And what concerns people—I think I know the answer to this, but I would like to hear you say it—what concerns people is that when Government makes a mistake, they know they are sort of a stockholder and they lose. But everybody loses in the country: The taxpayer, the stockholder in a sense.

But when a private enterprise makes a mistake, particularly banks who are not really well liked anyway—in my State, at least, and I do not come from a State that is unaccustomed to dealing with banks and corporate entities—they feel like they are being “had” and that only a relatively few people, relatively wealthy people are “being bailed out.”

My first question is: Is it practical from an economic standpoint for any of the banks to get out?

Secretary SHULTZ. Well, if it is just one bank, it is practical. But if one person gets out, everybody else wants to get out, and if everybody gets out, then you bring about just the situation you are seeking to avoid.

Senator BIDEN. The reason I ask that is I do not think it is a very fruitful discussion for us in the Senate to be discussing, whether or not the banks want to, are doing us a service by staying in or are being done a service by staying in.

The fact of the matter is, we are all in this mess together, and the banks just purely from their own economic standpoint know that one could get out but that might cause a run so they know there is not much they could do if the Government does not do anything, on the one hand. On the other hand, we sit here and we know that we have to do something, at least I think the majority of us do, that we have to do something to prevent what is a potential disaster.

Now, my question is: Is there anything, would there be any way—I think I know the answer to this, but I just want to ask it—is there any way that the U.S. Congress could so construct conditions upon this additional money that would result in helping avoid the catastrophe we are worried about; that is, doing its job, bringing about some stability without any profit accruing to the banks? Could you say, to be bizarre about it, we will come up with the ad-

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ditional money that we think we need but there will only be principal paid back by these countries to the banks; the banks have to swallow their interest; they are not going to make any money?

I know that sounds ridiculous, but those are the kinds of questions I get asked by my constituents. As I said, I think I know the answer, but I would like to hear you respond to that question. If you were at a town meeting in Dagberg, Del., what is the answer to that question? If it goes beyond 60 seconds, they do not listen.

Secretary SHULTZ. I think it is unwise to approach it as a punitive matter. The way to approach it is to try to make the system healthy, and then everybody can prosper.

Senator BIDEN. Well, I will be the devil's advocate. Let's say I do not want those banks to prosper. I do not care if they are going to prosper. They are going to take my tax dollars. Is there any way we can prevent it from being a disaster but make them pay the price for having made the bad judgment they made?

Secretary SHULTZ. Well, I think that when people approach our financial system with minds made up that says no one should prosper in our financial system, you have a fundamental problem there.

Senator BIDEN. No one should prosper for their mistakes.

Secretary SHULTZ. Well, they are not prospering from their mistakes. They are suffering from their mistakes. The question is how drastically and how catastrophic do you want to make it?

Senator BIDEN. That is good enough answer. I will try that one next time. [Laughter.]

Secretary SHULTZ. I think with a little thought, I could do better.

Senator BIDEN. I am going to ask you to maybe write a speech for me to justify what I am about to do.

Let me say on a more serious note, all of your proposals relating to the amount of money we are talking about here are premised upon certain assumptions with regard to economic growth not only in this country but around the world, that we are going to be coming out of this recession, which is not only U.S. recession but a worldwide recession.

Have you calculated how those numbers change if, in fact, we do not have an economic growth for fiscal year 1984 that the President is predicting in terms of U.S. economy, which is, as you pointed out, 25 percent of the whole ball game, and the world economy generally, or just take the big three, four, or five nations?

Secretary SHULTZ. I have not tried to run through the econometric models of what happens to this, that, or the other. But obviously, if our economy fails to grow and the other industrial economies fail to grow, that is very bad news, and that tends to make borrowings and debts look worse. And you can say that that shows that the judgment was bad to make the loan in the first place, but I do not know that that is necessarily the case.

Senator BIDEN. I would not argue that, just for the record.

Secretary SHULTZ. It is just like saying if things go bad and somebody has to foreclose on the debt for a farm, say, that the judgment was bad to have made the loan in the first place. That is not necessarily the case.

Senator BIDEN. The reason I asked the question is along the same lines I thought Senator Mathias was pursuing, and that is

that I would think our colleagues and making this infusion be back at it again say, this is what is

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The CHAIRMAN.

Senator Boschwin

Senator Boschwin

We find, Mr. Secretary, myself, who are nations, have a great system, though I banks from both

However, as Secretary understand that international trade. But the an explanation, what type of situation is created so heavily the farmers.

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Secretary Shultz from closing up for do to get them out

only be principal banks have to any money? the kinds of questions I think I know the answer to that question. If it is the answer to the question, I do not listen. I treat it as a punishment to make the system

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though the econometrician. But obviously industrial economies are going to make borrowings that shows that the place, but I do

the record. It goes bad and somewhat the judgment that is not necessary

ion is along the line, and that is

that I would think we should be realistic with the folks and with our colleagues and with the country and be saying, look; we are not making this infusion conditioned on the notion that we will never be back at it again. I think we should be more honest about it and say, this is what is needed now, we may need more.

And my time is up. One last question, like everybody always does in this committee when their time is up. We are not going to do it this time, apparently. OK, I will not ask it. [Laughter.]

I just do not think you should be increasing aid to Turkey by a quarter of a billion dollars this time. But I will get back to that.

The CHAIRMAN. Thank you very much.

Senator BOSCHWITZ.

Senator BOSCHWITZ. That was an afterthought, Senator Biden.

We find, Mr. Secretary, that Senator Biden, Senator Pell, and myself, who are more imminently facing our constituents in elections, have a greater interest in not intellectualizing the banking system, though I must say I have learned something about the banks from both my colleagues from Maryland.

However, as Senator Lugar pointed out, our farmers certainly understand that large portion of what they produce goes into foreign trade. But they do not have an explanation, or we do not have an explanation, when our country gets involved in the bilateral type of situation with Brazil, as we recently did, when they subsidized so heavily their agricultural exports in competition with our farmers.

I am careful in the legislation that I introduce. I am not particularly wild-eyed, but I am one of the Senators who has introduced some of the legislation you warn us about in your statement, that the 98th Congress you said will probably confront legislation in the agricultural and other subsidies, a host of protectionist proposals.

I have indeed introduced such legislation because I do not feel that some of our trading partners in the agricultural field or in other fields, particularly Japan, are going to lower some of their subsidies or some of their tariff barriers unless we confront them rather blatantly and straightforwardly with the understanding that we will act similarly.

They have not fired the first shot of a trade war; they fired several salvos already. And we find ourselves being excluded from world markets. So I was very approving with respect to the sale of flour to Egypt. In that one sale we sold more wheat flour than we had sold in the entire preceding year of the entire year before that to the entire world.

But my question is, Mr. Secretary: Our negotiations with some of these countries have not been very productive, and they just keep on doing the same old things and referring the cases to the GATT. It has taken almost a decade so far in trying to get the resolution to some of these cases. Would you respond to the necessity of such legislation that several of us have introduced for the purpose of ridding the world trading place of some of the subsidies that are imposed upon it by our so-called allies or some of the barriers that they impose against our trade?

Secretary SHULTZ. I think it is very important to keep things from closing up further and at the same time do everything we can do to get them opened up more. We do have to shake people and

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say, wake up, world, if this continues and we really get into a competitive protectionist subsidy game, it is bad for everybody.

And if the United States really gets into it, we can have a devastating impact because we have a very deep pocket, when you get right down to it. And if we start a big agricultural subsidy war and that becomes the common way in which agricultural products are marketed in the world, no doubt, we will be able to do our share. But the nut of it all will not be good; we will in effect, be, giving product away.

So I would say that the wheat flour sale that I referred to in my testimony and that you mentioned was on the one hand designed, of course, to sell some of our product but also to say to people that we are serious about this problem and we think that the negotiations to resolve these problems better be taken very seriously by everybody or this whole thing can slip out of control.

Senator BOSCHWITZ. Well, perhaps that is the answer then to legislation—that our Government exerts its seriousness in that manner. Perhaps this also includes that butter sale you spoke of since we sell the butter at about the world market price. Since it has sold at about half of the price that was taken to remove it by the CCC, I am sure that the butter would not be sold at one-quarter of what the American consumer would pay for it in Russia—unless they do subsidize it.

But the last time we sold a Communist nation some butter, they objected because it is salted, and that is not particularly desirable.

Secretary SHULTZ. Not only did they want to cut price but they want to have it to their specifications.

Senator BOSCHWITZ. Well, there is not much you can do with salted butter in the world market unless you melt it down.

I see you also mentioned services. I am aware that that is becoming a very significant element in our exports. And also I am aware that there were never really any considerations given to service exports, and as a result, rules or barriers have not previously arisen. But those barriers are now arising. Service exports I think have a very promising future for this country, and I would hope our Government would take a very firm viewpoint with respect to the erection of barriers in that regard as well as with respect to agriculture.

Secretary SHULTZ. We have been taking the lead in trying to get attention to that in the GATT, and there now is at least, a study under way of that general area. Of course, services is a word that covers a gigantic array of things that are very unlike each other, and in the end as this process proceeds I am sure there will have to be a breakdown of that word and much finer categories introduced.

Senator BOSCHWITZ. Mr. Secretary, I know that you are very short on time, and it is 12:15 and there are still a couple of Senators who yet are to question you.

I agree with your statement about the positive effects of a decline in oil prices to \$20 a barrel—you give that as a for-instance, I think that if open market principles were to play a part, oil certainly would be at that price or lower. And I believe that it will reach those prices, and I do not have much sympathy with the oil-exporting countries or those banks which have made loans to those countries. I hope you are right. I hope your example is correct.

I hope also the make the loans while it makes feel sorry for the sorry for the guy self on the court.

Secretary SHULTZ. way.

Senator BOSCHWITZ. oil prices will do recovery.

The CHAIRMAN. Senator Dodd.

Senator DODD.

Mr. Secretary,

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I hope also the increase in economic activity that will result will make the loans of many of the banks now in jeopardy much better while it makes others much worse. I feel sorry for the banks that feel sorry for the oil-exporting countries. It is kind of like feeling sorry for the guy who kills his mother and father and throws himself on the court for mercy as an orphan.

Secretary SHULTZ. I had not really thought of the analogy that way.

Senator BOSCHWITZ. Well, I have. And I think that the decline in oil prices will do a great deal in treating our general economic recovery.

The CHAIRMAN. Thank you, Senator Boschwitz.

Senator Dodd.

Senator DODD. Thank you very much, Mr. Chairman.

Mr. Secretary, let me quickly state that I found your statement to be extremely worthwhile, and I agree with an awful lot that you have said here. Senator Glenn and I took about 10 or 12 days in January and traveled to Central and South America. We spent most of our time in Mexico and Brazil, principally on the question of international indebtedness. As you know, there is approximately \$190 billion between those two countries alone, of the some \$700 billion in worldwide debt obligations.

Briefly, let me tell you, and I am sure Senator Glenn would agree, that our assessment was that both Mexico and Brazil are going to make it. Brazil is probably in a little better position than Mexico.

Mexico has some serious problems, and the question of reduced international oil prices, while it is very encouraging to the overwhelming majority of nations in terms of their ability to meet their obligations, given the existence of a 2,000-mile border with Mexico and its dependency on oil sales for a good part of its economic recovery program, this price reduction could have catastrophic implications in terms of immigration and the stress and strain it would place on our frontier.

But let me bring up one other point here. We have concentrated pretty much this morning on the question of the IMF and the economic recovery program. I would like to turn to the foreign assistance request that the administration has made for fiscal year 1984 along with its supplemental for 1983.

My concern is this. I could not agree more with your statements about economic stability in the world and how important that is, not just in terms of economic recovery but also because the political implications associated with economic stability are so profound. It is something I think you would agree with wholeheartedly.

And yet, as I look at the request that has come before us, totaling some \$13.5 billion, an increase of almost \$2 billion over the previous year, the bulk of the program as \$9.2 billion of the the \$13.5 billion is in security and military assistance.

Now, I am not one who suggests that we ought to eliminate military assistance programs. And I understand that a good part of it goes to Israel and to Egypt. But when you see a 20.8-percent increase in military aid and only a 3.3-percent increase in development assistance for fiscal year 1984 it seems to me that our actions

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in terms of providing funds for economic recovery are clearly unsatisfactory.

I would also point out to you that historically the coalition in this body and in Congress generally that have supported foreign assistance has been formed of those who generally agree with the development assistance programs and have had some concerns about military assistance. Increasing dramatically as we are the amount of military assistance jeopardizes that coalition in Congress at a time when we may need it most.

I wonder if you might address that general observation and the concern that I have both with respect to the increase in military assistance worldwide; and also the concern that I have that the coalition in Congress may evaporate if, in fact, this trend continues. You have heard Senator Pell, Senator Boschwitz, Senator Biden, and others as well talking about constituent concerns regarding foreign aid generally. And when we see the increase in military assistance, I think that concern becomes even more alarming.

Secretary SHULTZ. Our request is for \$14.5 billion all together, and represents an increase of 4.6 percent in current dollars from our request last year. In other words, in real dollars, it is about a wash. Now, the way it was broken down between security assistance and economic assistance is not precisely the way it looks in those categories. As we tabulated in the security assistance program of \$9.2 billion, \$6.2 billion is strictly military aid, and the balance, \$3 billion, is essentially economic growth-oriented money.

Senator DODD. Economic support funds, balance-of-payments funds.

Secretary SHULTZ. In the economic assistance program, you have a total of \$5.3 billion, so if you add economic support funds and the economic assistance together and compare it with the military, you have a little over half in economic support and less than half, 43 percent of the total, is military aid.

Senator DODD. Isn't it a fact historically that the economic support funds and funds that they are given in grant assistance, are generally used by nations to buy military equipment, which is hardly what many of these countries need to be doing. If they hope to achieve some economic stability, they ought to be investing those dollars in economic development programs at home.

Secretary SHULTZ. I think in the countries involved, being able to get themselves some stability is an essential ingredient for economic development, and if they are being attacked and ravaged by a guerrilla movement that is being supplied by arms from the outside, and they do not have the capacity to contest that, and thereby to try to create stability within their own country, they are not going to get anywhere in economic development.

You cannot expect there to be development in the context of a kind of military harassment.

Senator DODD. I am not suggesting to you that I am opposed to all military assistance. It is merely when we were talking about limited funds, growing domestic concern, the protectionist, isolationist mentality that is very strident in the country, when the major thrust of your remarks of this morning, ones which I agree with, emphasize economic stability and the danger of some economic collapse, then it seems to me at this very hour our limited dol-

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lars ought to be focused in the economic development area. If my figures are correct, they show a 20.8-percent increase in military aid, a 2.3-percent increase in Public Law 480, and 3.3-percent increase in development assistance. That is how it breaks down.

Now, it seems to me if these percentages are correct, our actions in terms of where those scare dollars are going seems to be contrary to the declared policy.

Secretary SHULTZ. Well, the figures represent our judgment and the President's judgment about the kind of help that is most needed for the stability and economic growth of the countries involved, and obviously there is a balance. As we have discussed, I do not have the numbers classified the same way you do, but when Mr. Schneider is here Thursday, he will have it classified every which way and can respond a little more directly to your questions.

But as a general proposition, we have sought to have the right balance between military and economic matters in the overall package, and I agree with you that having a healthy economy is the way to get stability in these countries. At the same time, I am sure you agree with me that it is hard to imagine that kind of economic growth if you not have some stability in the military conditions of the country.

Senator DODD. I was not speaking specifically of El Salvador as the thrust of my question.

Secretary SHULTZ. But you probably had it in mind.

Senator DODD. I have another question on that one, but I see my time is up. Mr. Chairman, I gather my time is up.

The CHAIRMAN. Thank you, Senator Dodd, very much.

Senator PRESSLER?

Senator PRESSLER. Thank you very much.

Many of the areas have been covered, but I would just reiterate what has been said so well here today regarding the two worlds of foreign policy. I just returned a few hours ago from my State of South Dakota, where I had 25 listening meetings or open door meetings, and almost every one was volunteered. Someone said, spend less on foreign aid. The big bankers are getting bailed out. The foreign policy establishment is working against us. I am sure you are well aware of that.

But the point is, we have to somehow have a marriage between the world of the Foreign Relations Committee and the Council on Foreign Relations and the conference in the State Department. We are coming to a head on this budgetary matter, and you have already answered that or responded to it, but is there any way that you can expand on your public statements to explain to the small business, the farmer, the wage earner that there is a great deal of feeling from some of the TV reports. I am sure you are well aware of it. In the 25 which were held over the last 10 days, it was voluntarily raised in every meeting that that is the feeling.

But in any event, I pass that on to you, and you have already commented. If you want to comment further, fine. If not, I will go on to some of the other questions that I have.

Secretary SHULTZ. I think it is a very good point. The President feels that these requests are appropriate and needed, but it is also up to us and to all of us here to convince people in our country

that these programs are good for them. That is the ultimate test. What is good for the United States?

We are saying that we are in a boat with a lot of other people, and we will prosper or go down together, and these are things that we think will be helpful in that regard. I agree with you, we have to get out and sell this program, and I am going to try and do it.

Senator PRESSLER. In your recent trip to Japan—Japan is very reliant on the Persian Gulf oil. I have been concerned about burden sharing both in aid and defense. Does the concept of the Japanese helping to defend the Persian Gulf ever come up in any discussions you had with them?

Secretary SHULTZ. There has been a lot of discussion between ourselves and the Japanese about their own effort in defense, and the new prime minister, Mr. Nakasone, has taken a somewhat more forthcoming leadership stance on that subject. We have to remember that Japan by its constitution, which we had a lot to do with, has certain restrictions placed upon itself militarily.

Nevertheless, I think within that framework there are more things that they can do, and I see evidence myself that they are trying to do those things.

Senator PRESSLER. As I understand it, and this is not a question on the banks, but it is related to aid, the administration's request would reduce the forgiven military assistance program for Israel by \$200 million from last year, from \$750 million to \$550 million. What are the reasons for this reduction?

Secretary SHULTZ. Well, again, we have tried to put forward a balanced program which looks at the needs of Israel and the needs of other countries around the world, and within a framework of what we think is doable, to divide that up accordingly. The overall share of these total funds that goes to Israel is very substantial. I do not have the proportion right in my head at this point, but at any rate, the numbers are, in the judgment of the President, the appropriate numbers.

Senator PRESSLER. The fiscal 1984 military aid request for El Salvador is more than three times the amount contained in the fiscal year 1983 continuing resolution, from \$25 to \$85 million, yet the economic assistance request has been reduced by \$20 million from last year. Does this indicate that the administration is inclined toward a military solution to the problems of El Salvador?

Secretary SHULTZ. The solutions in El Salvador have to emerge from a country that has political stability and is able to attain economic growth. The military situation in El Salvador is such that our judgment is that they need the military boost that those number represent.

Senator PRESSLER. In that region, should we be prepared to take special measures to assist Mexico should oil prices drop further?

Secretary SHULTZ. Well, we have talked about the Mexican situation. I think we have to keep watching it. It is obvious that if oil prices drop further, the countries that are the big exporters will be the ones that will be affected adversely. I believe, as I said in my testimony, that the world economy generally will be affected very positively. We have to look at the Mexican situation, thinking of not only their interests, but our interests, and certainly I think we

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should look at it very sympathetically in trying to be helpful to Mexico.

Senator PRESSLER. Another country that is suffering somewhat from the decline in oil prices is the Saudis, and I am told that they are not fulfilling their previous financial pledges to Lebanon. How much they expected to contribute to the Lebanese construction efforts, and is this likely to be affected by the falling oil revenues?

Secretary SHULTZ. Well, obviously, they have had the greatest flow of oil revenues. On the other hand, they have very large total of assets that have piled up, so they are not broke by a long shot. They have the ability to provide additional funds. The question of how much for Lebanon comes forward from the Arab world, Saudi Arabia in particular, no doubt will depend on how successful we are in our efforts to get the foreign forces out of Lebanon and to have emerge an independent Lebanon able to govern itself and exert its sovereignty.

At this point, we are not there yet. So, people who are thinking about putting money in there are waiting to see what happens. The foreign forces are still there, as we all know, and there is considerable turmoil still in southern Lebanon.

Senator PRESSLER. Could the decline in oil prices have any effect on the Saudis' ability to carry out some of the pledges they have made during the sale of the AWACS?

Secretary SHULTZ. Well, the declining oil revenues have an impact on them, obviously, but the assets they hold are so large that they do not have any real problem with fulfilling any past pledge, I am sure.

Senator PRESSLER. I see I have a red light. I will submit additional questions for the record.

The CHAIRMAN. Thank you very much, Senator Pressler. We will make a phone call, if you would like, that you are a little tardy to your next appointment.

Mr. Secretary, before you leave, we have two very important nominations I would like your judgment on. Tomorrow morning at 11 o'clock we will be available for opening statements for Senators or comments on Director Adelman's nomination. We will have that vote at 11:45. We received notification, an announcement from the White House last year that our colleague, Ed Derwinski, would be nominated to be counsel to the State Department. We understand his papers will be arriving in the very near future, today some time. Would you care to comment on both of those nominations? Do both of those nominations have your full support?

Secretary SHULTZ. Absolutely. I have known both before they were nominated, and thought very well of them. In each case, I have had a fair amount of contact since they were nominated, and I feel that both will do a first class job; in the case of Mr. Adelman, that he will contribute significantly to the extremely important efforts in the field of arms reduction, and in the case of Ed Derwinski, an across the board kind of counselor role can be extremely helpful to us, and it would not hurt us at all in the State Department to have somebody there in addition to our excellent congressional relations staff, but somebody in our top group who is thoroughly familiar with the workings of the Congress and knows what

listening to the grass roots is all about from his personal experience.

The CHAIRMAN. Well, I concur completely with you. I have known Ed Derwinski for decades. I think he can be of invaluable assistance to the Department at this particular time. And I will announce tomorrow the significant progress that Ambassador Adelman has made, including his last appearance, but also subsequently to that.

Thank you very much.

Secretary SHULTZ. Thank you, Mr. Chairman.

The CHAIRMAN. We will leave the record open for questions and for the Secretary to reply to them.

[Additional questions and answers follow:]

STATE DEPARTMENT'S RESPONSES TO ADDITIONAL QUESTIONS SUBMITTED BY SENATOR PRESSLER

Question 1. Secretary Shultz, what are your thoughts about the role of tourism in our economy and our foreign relations?

Answer. Clearly the tourism and travel industry occupies a prominent position in our economy. In 1982 it became the second largest retail industry in America in terms of gross sales and employment. Travel in the United States now accounts for more than \$200 billion in domestic and foreign visitor spending, about 6 percent of our gross national product. It generates substantial employment, accounting for 18 percent of all new jobs in 1981. The industry employs directly 4.6 million Americans at every level of skill and an additional 2.3 million workers indirectly, generating over \$40 billion in wages and salaries annually.

Tourism can play an important role in enhancing our foreign relations. Increased and less inhibited international travel of people from all nations for the purpose of cultural exchange, recreation and trade leads to understanding, friendship and ultimately to greater prospects for world peace. Tourism and travel to the United States is a valuable method of fostering appreciation of the values of democracy, freedom and human dignity.

Question 2. Would it be possible to designate at least one officer in each of our foreign embassies to work for an increase in travel and tourism trade to the United States? Some of the specific responsibilities of these officers would include the promotion of travel to the United States, informing foreigners about all that the United States has to offer, and facilitating and expediting foreigners' U.S. travel plans?

Answer. In accordance with the significant economic and foreign relations impact of tourism and travel to the United States, our ambassadors and their staffs are and will remain involved in tourism promotion and facilitation.

Scarce resources preclude assignment of individual officers at our posts abroad as tourism attachés to devote full time to the tourism promotion effort. Commercial, economic and consular officers now are jointly responsible for this function in addition to their other duties.

In the 66 largest markets for American goods and services, officers of the Foreign Commercial Service (FCS) of the Department of Commerce have principal responsibility for tourism promotion with support as required from consular and other mission sections. State Department economic/commercial officers have the lead in promoting increased travel to the United States in the remaining 73 countries. We will be pleased to explore with the Commerce Department the feasibility of designating a specific officer at each embassy or consulate as principal tourism promotion officer along with his or her other responsibilities.

In six key countries in which the U.S. Travel and Tourism Administration operates field offices, staffed by travel promotion officers with wide regional responsibilities, our missions provide administrative support, while commercial, consular, economic and information officers work closely with their USTTA colleagues to coordinate overall program activities.

Question 3. If such designation was made, could we also implement a training program to help these officers in the performance of their duty?

Answer. Whether or not specific officers are designated, it would be desirable for the U.S. Travel and Tourism Administration to develop a training and operational manual for the guidance of all officers involved in tourism promotion and facilitation.

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DEBT CRISIS: NEXT PHASE

International debt crisis: the next phase

Dr Wilfried Guth
Deutsche Bank, Frankfurt

Bank lending to developing countries is likely to be limited by the growth in each bank's capital base. Other contributions will have to come from the public sector, including the IMF and the World Bank, and from private direct investment

We surely all agree that the grave international payments and financing problems, which began last autumn with the Mexican debacle, have confronted the world financial system with its greatest challenge in the post-war period. There is also no disagreement that this debt crisis, which is mainly concentrated on a number of countries in Latin America and Eastern Europe, is the cumulative effect of a prolonged recession, extremely high interest rates (nominal and real), and growing protectionism in the industrialised world.

In addition, certain countries have had specific, 'home-made' problems, such as the Falklands conflict in Argentina, or the massive capital flight in Mexico, whereas a country like Brazil became more or less a victim of these adverse developments elsewhere, which caused a sudden decline of international lending to the third world. At the same time, it should be noted that a number of problem countries have not made sufficient efforts to adjust to deteriorating world economic conditions. Some of them have taken greater recourse to short-term credits, thus increasing further their vulnerability to fluctuations in market confidence.

At this juncture a total of over 40 countries who owe the greater part of their combined external debt to commercial banks, have agreed to or applied for debt reschedulings or have accumulated *de facto* substantial payment arrears. At mid-1982 the total exposure of international banks in these problem countries amounted, according to BIS statistics, to about US\$240 billion. This sum represented about 55% of all outstanding loans by banks to non-industrialised countries, or 15% of all international bank credits recorded by the BIS (that is including credits to industrialised countries).

These facts notwithstanding, we can say today, with some satisfaction, although not with complacency, that any disruptive effects of these debt problems on the entire financial system have been

successfully prevented through the unprecedented co-operative effort of the debtor countries, the International Monetary Fund, governments and central banks of creditor countries and commercial banks. The rescue 'packages' were put together with speed and efficiency, thus preventing a breakdown of the debtor countries' economies.

Apart from the injection of badly needed funds, the IMF has played a crucial and highly responsible role in coordinating this concerted action to stabilise the international financial system. And I should also like to mention the extremely useful contribution of the BIS, which on various occasions has provided bridging finance to countries negotiating adjustment and medium-term financial support programmes with the IMF and the banks.

Fresh money

The commercial banks' contribution towards restoring the financial viability of the debtor countries consists in the rescheduling of the repayments on outstanding credits and, in most cases, the provision of fresh money through medium-term credits (in addition to maintaining or restoring short-term trade credit facilities and interbank lines). For the three largest Latin American countries alone, the banks have agreed to extend more than \$10 billion in new assistance, that is to increase their exposure by this amount; in addition, bank loan repayments falling due in 1983 will be rescheduled in the order of \$35 billion.

This great cooperative financial effort of the various creditors can, of course, only be help towards the self-help of the debtors. Restoration of their financial viability depends on the successful implementation of the stabilisation programmes agreed upon with the IMF. This is by no means an easy task and we should not ignore the inherent risks. The rescheduling countries have to undergo an often painful adjustment process implying considerable strains on their

DEBT CRISIS: NEXT PHASE

economies and, in some cases, their social and political fabric.

Yet as there are many who like to play the role of Cassandra, we should also take note of some encouraging developments. In the first quarter of 1983 there has been a pronounced further improvement in the trade balances of the three largest Latin American debtor countries, which together account for one-third of the developing world's public and private debt (of \$700 billion). The marked decline in dollar interest rates since mid-1982 (by about 6 percentage points) has also helped to alleviate the debt service burden of these countries (in the cases of Brazil and Mexico each by around \$700 million annually for every one percentage point).

Nevertheless, there is general agreement that a sufficient strengthening of the rescheduling countries' debt service capacity — perhaps one should even say the very feasibility of the stabilisation programmes — will depend decisively on a sustained recovery of economic activity in the industrialised world. In addition, it is essential that the industrialised countries refrain from any further restrictions on trade with developing countries and that they embark on removing protectionist barriers to third world exports. It is reassuring that in their Williamsburg declaration the leaders of the major industrial nations stressed their commitment to these aims but of course, as in other respects, it will be the enactment of such high level intentions which counts in the end.

Much as we all hope that the economic upswing will proceed in line with the moderately optimistic forecasts of international institutions like the IMF and the OECD, we cannot expect that this will speedily resolve the critical situation of some debtor countries. We will, therefore, have to face — and to master — several more difficult years before we can hope to see the 'light at the end of the tunnel'.

The question now therefore is how the successful 'first round' of cooperative rescue efforts can best be continued and eventually transformed into longer-term policies to stabilise the structural situation of debtor countries. But first I would like to make a few brief comments on some of the lessons to be drawn from recent experience and on the implications of the debt problem for the international banks.

Maturity extension

There are in particular two aspects which, to my mind, give cause to further consideration. The first is the question of the maturities to be included in debt reschedulings. Most of the recent arrangements were restricted to bank loan repayments falling due in 1983; in a few cases (such as Mexico and Chile) maturities for 1984 were included. These payments obligations have been rescheduled over a six to eight-year period, a maturity extension which would seem to be realistic in terms of the debtor countries' basic situation. I am not so sure, on the other hand,

whether it would not have been wiser to include the maturities of some further years in these reschedulings. Dealing with the problem on a year-to-year basis (as in the special case of Poland) does not seem to be in the best interest of either the debtor countries or the creditor banks for practical as well as psychological reasons.

Speaking very generally, I would like to add that it makes little sense to tailor the 'rescheduling costume' too tightly, all the more so as the projection of the debtor countries' cash flow cannot have the precision of a mathematical equation. The arrangements should also leave sufficient scope for flexible reaction to unforeseen developments which are beyond the debtor country's control; on the other hand, they should not allow for any new inflationary deviations.

My second point relates to the impact of the debt crisis on the interbank market, which the banks use to balance their short-term assets and liabilities. Over the past twelve months this highly sensitive worldwide market has emerged as a critical element and potential problem area in a two-fold sense.

Interbank market

Banks of some highly indebted developing countries last year raised increasing amounts of very short-term money on this market through their foreign branches, using this money for the funding of longer-term loans to debtors at home; in the final analysis, and in contrast to the underlying logic of this market, bank-to-bank deposits were thus used to finance balance of payments deficits. On the other hand, creditor banks reacted to emerging payment difficulties of debtor countries or to debt problems in neighbouring countries with substantial cuts in interbank lines, thereby adding to the countries' worsening foreign exchange situation.

The maintenance of interbank lines — and in the case of Brazil the restoration of lines to the higher levels of an earlier date (the by now famous Project IV) — has been an essential ingredient in several of the recent debt rescue 'packages'. Although under the given conditions there may have been no alternative, this aspect of the rescheduling exercises has given rise to unease among the banks and to criticism such as 'coerced interbank lending is a contradiction in terms' or 'abuses of the market are being institutionalised'. And even in official central bank quarters the attitude towards this ambiguous interbank problem seems today to be divided.

The interbank market will, at any rate, remain highly susceptible to fluctuations in confidence and to any official intervention in the international banks' liquidity management. This should be taken into account by all parties involved, since this market must be kept fully intact as an essential cornerstone of our international financial system. By the same token, banks and banking supervisors alike all over the world ought to be fully aware of the potential dangers of excessive short-term borrowing in this market.

DEBT CRISIS: NEXT PHASE

I think it is evident to everyone today that the position of the commercial banks in the rescheduling process is a very difficult one. A number of big international banks have accumulated rather high exposures in problem countries — high in relation to their capital and reserves and in some cases to current earnings — and the same presumably applies to some of the regional and smaller banks which have in recent years increasingly participated in international lending.

'Punishment'

Of course, voices can now be heard to the effect that the banks should not have entered the whole field of balance of payments lending in the first place. But, quite apart from the fact that the same people cannot explain how the recycling of petrodollars could have been achieved without the major contribution of the commercial banks, this kind of critical reasoning on past events is of no help when it comes to solving our present problems. And it becomes even counter-productive when politicians, in order to 'punish' banks for alleged past mistakes, feel tempted to block necessary contributions from the public sector. I shall refer to this question later on. But let it be said here that 'punishment' for imprudent banking, if there has been any, invariably comes by itself; it need not be imposed by anyone.

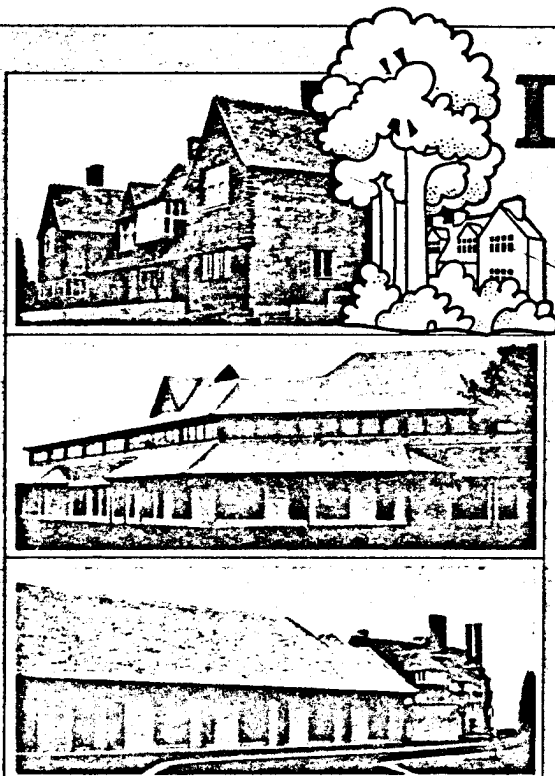
How then should the banks today act *vis-à-vis* the problem countries? On the one hand, there can be no

question that beyond the stretching of maturities, which is the core of rescheduling agreements, most of these countries need fresh money to achieve a moderate rate of growth; otherwise social peace might be endangered. Nobody can say that the commercial banks of industrial countries — with very few exceptions — have not responded very constructively to this undeniable necessity. I have given some illustrative figures on this earlier.

Yet there is another side to the coin. It is equally obvious that the commercial banks cannot ignore, even for the best of reasons, prudential limits to their country exposure. In many countries, supervisory authorities have begun surveilling these country exposures and the boards and credit committees of the banks themselves (not to mention shareholders at general meetings) are keeping a close watch on country exposures. But even if these bodies were to take a very lenient attitude bank management, which carries the main responsibility, cannot allow certain ratios to be surpassed. It is true such ratios should not be defined too rigidly — and nobody can give exact proof that one ratio or another is the right one — but we would have a distinct feeling of insecurity if some exposures became too great in relation both to total lending and to capital and reserves.

Loan provisions

It can be argued that such insecurity can be overcome if new lending to rescheduling countries



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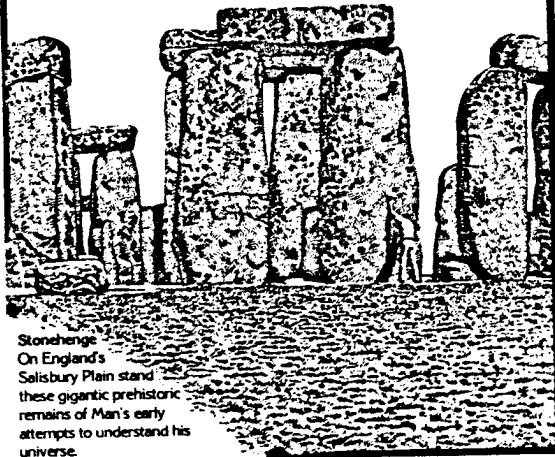
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were accompanied by parallel increases in existing loan loss provisions for these country risks. And this is indeed what most banks have already done. We should not overlook, however, that this represents a somewhat unusual method of banking, the normal and logical attitude being that exposures against which loan loss provisions have to be made are not to be increased, but rather decreased if possible.

What conclusions can be drawn from all this? I would like to stress three points:

- Adequate provisions for possible loan losses from sovereign risk lending are an absolute necessity, no matter what sums fiscal authorities might accept. By the same token, finance ministers ought to be aware that they are apt to put their own responsibility for the soundness of the country's banking system in question if they allow the attitude of fiscal authorities in this matter to be determined by budgetary needs rather than by an objective risk analysis.

I would like to add that I am not in favour of uniform, fixed and inflexible percentages for such provisions prescribed by supervisory authorities. I clearly prefer a system in which banks have the freedom to fix those percentages according to their own judgment. All I venture to suggest is that the minimum percentage to be set aside ought not to be so small that it becomes meaningless in the moment of need.

- While there will be strong reasons for banks not to withhold their support for the debtor countries during the critical years of rescheduling — to some extent out of solidarity with the world banking community, but mainly to bring their debtors 'out of the woods' — additional inputs of fresh money, if at all necessary, can only be moderate, given existing exposures, capital ratios, and other factors. To my mind, it makes no sense, therefore, when some observers today want to determine what they call the 'necessary contribution of commercial banks' by estimating the needs of the debtor countries for such credits.

Uncomfortable logic

Such assessments of needs ought to proceed in a different manner. Starting from the Fund's estimate of foreign exchange requirements of debtor countries, in the framework of their stabilisation programmes, a realistic figure for the commercial banks' possible contribution should be deducted in order to arrive at the 'necessary contribution from the public sector'. Governments and parliaments should not close their eyes to this uncomfortable logic and take appropriate steps to ensure greater public contributions in one way or another. They ought to be aware that the ultimate costs for them are likely to be higher if a crisis is allowed to develop.

- Creditors and debtor countries alike must have one overriding interest: to make sure that scarce foreign exchange, that is the 'fresh money' supplied by the IMF and the commercial banks, is utilised in

DEBT CRISIS: NEXT PHASE

the most productive manner so as to strengthen the countries' repayment capacities. On the other hand, commercial banks are hardly in a position to ensure the proper use of those credits; they might even find themselves in a dilemma if they were confronted with financing requests from export firms in their own countries for purposes which did not appear very convincing in terms of structural balance of payments improvements of the debtor countries. In fact, there seems to be an urgent need for advising on and supervising the most efficient use of the new credits in rescheduling countries. One would think that the World Bank, with its great experience in project selection and monitoring, is well suited to assume this role in close cooperation with the IMF.

Most urgent tasks

After these general remarks on the problems of the commercial banks I want to return to the basic question of how the problems of highly-indebted third world countries can be resolved in such a way that they can become creditworthy again. It was certainly clear from the beginning to everyone involved that only in the most favourable — and unfortunately unlikely — circumstances (rapid world economic recovery, dismantling of protectionism) would the 'first aid' packages for some of these countries be sufficient to achieve this aim. But little thought, if any, was given during this heavily strained period to the way in which inevitable follow-up measures ought to be conceived.

Today, however, we are confronted with clear evidence that crisis management will have to continue in a number of cases. How then should 'the second round' be tackled, for instance with respect to Brazil? Estimates differ widely as to the extent of the additional foreign exchange requirement likely to arise for 1983. But, whether it is \$2 billion or \$3 billion, we should say right away that the commercial banks cannot be counted upon to fill this gap by themselves. While it may be necessary for all banks engaged in Brazil, including those which are still lagging behind on the old programmes (Projects III and IV), to act in solidarity and provide a certain percentage of 'fresh money' for the second time, such new credits must be matched by additional contributions from public sources.

Naturally, our eyes are primarily directed towards the IMF in this context. As the Fund has already committed the maximum amount available for Brazil under the present enlarged access policy, that is 450% of its quota, it is argued that the only way in which the IMF could help in the given situation is by accelerating disbursements. This may well be advisable, but it will in all likelihood not be sufficient nor will it satisfy the banks as a 'matching formula'. The same would be true for another stopgap measure, namely a roll-over of the bridging loan from the BIS.

Accelerated disbursements under an existing loan agreement or the extension of bridging loans only

make sense if, to extend the metaphor, there is firm ground at the other end of the bridge or, to put it in terms of the actual case, if Brazil's external cash flow is expected to improve sufficiently or if the country can be eligible for market loans after such operations. Unfortunately this state of affairs is not yet in sight and cannot be safely assumed, unless the world economy sees a very vigorous upturn.

In order to ensure an appropriate contribution of official funds towards debtor countries' additional borrowing needs, the speedy enactment of the proposed increase in IMF quotas and enlarged General Arrangements to Borrow is essential. Besides providing the IMF with adequate resources the quota increase should also be reflected in the Fund's lending policy. At the very least one half of the quota increase ought to be made available to problem countries on the same basis as under the present Fund guidelines for members' enlarged access which specify maximum assistance of 450% over a three-year period, as already mentioned.

Wrong setting

As we know, the more restrictive attitude of some governments or parliaments towards increased IMF lending is largely based on fears of inflation. This is certainly legitimate and in principle by no means unfounded. Yet in my opinion the rescheduling countries facing negative growth rates and social tensions are today the wrong setting for the curtailment of international liquidity. Furthermore, it

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DEBT CRISIS: NEXT PHASE

is the very essence of the stabilisation programmes carried out in these countries under the guidance of the IMF to keep inflation under better control.

In search of other contributions from the public side to ease the balance of payments situation of rescheduling countries one is inclined to think of the debt incurred on guaranteed export credits of the industrial countries, for which no rescheduling has been arranged so far. Although the amounts involved might not be very substantial, it would in my view represent a fair 'burden sharing' if the debtor countries in question were to call on the official creditors of the Paris Club to agree to a rescheduling. Needless to say, parallel to such operations, the creditor governments' extension of new export credit insurance must go on — just as the commercial banks have been prepared to provide fresh money in addition to rescheduling the maturities of non-guaranteed loans.

Another way — indeed a very natural one — of increasing official contributions is, of course, to intensify World Bank and regional development banks' lending to problem countries. In fact, the World Bank and the InterAmerican Development Bank have already responded to this challenge and have greatly increased their commitments to Brazil and Chile.

Financing future growth

As I indicated at the outset, the immediate task of continued crisis management must not detract from the more far-reaching basic problem of how to ensure the necessary financing of future growth and development of third world countries under the world economic conditions of the 1980s. On this broad subject I would like to make only a few concluding observations:

- The great progress in international cooperation of public and private creditors, which has been achieved during this difficult period, ought to be maintained. The main purpose of such cooperation should then be crisis prevention. To achieve this aim, the Fund will have an important role to play within the framework of its surveillance function, which it must exercise strictly wherever necessary. But ways and means should also be explored to assure that the commercial banks in their lending to the various countries do not work at 'cross purposes' to the Fund's intentions. This has nothing to do with 'early warning', a term currently often misused; it is rather to be seen as a joint effort to avoid a situation where market lending comes to an abrupt end.

- There is little doubt that after the deep shock which the debt crisis has caused, the role of private banks in the financing of developing countries will take on a somewhat different character in the remainder of the 1980s. Banks will, in my opinion, be concerned in future that the expansion of their international lending will, as a rule, not proceed faster than the growth of their capital base. They will

probably be rather reluctant to grant loans for general budget or balance of payments purposes and will concentrate instead on project-related credits, especially the financing of capital goods exports.

- In this context, the World Bank's introduction of new co-financing schemes for high-priority projects in developing countries, designed to provide greater risk protection for the banks while at the same time accommodating those countries' need for longer-term maturities, is to be welcomed. One possible idea worth considering is to extend co-financing to the broader programme loans of the World Bank. Co-financing should also be intensified by the regional development banks, such as IADB and ADB, which are also becoming increasingly active in this field.

- One of the most important lessons of this crisis period is the confirmation of the crucial importance of the two Bretton Woods institutions, the Fund and the Bank. Rather than pondering over the need for new institutions, governments and parliaments ought to do everything to keep these well-established and highly efficient institutions intact, and to assure the adequacy of their capital base; endless negotiations for every capital increase would appear rather anachronistic after the events of 1982-83.

- This is by no means to say that the share of public lending ought to remain at the high level indispensable during the present period. On the contrary, there is no other policy aim of such fundamental importance than to attract a large flow of private funds in all possible forms to the newly industrialising countries of the third world.

Direct investment

Promotion of private direct and equity investment, whose importance in the overall transfer of resources to the developing countries has decreased over the past decades, represents an ideal way for these countries to expand their growth potential without increasing their debt burden. Foreign private investment could make a significant contribution in helping to develop new primary product sources, and by transferring technology and marketing skills.

In many countries such a change in development financing strategies would imply a revision of the hitherto often restrictive and even hostile attitude of governments towards foreign risk capital. Another member of the World Bank family, the International Finance Corporation, could be called upon to assist these countries in improving the conditions for productive investment, particularly by medium-sized and smaller firms from industrial countries.

The guiding principle must be no more public funds than absolutely necessary. This is all the more important as scarce budgetary contributions of the industrial countries will continue to be urgently needed for supporting growth in the poorest developing countries.

Dr Guth is joint spokesman of the Board of Managing Directors of Deutsche Bank.

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International debt crisis: the practical lessons of restructuring

M. S. Mendelsohn
London

In the past year, some 25 developing countries have been renegotiating the terms of about \$100 billion of external debt to the markets. Borrowers, banks and the authorities have all learned in this 'crucible of recent experience'

The past year's concentration of sovereign debt restructuring has taught a few new lessons, driven home again some half-forgotten truths, but has also revived some popular misconceptions. Since Mexico abruptly interrupted full service of its external debt last August, some 25 developing countries have followed or returned to the bargaining table to renegotiate the terms of about \$100 billion of external debt owed to the international banking system and other private creditors, or about 20 times the amount of cross-border debt to the markets renegotiated in any previous year. About three-quarters of that total is being renegotiated by five borrowing countries alone — Mexico, Brazil, Argentina, Venezuela and Poland.

This is a new phenomenon, representing the realisation of a fear long felt. Of about 80 debt relief agreements signed in the 25 years up to 1982, nearly 70 covered debt owed by the governments of developing countries to the governments and the officially-supported export credit agencies of the leading industrial countries. Relief agreements with the banking system were isolated events until the mid-1970s and only nine countries restructured such debt even in the six years up to 1982. With the exceptions of Turkey, which renegotiated \$3 billion of market debt in 1979, and Poland, which renegotiated \$4.8 billion in 1982, most such market relief agreements were with smaller African and central American countries and the sums were relatively small for the creditor banks though not, of course, for the countries concerned.

So far, it is the macro-economic lessons and implications that have received most attention, but a study published this month by the Group of Thirty concentrates, instead, on the practical experience of cross-border debt renegotiation gained over the years and 'in the crucible of recent experience'*.

The economic aspects need therefore be rehearsed here only briefly. Much comment on the present

'debt crisis' of developing countries has suggested, or at least implied, that borrowing on the part of economically developing countries is a recent phenomenon, that it is intrinsically unsound, that the banks lent recklessly during the 1970s and that the borrowing countries squandered the proceeds. It is impossible not to detect in all this a thinly disguised strand of xenophobia and, indeed, racialism, tinged with a certain *schadenfreude* that matters have apparently gone so very wrong.

That attitude was summarised in a question put recently by an intelligent television interviewer in the United States who asked her panel, 'why did our banks lend all this money of ours to foreign countries and how will the countries ever pay back their debts?' The same question is being asked by legislators, especially in the US Congress, echoing Calvin Coolidge's celebrated observation, 'well, they hired the money, didn't they?'

Classical process

The recycling of oil surpluses during the 1970s was novel only for the enlarged part played by the banking system in the classical development process, by which poorer countries augment domestic savings with imported capital to finance their economic advance until they join the ranks of capital exporting countries, a transition which the United States made only at the turn of the present century and countries like Switzerland and Sweden later than that. Indeed, the same process takes place within sovereign states, where unrecorded imbalances of payments between regions are adjusted by flows of short-term banking funds, longer-term capital, the built-in redistribution of the tax system and, in the last resort, all else failing, by migrations from poorer to richer regions.

So far from squandering the capital they borrowed

*Commercial banks and the restructuring of cross-border debt, Group of Thirty, New York, July 1983.

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during the 1970s, the advanced developing countries responsible for most market borrowing used the money wisely and productively. Taken as a group, they achieved an impressive record of export-led growth by concentrating much of their investment in ways that increased their net foreign exchange earning capacity, as pointed out by the World Bank recently in 'an unfashionably positive view of the external indebtedness of developing countries'*.

Yet the successful use made by advanced developing countries of borrowed capital during the 1970s has caused almost as much dismay as the recent suspension of full debt service by some of them, including the biggest borrowers. The resentment created in the older industrial countries and especially in their declining industries by the growth of competition for world export markets by the newer industrialised countries and the advanced LDCs explains at least in part the covert pleasure now felt in their plight and that of their bankers.

For the most part, the foreign debt taken on at minimal or negative real interest rates in the 1970s seemed manageable to the countries and their creditors and actually was in the circumstances in which the debt was contracted. There were certainly inefficiencies at the all-important margin, but the main cause for the difficulties of sovereign and other borrowers has been the global disinflation of the past three years with its undue emphasis on monetary restraint, which steeply increased the real cost of borrowed money while severely restricting the ability of domestic and sovereign borrowers to earn enough for the maintenance of full debt service.

Paris club

The plight of sovereign borrowers is only one symptom and not the most important of the economic difficulties from which the world is just beginning an uncertain recovery and, even on the most hopeful outlook, many sovereign borrowers will be returning to the bargaining table with their bankers this year, next year and quite possibly for several years. The first shock of sovereign market debt restructuring has been absorbed more smoothly than many dared hope in the panic of the late summer and autumn of last year, but the difficulties are by no means over. What, then, has been learned from earlier and more recent practical experience?

Some lessons have undoubtedly been absorbed from the Paris club in which developing countries have been renegotiating since 1956 the terms of public sector debt owed to the 17 members of the DAC, or Development Assistance Committee of the OECD. The 'club' has been notably shy about publicising its workings or even existence from the very first, for fear that this might encourage more relief applications, and it hesitated until 1974 before appointing a small secretariat at the French treasury where it meets. Yet a set of procedures has evolved by trial and precedent over the years.

With few exceptions, creditor governments have tried to confine relief to the stretching out of principal repayments falling due within a 'current period' of up to 2½ years. These are commonly allowed to be stretched out over 8-10 years, of which the first half is usually conceded as a grace period during which no principal is repaid, although interest payments must be kept up at a 'moratorium' or market rate which is usually, but not always, above the rate at which the loans were contracted.

Equal treatment

Over the years, Paris club agreements have tended to incorporate provisions intended to provide equal treatment for all creditors. These require debtor governments to renegotiate debt to non-DAC governments and also to private creditors, mostly banks, on terms no more favourable to the creditors than those

DEBT RENEGOTIATIONS WITH COMMERCIAL BANKS 1982-83

Amounts being renegotiated in \$ billion

	Public sector debt	Private sector debt	Total liabilities to inter- national banks	
			Gross	Net
Mexico	19.5	15.0	59.0	48.5
Brazil	4.7	...	56.0	51.8
Argentina	5.5	6.0 (Est)	22.2	16.4
Venezuela	16.3	n.a.	22.7	9.7
Peru	2.0	0.3	5.2	3.3
Chile	3.4	...	10.5	8.0
Uruguay	0.8	n.a.	1.2	0
Ecuador	1.2	1.3	4.1	3.3
Jugoslavia	3.4	n.a.	9.3	7.3
Romania	0.6	n.a.	4.0	3.7
Poland	7.0	n.a.	13.4	12.4
Cuba, Costa Rica, Nicaragua, Honduras	2.1	n.a.	2.5	2.1
	66.5	22.6	210.0	166.5

Estimated by authoritative supervisory sources. Source for end-1982 liabilities to banking system: Bank for International Settlements.

n.a.: not available or applicable.

... Some private sector debt included in public sector total.

(Est): estimated.

agreed with the Paris club governments. In practice, however, the debtors are required to show only that they have sought to restructure such other debt, not that they have actually succeeded in doing so, and the requirements to restructure debt to all creditors are not, therefore, always met†.

The difficulty faced by the Paris club and, indeed,

*World Debt Tables 1982-83, February 1983.

†An exception in all cases is the World Bank, whose loans are always serviced in full because of its inflexible policy of treating any interruption of service as a default, which would bring the borrower into default to all creditors under cross-default clauses. That threat has never yet had to be carried out.

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all creditors, is to discover the fine point between conditions which are too lax to induce a sufficient adjustment by the borrower or too harsh to be met. The result in either case is a fresh round of negotiations, as shown by the number of 'recidivists' who have returned to the Paris bargaining table three, four and even five times, in many cases in successive years.

However, a common sense approach to that difficulty has evolved over time and, like all evolutionary solutions, seems for that very reason to be the best of the alternatives available for reconciling the legitimate differences of interest between those involved.

It consists of a 'goodwill clause' under which creditor governments undertake to consider favourably fresh relief applications in succeeding years, provided that debtor countries can show that they are continuing to meet the performance targets agreed with the International Monetary Fund for the adjustment of their balances of payments. This is, indeed, the criterion by which the Fund itself disburses conditional assistance to member countries.

Precedent

That may be the most important practical lesson learned from the experience of intra-government debt renegotiation and it has crept into the renegotiation of cross-border debt owed to the commercial banking system although it has not been and is unlikely to become a formally acknowledged practice for fear of

setting a precedent. Nor is it without some dangers, unless the creditor banks show their determination to see actual performance rather than mere promises.

At least one small developing country has repeatedly renegotiated its external debt to the banking system for several years past without meeting any of its performance targets and its debts are so small for the creditor banks that they would gladly write them off, excepting for the dangerous precedent which that would create. Indeed, they are troubled by the precedent already created, which amounts to default by attrition (as distinct from outright default, which most bankers still think unlikely).

Corporate debt

Some practical experience of corporate debt renegotiation in the United States has likewise been applied to the renegotiation of cross-border debt owed to the international banking system. In the US, it is more usual for companies to have several bankers and corporate debt is common syndicated in the domestic market. As in other countries, the restructuring of corporate debt is a routine experience but, because US banks have more experience than many others of restructuring syndicated corporate debt, they are perceived by many other bankers as being especially good also at renegotiating syndicated international debt, their alleged 'bullying tactics' evoking, on the whole, more admiration than resentment among European bankers.

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DEBT RESTRUCTURING AGREEMENTS SIGNED WITH
COMMERCIAL BANKS 1978-82
\$ million

		Amount restructured	
1978	Jamaica	83	
	Peru	821	904
1979	Jamaica	149	
	Turkey*	2,930	
	Guyana	29	3,108
1980	Togo	69	
	Zaire	402	
	Nicaragua	562	1,033
1981	Jamaica	103	
	Sudan	538	641
1982	Poland	4,800	
	Guyana	35	4,835

*1979 agreement extended in 1982
Source: World Bank

In the case of cross-border debt restructuring commercial banks have, over the years, found themselves giving ground, as have the governments of the Paris club. In earlier international renegotiations, commercial banks tried to confine themselves to refinancing, a term which then meant, more narrowly than now, the provision of new money to allow unimpeded servicing of existing obligations. But they have found themselves obliged, over time, to renegotiate also principal, arrears of principal, even some interests and arrears of interest and, most disconcerting of all, short-term credits of up to a year are now commonly included in stretch-outs of up to 8 year, locking banks into far longer positions than they intended to take.

Interbank lines

However, the full implications of this have begun to make themselves felt in the growing reluctance of banks, mostly but not exclusively regional and smaller banks, to maintain interbank lines or even the flow of trade-related credits to troubled countries, thus threatening not only vital imports, like food, but also the flow of imported inputs which the debtor countries need to recover the export earnings on which they and their creditors depend for a return to full debt service.

The dangers of incorporating short-term liabilities into restructuring packages are being driven home to debtor countries in a way that is beginning to trouble the authorities in the creditor countries and they, too, have learned an important lesson. Unlike the German and Swiss central banks, the Federal Reserve System and the Bank of England put what was authoritatively described only a few months ago as 'very heavy pressure' on banks in their jurisdictions to maintain interbank lines to Mexican and restore them to Brazilian banks or, at least, the central banks of those countries.

The patent failure of those efforts in the Brazilian

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case has shown that monetary authorities risk their credibility when attempting more than they can achieve in influencing the markets, and a quiet face-saving campaign has been mounted to the effect that the Swiss and German central banks were, in reality, somewhat more pressing than they may have seemed and the US and British authorities somewhat less so than they appeared.

Another lesson that has emerged, for the commercial banking community, is the need to take more seriously the concern of regional and smaller banks. It is not enough to say that these were willing enough to follow when the going was good and deserve no sympathy for complaining of their relative impotence when matters go wrong. Nor is it enough to dismiss their partial withdrawal from the international market on the ground that they comprise only a small part of it.

The truth is less simple. In the scramble for international lending, regional and smaller banks were influenced to an important extent by their wish for closer relations with the leading money centre banks. In the colder climate of restructuring, however, the managements of regional and smaller banks are more concerned with the attitude of their boards and shareholders. This has wonderfully concentrated management minds on what their critics can easily dismiss as 'narrow' self-interest.

So far from being impotent, many have simply refused to maintain or restore interbank and other short-term credit lines to debtor countries despite requests from the IMF, the Fed and other authorities as well as pressure from the major commercial banks. And, although their contribution may be relatively small, margins are decisively important, especially at times of difficulty. The creation of the Institute of International Finance, or Ditchley group, has been motivated to an important extent by the recognition that regional and smaller banks need to be taken more seriously than they have been.

Judgment

A related objective of the IIF is to provide more information more promptly, especially where 'gaps' exist, as in the prompt flow of information on short-term credits. However, it is refreshing to discover from many of the bankers who cooperated with the Group of Thirty study that some scepticism is being expressed about the quest for ever more information. This is coupled with a new recognition of the need for more judgment to be based on the information available.

Soaring real interest rates and the stagnation of world output and trade should, in themselves, have warned that heavy market borrowers among the LDCs would, like borrowers everywhere, face growing debt servicing difficulties. It was unnecessary to know the last number. Yet credits were still being offered to Mexico at a keenly competitive 1/2% margin as late as June 1982

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apparently on the assumption that petroleum prices are 'uniquely immune to the laws of supply and demand', to cite the G-30 study.

Likewise refreshing is the distinction more bankers now seem willing to make between the need for complete information before difficulties arise, when it is less essential than often asserted, as argued above, and the real need for it once difficulties have surfaced, because it then becomes imperative to know precisely what is owed to whom and on what terms.

Contrasting approaches

On the part of the borrowers, an important lesson may have emerged from the approach to rescheduling adopted by Mexico on the one hand and Brazil on the other. The Mexican approach last August was abrupt and even brutal. The declaration of a moratorium, the appointment of a bankers' advisory group, the arrangement of bridging finance from the US treasury and the Bank for International Settlements and the imposition of exchange controls all came within a matter of days. Negotiations with the IMF started at once, so did the pressure on foreign banks to maintain interbank lines to Mexican banks, and Mexico agreed from the first that the managing director of the Fund should make complementary bank financing a condition of IMF assistance (on the little publicised precedents of Togo and the Sudan in 1980 and 1981).

The Brazilian approach was, by contrast, positively leisurely, partly because of the insistence of the

Brazilian authorities that they were suffering no more than a 'contagion' from Mexico, which would soon pass, and partly because of a well-intentioned wish to interfere with market forces as little as possible and to win the confidence of creditor banks by a low-key search for new finance. Although difficulties surfaced in the interbank market as early as August of last year, it was announced from the first that no approach would be made to the IMF until after the November elections to Brazil's federal assembly.

Little attempt was made to hold interbank lines in place and the subsequent efforts to restore severely eroded lines met with very limited success. Representatives of creditor banks were not appointed until December, when four such groups with overlapping and competing functions were created, only to be dissolved a month later when a single advisory committee was at last appointed. The suspension of external public sector debt service likewise came only five months after the first signs of difficulties.

Fine point

In summary, the Mexican authorities acted with an abruptness which at first took the markets aback, but presently created a comfortably business-like impression. The Brazilian approach, well motivated by the desire to cause the least possible upset, had the opposite of the effect intended by conveying an impression of indecisiveness. Although more countries have so far tended towards the Brazilian rather than the Mexican approach it is possible that the difference of experience of the two major debtor countries may influence a changed approach in other countries.

Time will, likewise, show whether the banking community has been well advised to charge penalties in the form of lending margins of well above 2% over Libor, plus arrangement fees, with the bonus of receiving those lending spreads on the full amounts of restructured debt during the grace periods when principal is not being run down. The Group of Thirty has suggested that banks may be earning as much as an extra \$1.75 billion a year on cross-border debt recently renegotiated or being renegotiated. It is true that this belatedly compensates banks for the very narrow margins conceded in the borrowers' market which persisted through most of the 1970s and into the first years of the 1980s, and allows them scope for more adequate provisions. At the same time it adds another spur for a prompt return to full debt service by borrowing countries.

On the other hand, high penalty margins can impede the recovery of debtor countries and, since the LDCs now account for nearly a third of the value of world trade, they cannot all retrench severely and simultaneously without endangering the world economic recovery on which they depend for a return to viability. Here, too, the fine point between necessary and excessive penalisation may become more apparent only with experience.

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THOSE DEBT PROPOSALS: RADICAL OR JUST WRONG?

Some bankers are suggesting radical solutions to the world debt crisis. But most think they can keep muddling through.

By Charles Grant

Radical plans to modify sovereign debt arrangements have been sprouting as fast as reschedulings over the past few months. The Bank of England has 16 on file. The reason: as the immediate panic over sovereign debt has subsided even before bankers' minds have begun to focus on the longer-term problems of financing the less developed countries.

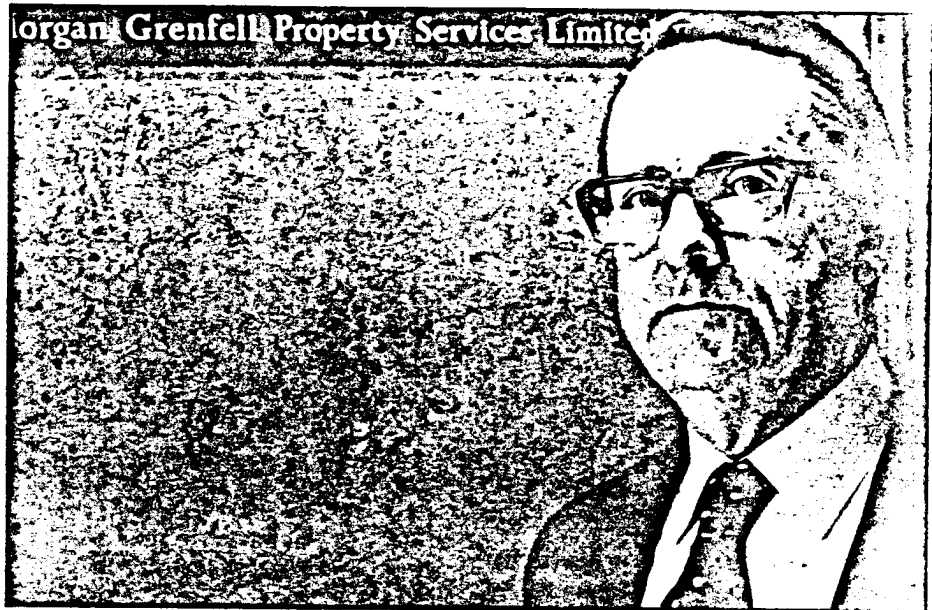
Some of the plans call for the stretching out of debt and its conversion into bonds guaranteed by an official body. Others propose that commercial banks should discount their problem debts with central banks to free their balance sheets for further lending while retaining the risk. Yet others assert that if the governments want banks to throw good money after bad, the governments should guarantee new loans.

Everyone's agreed that while the short-term problems are still causing headaches — bankers held their breath in May as Brazil seemed on the brink of declaring a moratorium on its foreign debt — there should now be more discussion of how to ensure a sufficient flow of funds to the LDCs beyond 1983.

"It's time to look beyond crisis management," said William Bolin, Bank of America vice chairman. "Our main concern now is how mechanisms will be implemented which continue to provide an adequate flow of funds to LDCs."

Paul Volcker, chairman of the Federal Reserve, said at the Brussels International Monetary Conference in May: "The fundamental problem is to get growth, long-term growth."

A vital component of that growth is continuing access to international bank credits by the LDCs. Jacques de Larosière, managing director of the IMF, indicated in May that the commercial banks would need to provide \$15 to \$20 billion towards an expected \$70 billion current account deficit



William Mackworth-Young: LDC bonds should be guaranteed by the whole developed world, not just the banks.

of the non-oil LDCs this year. That \$15 to 20 billion represents an increase in commercial bank exposure to those countries of only 7%, compared with 14% in 1982 and an average 20% from 1973 to 1981.

Many in the banking community doubt that even that kind of growth in lending will be possible. One bank economist in London thought "confidence in sovereign lending won't recover enough in that time to create the additional flows."

If the banks won't provide the new money, official bodies lack the resources or the will to fill the gap. The increase in the IMF quota, still being approved by member states, will not become effective before the end of 1984. Central bank governors are chary of allowing the Bank for International Settlements to become enmeshed in long-term lending. Bridging loans were hastily assembled by the BIS for countries like Hungary, Mexico and Brazil, but Fritz Leutwiler, BIS chairman, said in Brussels in May: "We must see the end of the bridge. We must know when we are going to get

repaid." And he was supported by Bundesbank president, Karl Otto Pöhl: "Don't forget the BIS is a bank, not an aid agency."

If the problem countries don't go on receiving new money, the commercial banks' existing exposure will be imperilled; social and political tensions might reach breaking point in the debtor nations and provoke an outright default; and the austerity programmes needed to counter-balance shrinking bank credit would dampen the world economic recovery, because one-third of exports from the industrial OECD countries go to the LDCs.

Such prospects as these have inspired several proposals for radical reorganization of LDC debts. The starting point for some of these is the belief that the major debtor nations are insolvent and not simply illiquid.

The majority of international bankers appears not to agree with these new ideas. They pin their hopes on economic recovery and the success of IMF stabilization programmes. Said John Heimann, deputy chairman of AG Becker Paribas and former Comptroller of the Currency: "If we get a world recovery and OECD growth of maybe 1½% this year and next year, then commodity prices and LDC export earnings will rise. Then the banks would become more relaxed about LDC lending." Argued Walter Wriston, chairman of Citicorp, at the IMC: "The key question is whether Fund programmes get implemented." Two years ago, he said, Turkey had enormous problems before it started to take the IMF medicine. "Today, the markets are open to it, and, if Latin America puts through adjustment programmes, in a couple of years from now I suspect the markets would be open to them as well."

Wriston's belief in the adequacy of existing mechanisms for dealing with

The starting point [for these radical reorganization proposals] is the belief that the major debtor nations are insolvent and not simply illiquid

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sovereign debt is supported by former Chase vice chairman, William Ogden, now chairman of the interim board of the Institute of International Finance. "I don't believe in these radical solutions," he asserted. "They deal with problems which don't yet exist, namely LDC insolvency. They would not maintain sufficient flows of funds to LDCs." Assume permanent insolvency and you certainly don't get an adequate flow, he maintained. And he added: "It's naive to lump together all the problem countries with their very different economies into a single global problem."

That is also the view of de Larosière: "There can be no generalized solutions to the debt problems," he said in May at Boca Raton, Florida. What are needed are "forceful and well crafted adjustment programmes geared to the individual circumstances and problems of each debtor country and supported in each case by judicious and coordinated financing arrangements."

Heimann, too, was sceptical of the need for far-reaching reform: "To bail out the banking system is neither necessary nor moral. We already have the central banks in place to deal with any liquidity or solvency problems the banks might encounter."

Wilfried Guth, chairman of the

managing board of Deutsche Bank, believes that the existing financial institutions can tackle debt problems. In a speech in Stockholm, he said: "Banks should not ask for or be given a bail-out or a lifeboat. I agree with the public opinion that we must ourselves carry the consequences of earlier lending policies . . . these [sweeping reforms] are contingency plans which would be taken out of the drawer only if the situation were to deteriorate dramatically."

Advocates of this *ad hoc* system stress that the banks have an orderly approach to reschedulings and are not muddling through. Laurence Brainard, senior vice president and chief international economist at Bankers Trust said: "An understanding has developed among the banks on the methods of approaching reschedulings. Nowhere is it codified, but there are understood priorities. For example, trade debts should be kept out of reschedulings, so that countries can continue to have access to trade finance. And we've learnt; on Poland we made the mistake of ignoring the short-term lines, so everyone tried to pull out on them. So, subsequently we've tried to ensure the short-term lines are kept open."

Proponents of radical change accept that the piecemeal approach has worked so far, but doubt if it can satisfy the funding needs

of borrowers like Mexico and Brazil over the next few years. Mexico is paying about \$12 billion a year in interest, and will have to find \$20 billion to repay principal due at the end of next year. According to IMF calculations, Brazil's annual repayments of principal will reach \$16 billion by 1987, together with about \$10 billion a year interest. Even some of the most conservative bankers recognize that the big debtors are going to keep coming back for reschedulings, each time demanding more fresh money so that they can meet interest payments.

Would the system be able to survive this? A British bank economist stressed the difficulty of persuading commercial banks to increase their exposure to the rescheduling countries: "We've gone along with arm twisting this far. But at each rescheduling of reschedulings, the central banks will have to twist harder, and more banks will drop out of the net. It's not likely to work more than once or twice."

The Bretton Woods institutions have already begun to increase their contribution to Third World deficit financing. In January, the World Bank launched a scheme for cofinancing under which the bank will encourage more commercial bank project-lending by guaranteeing or partici-

How the Ditchley initiative is becoming reality

"We've found a beautiful location, just opposite the US Treasury Department. From one side we can look right down on the White House," said Bill Ogden, chairman of the interim board of the Institute of International Finance (IIF). In April the institute picked a permanent HQ, in downtown Washington DC, and sent out about a thousand application forms, inviting banks to join the institute. Recently, the interim directors chose André de Lattre, a former deputy governor of the Banque de France, to be the institute's first managing director. Conceived at Ditchley Park, in the UK, last August, the institute should begin operations by the end of this year.

The IIF will gather country information, to be used by second-tier banks, which don't have their own large research departments. This should allow smaller banks to evaluate credit risks better, so that they may become less reluctant about cross-border lending.

It will also engage in an on-going dialogue with borrowing countries, on a voluntary basis. The IIF will discuss borrowers' economic plans, assumptions and borrowing needs. The discussions will include missions to the borrowing countries, though the IIF is not keen on that word because of its IMF connotations of browbeating.

One interim director described the

institute's dual purpose: "The data collection is for the banks, the missions will be for the borrowers."

One difficulty for the IIF is that many bankers, even some of those associated with it, are unclear about what it will do. While it is now generally understood that the IIF will not act as an equivalent of the Paris club for bank reschedulings, some bankers believe it will have access to IMF information which it could relay indirectly to the banks.

That is not the case. One IMF official said: "We cannot pass on to the institute information given to us on a confidential basis, unless the countries concerned agree. So I don't think Ditchley will make a great deal of difference."

The most common criticism levelled at the IIF by commercial bankers is that it won't make much difference now, because the small banks it is aiming at have already left the sovereign loan market. One senior vice president of a US bank said: "It's missed the gun by five years. It's a good idea five years too late."

But criticism is unfair; the IIF's founders are aware that it will not solve contemporary problems of sovereign lending. "The institute is not really designed to deal with today's problems, like Mexico and Brazil," said Ogden. "We'll only be able to test how successful the institute has been in five to 10 years

from now. Its major task is to prevent these sorts of crises from happening again. If countries choose to approach us for consultations, they will be able to adjust voluntarily on their own, before they are forced to go to the Fund."

Although some have reservations, most leading international banks support the establishment of the institute. Deutsche Bank was the only leading bank which turned down the invitation to be one of the 35 founding members.

Ogden hopes the despatch of country information to member banks will dissuade them from the extreme swings which, in the past, have sometimes resulted in all the banks rushing into a country, only to suddenly rush out again. Said Ogden: "As I see the institute's role, it shouldn't put up red lights or green lights, but rather it should put up yellow precautionary lights and point to the speed limits."

Ogden is particularly pleased that the initiative behind Ditchley has been private sector. "The private sector has come up with a better mechanism for tackling these problems. No one told us we had to do this. It's a good argument to use against the regulators who don't trust us."

Ogden has made it clear that he does not wish to be the institute's first managing director — but he wouldn't mind being the first non-executive chairman. □

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Laurence Brainard: Trade debts should be kept out of reschedulings.

pating in normal syndicated credits. In February, World Bank President Tom Clausen announced a special action programme of accelerated disbursements on project lending, and more structural adjustment loans.

The IMF has achieved a quota rise of 47.5%, and an increase in the general arrangement to borrow from SDR 6 billion to SDR 17 billion. But these new funds for the IMF are unlikely to be approved by the various national assemblies until at least the end of the year. According to a study published in March by the Group of 30, the IMF had only \$9 billion of spare resources to lend. Considering the likely demands on IMF funds, the Group of 30 estimated that the IMF would need to borrow an extra \$9 billion on world capital markets before the end of the year.

The IMF and the World Bank will take a bigger share of LDC financing this year, but, even if the IMF starts to borrow in the loan market, they will lack the resources to supplant the banks, if the banks will not provide the 7% increase in exposure requested by de Larosière.

Supporters of sweeping solutions maintain that increasing the resources of the IMF and the World Bank will not preserve stability in the world financial system, nor keep an adequate flow of capital to LDCs.

The most radical idea is to stretch out the maturities on existing LDC loans by converting them into long-term bonds. Variations on this idea have been canvassed by Peter Kenen, Professor of Economics at Princeton; Felix Rohatyn, a partner of Lazard Frères; and William Mackworth-Young, chairman of Morgan Grenfell.

They believe a stretch-out would act as a bulwark against the threat of default, and would reduce the need for new bank loans to LDCs, by diminishing debt service burdens and easing current account deficits.

Kenen and Rohatyn suggest that governments of developed countries should set up a new agency. (Kenen suggests the name International Debt Discount Corporation.) This would buy LDC loans from the banks, at a discount of, say, 90%, and issue in return guaranteed long-term bonds in its own name. The agency would reschedule its loans to problem borrowers on a long-term, low interest, and final basis.

According to Rohatyn: "The reality of the situation is that a significant part of the approximately \$700 billion now lent to the Third World and the eastern bloc will come back, if ever, only over a long period."

Geoffrey Bell, a director of Schroder International, expressed a general criticism of the Kenen/Rohatyn model: "These schemes don't address themselves to the real issue, which is how to get new money to these countries, rather than dealing with existing debts." (Bell has himself proposed an international lending facility, linked to the IMF: banks would place funds in the facility, which the IMF would lend alongside its own loans).

Rohatyn and Kenen assume new lending to LDCs on a normal commercial basis. But Mackworth-Young's idea tackles Bell's criticism. LDCs would fund their deficits by issuing bonds, carrying an international guarantee.

from now on must be incurred outside the international banking system," said Mackworth-Young. "It's right for banks to finance trade and projects, but you shouldn't ask a bank to lend if it's not clear how and when it'll be paid back, and if it has no control over the financial management of the borrower."

Mackworth-Young wants this principle to be applied retrospectively. Balance-of-payments assets should be stripped off the banks and put into the capital markets with a guarantee. "The LDC bonds need to be guaranteed, so that if there is a default the whole developed world bears the weight, and not just the banks, because if banks lose their capital it's a catastrophe."

Mackworth-Young said he did not want to boost bank profits, but to strip assets from them, to free them for new lending to LDCs of the right sort. "I know of projects in some countries, for example a good copper mine project, where the banks won't finance it because they are full up on country limits. That's a shame; it's the sort of lending banks should do."

At the moment these stretch-out schemes are politically unacceptable to the governments of the developed countries. The US Congress would not vote money to bail out the banks.

The practical difficulties of setting up such a scheme would be enormous: for example, how should the cost be borne by the various participants? Which debts should be included and which should not?

So far the schemes have won little support from commercial bankers. George J. Clark, executive vice president in charge of international lending strategy at Citibank said: "Not only do lenders not want to discount loans at 90 cents to the dollar, but the borrowers don't want it either. If, say, Chilean paper circulates at a discount, that's a severe impediment on Chile's ability to borrow anew. Nearly all these ideas are written by people outside the rescheduling process, like academics and politicians."

Clark believed the *ad hoc* system could maintain an adequate flow of funds to LDCs. He maintained that the biggest threat to this flow was not the borrowers, but the legislators and regulators, who may impose country limits that are too restrictive.

Yves Laulan, chief economist of Société Générale, is concerned about the impact of plans like Rohatyn's on confidence in the financial system. "They could be very dangerous and counterproductive," he said. "Instead of forestalling a crisis of confidence, they could actually create one." He thought the other major drawbacks about the plans was that "they address only the problem of outstanding debt, not what happens in the future."

Laulan himself has a plan, with what he calls upstream and downstream procedures.

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on annual country-by-country reviews between commercial banks, the IMF and the World Bank, to provide better data on Third World debt.

The latter proposes a degree of risk sharing in lending to the Third World by commercial banks and the World Bank, possibly through greater use of cross-default clauses to co-financings, and by risk sharing between the banks and the IMF, possibly by opening a new window.

Through this facility, Laulan believes international banks could, under certain conditions, enjoy an indirect guarantee from the fund. If the fund were unwilling to go that far, he thinks the banks themselves might be able to organize multi-bank guarantees.

His proposals raise legal and confidentiality problems, but they have the merit of working within the existing framework of relationships between the multilateral institutions and commercial banks.

The idea proposed by Peter Leslie, senior general manager of Barclays Bank International, tackles the criticism that bankers should not be bailed out. He suggests that commercial banks should discount problem loans with central banks, to clear them off their balance sheets. Central banks would buy the loans on condition that, for each loan discounted, the commercial bank should make a new loan to a more healthy borrower in the Third World, perhaps in the form of export credits. The commercial banks would still be liable for the risk on the loans they discounted; the discounted loans would appear as contingent liabilities on their balance sheets.

The discounting facility is meant to boost banks' liquidity. "I don't think some new scheme, such as the discounting facility, is necessary to avoid disaster, or maintain confidence in the financial system," said Leslie. "But we will need some new initiative to maintain an adequate flow of funds to LDCs."

Leslie said that the place of immobilized debt on the balance sheet is insufficiently appreciated. "Even if a bank such as ourselves has, say, less than 3% of its assets out to problem borrowers, those assets will make up a much bigger proportion of our Eurocurrency book. The funding of bad loans can become quite significant, as you will have less cashflow coming in as repayments of principal from problem borrowers. So if you don't want your Eurocurrency book to grow, you may not be able to do any new lending for several years, especially as you may have undrawn loan commitments being drawn down in the future."

Manfred Meier-Preschany, who is a member of the managing board of Dresdner Bank, has put forward a similar proposal: the World Bank, rather than central banks, should take problem debts off the banks' balance sheets, while the banks retain the risk. The debts should be converted into long-term loans or bonds.



Felix Rohatyn: A debt discount corporation should be set up to buy LDC loans.

Meier-Preschany, like Leslie, wants to encourage new bank lending to LDCs.

Other bankers dispute whether the banks have a liquidity problem. Said Dr Kurt Richolt, deputy manager on the board of managing directors of Commerzbank: "Lack of liquidity on the part of the lenders is certainly not the reason for the slackened flow of credit funds to LDCs."

A British bank executive agreed: "We've had no problems funding ourselves in the interbank market. We could probably raise another 25% in deposits if we saw the commercial outlets. It's for other reasons that we prefer a lower growth of assets." He said that the discounting facility involved more risk. "We've too much risk. Any scheme which assumes we'll voluntarily increase our risk is being unrealistic."

Clark of Citibank agreed that funding rescheduled loans did not create liquidity problems: "Rescheduling principal isn't a very big problem — you're just maintaining your exposure, instead of making new loans to refinance the maturing ones."

There are no signs that central banks are willing to offer discounting facilities; the discounting facility, like the stretch-out models, has so far attracted very little support from commercial bankers. The one radical solution to win some support is the state guaranteeing of new LDC lending. Its advocates include Harry Taylor, president of Manufacturers Hanover Corporation, Hans Baer, chairman of the management committee of Bank Julius Baer, and a number of senior UK clearing bankers. They wish to overcome the problem of supporting LDC current account deficits.

Baer explained: "New sovereign lending should be guaranteed by institutions or governments. Without this carrot it will be difficult to achieve the \$20 billion [de Larosière has asked for]. In the interests of making LDC economies grow, some risk should be taken off private shoulders." Baer believes that the potential losses which governments might suffer from guaranteeing new loans would be preferable to the increased amounts of unemployment bene-

fits they would have to pay if LDCs were forced to cut back imports from developed countries.

"The problem is not so much to get one or other scheme adopted, but rather to get banks to agree there is a problem, which is greater than a liquidity crisis," said Baer. "Many American bankers won't talk about the problem, and just hope it will go away."

Taylor agreed that the banks needed a larger carrot. In a recent speech, he said: "Can those banks which have stayed put accept an even larger burden on top of the involuntary new loans we are now required to make? I think not . . . One possibility would be a new application of the guarantee mechanism."

A senior executive with a London clearing bank asserted bluntly: "We won't increase our risk to problem borrowers without guarantees. Governments have been cowardly since 1974. They encouraged the banks to take on difficult problems like recycling. It's the public sector's problem."

He added that his bank would say nothing in public on guarantees, because there would be a clamour about the bank wanting a bail out, which was not the case.

"I don't particularly want a guarantee scheme, but I'd prefer it to the Bank of England calling us in again and telling us to increase our exposure to Mexico by another 8%."

Those who dislike radical change could regard guarantees as an extension of export credit guarantee schemes to balance-of-payments loans. The guarantee would be less than 100%, to make bankers keep their wits about them.

Compared with the stretch-out ideas, it would be very cheap for western governments: they would only have to underwrite new loans to problem borrowers, rather than all past lending.

But that is also the plan's disadvantage for those who think it insufficiently radical. It offers LDCs no relief on the burden of debt they have already accumulated, or on the heavy cost of servicing it.

As with the stretch-out models, there would be political opposition to the use of public funds to help bankers. But a guarantee scheme, like the discounting facility, could be implemented unilaterally by one or several countries, without all developed countries having to follow.

The debt nightmare may have to become far more disturbing before the majority of bankers are prepared to consider seriously any radical plan for changing the relationships between commercial banks, official bodies and sovereign governments. The existing system will probably hang on for the moment. But for how long? "The *ad hoc* system may not work the second time around," Mackworth-Young cautioned. "We may not be so skilful or so fortunate next time."



INTERNATIONAL DEBT

A new approach to international indebtedness

Yves Laulan
Paris

Servicing existing debt is not the main problem: it is maintaining the flow of capital finance to developing nations. To help banks play their part in that, the IMF and the World Bank could undertake two additional functions

The problem of international indebtedness will not disappear by magic. A first major crisis was narrowly avoided last autumn, but the problem is still there. By this coming September, Mexico, Brazil, Argentina and other countries will be experiencing further financial difficulties and possibly face default.

The problem has both short-term and long-term aspects. In the short term, it is important for the various sources of international financing, namely the banks and official financial institutions, to come up with the means required to avoid a liquidity crisis. The long-term problem is different, since it entails finding a way to prevent the depletion of financing sources from threatening the fundamental economic health and stability of the third world. A drop in average income a head, however necessary to restore order in the economy, is acceptable for only a limited period of time. Over a five or ten-year span, such a drop might have a strong destabilising influence.

That is precisely what might happen should banks — through caution in the face of an economic crisis — sharply reduce their financial flows to the third world (not by 10 to 15% but by 50% or even more). It appears inevitable that small and middle-sized banks, especially in the United States where they account for 15% of the total exposure US banks have in the third world, will withdraw from the market. The tightening of international lending control procedures which is currently occurring in the major banks can be expected to lead automatically to a drop in the volume of loans to the third world.

The practice of debt rescheduling is clearly growing. It is natural for borrowing nations to reschedule since there is no immediate punishment involved. Under the twin pressures of the IMF and governments, banks have readily gone along with this practice, especially because they claim to be getting a profit of 2% or more from it. But, just as the banks

precipitated the crisis last year by shortening the maturity of their loans (in 1982 50% were short-term loans), one may well wonder whether they are not going to precipitate a new crisis by increasing the cost of refinancing these loans.

The borrowers too are taking a tougher line. One may well wonder whether a 'cartel' of borrowers in difficulty may emerge, ready to threaten default, similar to the 'cartel' of oil-producing countries.

A worldwide recovery, with higher commodity export prices and lower interest rates, will certainly moderate the harshness of the crisis. But it would be a serious mistake to suppose that it will cause it to disappear. Even with recovery, debt servicing/exports ratios will remain unfavourable (between 70% and 100% for Latin America and other deeply indebted countries) in the next few years. A laissez-faire or free-market approach alone cannot be expected to solve this problem. It is necessary to come up with a more strategic and convincing remedy.

Shared burden

Another kind of solution which at times is put forward consists of saying that 'the banks should pay' out of their reserves or their own funds — an approach which is reminiscent of the famous adage of the 1920s that 'Germany will pay' and history has shown us the consequences of that approach. The banks are scarcely capable of paying. The total equity of the major banks (capital plus reserves) amounts to about 5% of their total outstanding assets (some \$200 billion), and is about equivalent to the amount of the doubtful claims on the third world. The mere matching up the two figures should suffice to demonstrate how questionable any solution would be which consists of asking the banks alone to bear this burden.

It should be realised that banks are essentially financial intermediaries. In the final analysis, the burden will have to be shared between lending and borrowing countries, with a proportional breakdown

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INTERNATIONAL DEBT

to be determined by an initial arbitration. A second arbitration will be required among the creditor nations, who will be forced to make consumers carry part of the burden through inflation and/or interest rates and/or make tax-payers do their part through taxation. Expressed in these terms, the problem consists merely of providing a smooth, untraumatic transition towards a more healthy state of affairs.

It is also worth dispatching the widely-held belief that the debtors should pay back their debts. A country never pays back its debts, except over a very long period (for example, the US in the nineteenth century). The problem for the third world is simply to provide for regular and balanced growth of debt (in accordance with the world's inflation rate and their real growth rate) so as to be able to service their debt regularly. No more and no less is involved. It is a matter of confidence as well as of good financial management and proper utilisation of the funds borrowed.

Last but not least, it is worth bearing in mind that the nature of the problem varies from one country to another. Some people have argued that the current crisis is above all a matter of 'liquidity problems'. That is the well-known assertion of Walter Wriston, chairman of Citibank. Others, on the contrary, have claimed it is essentially a crisis of 'insolvency'. The truth is that it is a bit of both, in a mix that varies with the country concerned. The Citibank position is hard to accept; part of the funds have been wasted. Nevertheless, for Mexico, the crisis seems to indeed involve 'liquidity' and much less 'insolvency'. Exactly the reverse situation applies however to the Sudan. Moreover, at present, everything is a matter of 'liquidity' whereas in the long run, especially in a time of inflation, any problem of insolvency can be resolved.

Debt discounting . . .

Rather than get caught up in a theological quarrel, one is better off recognising that it is difficult to conceive of solutions that can be applied broadly to every case. On the contrary, solutions must be pragmatic and flexible. They must vary from case to case and must be tailored as closely as possible to the particular conditions of the creditors, the banks, and the debtor nations of the third world.

On the basis of these introductory remarks, it is possible to examine the solutions which are currently being put forward, particularly in the United States, to provide a remedy for the crisis*. We will purposely avoid dealing with the bills currently before the US Congress which are designed to control banking activities and which are only indirectly relevant to our topic.

The common feature of these plans is the removal

*Among others, such plans have been proposed by Norman Bailey of the National Security Council, Professor Peter Kenen, Congressman Clarence Schumer, Senator Bill Bradley, and by Felix Rohatyn of Lazards.

of bad debts from the balance sheets of the lending banks so as to stabilise their position and provide them indirectly with new liquidity. The idea is that these debts would be bought back at a price less than their nominal value (a discount of 10% to 15% for instance) either by some newly created agency, for example some international debt retirement fund, or by the IMF (or the central banks according to some versions), or even by investment mechanisms on some secondary market (to be set up for the purpose).

The authors of these plans believe they have two virtues. They make it possible to restore a certain truthfulness to balance sheets and they also improve bank liquidity at the cost of limited accounting losses. Moreover, consolidating these debts over a very long time period (up to 30 years) and with a very low interest rate would reduce the borrowers' debt servicing costs.

. . . not the answer

However good their intentions, these plans have serious flaws. They are dangerous in the short run inasmuch as they would be likely to precipitate the very crisis they aim to avert. They are counter-productive inasmuch as the long-term side effects, even assuming an immediate crisis is avoided, would make the cure worse than the disease. Implementing them would be very likely to damage the reputation of the lending institutions, whose real or supposed management errors would thereby be revealed in broad daylight, and at the same time ruin the credit of the debtors, whose solvency troubles would be cruelly brought to the fore. If such plans were applied, they would undoubtedly help to make the loans granted to the third world in the 1970s go down in history alongside the notorious 'Russian loans'.

Expressed more systematically, the main objections to these plans may be summarised as follows:

- It is doubtful under present circumstances that institutions or individuals operating on a secondary market would be inclined to buy bad debts with just a 10% discount. A discount of 50% or more would seem more likely. That would be enough to cast a shadow over the reputation of the debtor nations and cause the creditor banks to withdraw permanently from this kind of operation.
- As for the possibility of having the IMF or some other financial institution buy these debts with a reasonable 'discount', the objections are of another kind. First, one can well imagine the difficulties involved in defining which bad debts are eligible. Even if this delicate issue were resolved, an opportunity of this kind would bring about a vast shift in debt positions, first on the part of small US banks and then by the larger banks under pressure from their shareholders. Indeed, they would be sorely tempted to unload much of their third world portfolios in the rediscount institution.

Since countries with debt rescheduling problems

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account for about half of the medium-term and long-term debts declared by the banks (that is about \$320 billion), one can readily imagine how much money the IMF would need to handle this influx of debts. The IMF is currently lending no more than \$10 to 12 billion a year and Congress has already been baulking at the prospect of increasing the IMF quotas in 1983. Needless to say, the practical obstacles such plans would encounter would be considerable.

New approach

The real problem is not so much to deal with the outstanding debt as to give priority to new debt. The current problem of indebtedness can be solved satisfactorily over time if it is possible to find reasonable conditions under which banks will be willing in future to help third world nations borrow money. In other words, handling the future problem would make it possible to provide a solution to all the problems.

Banks have always had to carry bad debts on their books. The most striking recent example was the experience with real estate loans in the mid-1970s which weighed heavily on the accounts of US banks. The problem today of course is much bigger. Nevertheless, the prospects for an economic recovery allow one to think that banks, by wise long-term provisions, may gradually manage to rehabilitate their own balance sheets.

For such a process to occur, it will be necessary to re-establish confidence at two levels.

First, a way must be found to make sure that in future the best possible use is made of the funds made available to borrowing countries. The current crisis is to a large extent due to poor resource allocation. Far more credit was granted than was reasonable over and beyond the normal absorptive capacity of the borrowing nations. Mexico figures as a classic example, with a foreign indebtedness rate that rose to more than 30%. A lot could also be said about the utilisation of these resources in some countries (some African countries built fancy edifices or even schools). One need not be a specialist to realise that, however justifiable such programmes may be, they do not call for commercial-type financing. Yet that is what was attempted all too often. There must be an end to such practices and a return to more realistic and rigorous modes of financing.

Secondly, bankers must be able to recover their confidence in reasonable operations in the third world so that they do not give in to a panic reaction or mere distrust as far as this kind of operation is concerned.

On the basis of this sort of reasoning, it is possible to envisage 'upstream' and 'downstream' solutions for bank loans. The purpose of both would be to re-organise the relationship between the leading international banks, the IMF and the World Bank.

Upstream. Banks should promise to provide systematic information about their intentions to grant loans to any borrowing nation, to be sent to the IMF

for general loans and to the World Bank for project financing. There would thus be a systematic form of consultation and analysis before the loans were made. That would put an end to 'telex lending' which has contributed considerably to increasing indebtedness. Banks cannot carry out such prior studies because they lack the technical facilities to do so. But the IMF and the World Bank have well-staffed technical departments capable of providing this service. That will not be easy to achieve. The Fund and World Bank people like to keep secrets and they are wary of banks. They will not open up their files willingly but, over time, their distrust may be overcome.

Downstream. In return for this prior examination, the commercial banks might be given a guarantee of some sort. Their main concern nowadays is to get their money back. They do not always succeed in doing so. The present spate of rescheduling arrangements, even if the result does not immediately show up as losses on bank balance sheets, entails a serious future threat for the banks' operating accounts and they are aware of that. So their chief concern today is security rather than a return on investment. That is why the intervention of the Fund and the World Bank could prove valuable. Banks must have more confidence if they are to continue to engage in an adequate amount of lending. They must be sure that, under certain conditions, part of the risks involved will be borne by some international insurance system, comprised of a network of international institutions.

Implementation

While the principles behind such measures may be clear, there are awesome problems involved in putting them into practice. The implementation process must therefore be examined carefully.

Upstream. Clearly there would be no point in asking the 15,000 banks which are directly or indirectly involved in international financing operations to go knocking on the door of the IMF or the World Bank every time they grant a loan to some developing country. But it is worth noting that the Fund is already consulted when rescheduling arrangements are made. That amounts to a precedent which may perhaps prove valuable. An annual country-by-country review system of sorts could be set up under the auspices of the Fund, which could provide a forum for exchanging information of two kinds.

First, this annual review would make it possible to learn more about present conditions in any given debtor country and their likely future evolution, on the basis of the loans under consideration. It would then be possible to find out if a country's rate of debt increase is in keeping or not with its capital absorptive capacity. Opinions vary about absorptive capacity. Nevertheless certain guidelines could be used which take into account both the country's real growth rate and the worldwide inflation rate. Any

INTERNATIONAL DEBT

debt growth greater than the sum of these two percentage figures could be deemed excessive and hence potentially dangerous.

Determining the volume of a nation's debt would in itself be an advance on the previous state of affairs, as has been evident when rescheduling occurred. Beyond that, however, it is worth considering whether investigations should not go further, to the point of making an assessment of the various factors (the budget, investment programmes, the balance of payments situation, export prospects, and so on) likely to influence a country's overall solvency. It would be important for the analysis to deal with world economic trends as well since certain parameters, such as the price of oil, raw materials and so forth, can have an important bearing on a country's future prospect.

In addition to these annual reviews, it would be necessary to have constant discussion of technical and financial matters among specialists, especially with officials from the World Bank when it comes to examining the financing of certain projects. Such discussions have already begun to take place concerning co-financing.

Downstream. Establishing a degree of risk-sharing between international banks and international institutions is perhaps a more delicate problem to resolve. It appears dangerous and useless to set up new structures, as the Rohatyn plan proposes to do. It also seems venturesome to seek to initiate new procedures, especially for the IMF. Having the Fund buy up certain kinds of debts, as has been suggested, would require an amendment to its by-laws. Given the current state of thinking, it is doubtful whether such a change could readily be achieved. Yet a third pitfall to be avoided would be to make a large-scale appeal for government financing. This approach would run up against the opposition of the US Congress and perhaps that of other governments as well. It would therefore seem preferable to operate within the existing or already known procedures, while adjusting them as need be.

Cross-default

For the World Bank one could, for instance, consider using a cross-default clause under appropriate conditions. This clause would entail linking loans granted by the World Bank to those agreed by banking establishments. Once again, it should be pointed out that this is only a limited innovation. The extension of cross-default to co-financing, as the banks have requested, has so far not been agreed under conditions that the banks find acceptable. If the World Bank agreed to allow a cross-default clause to apply to loans issued by international banks for some financing projects, the result would be the very risk-sharing scheme which is sought.

For the IMF, the problem is similar. It appears quite unreasonable to put the IMF into a direct relationship with banks. That is entirely outside the

scope of its legal jurisdiction. Nevertheless, interesting possibilities could well be explored within the framework of existing procedures. As an example, the IMF in recent years has set up various 'windows' to meet the needs of member states — for example, the compensatory financing facilities. One might consider opening another 'window' for member states which would allow them to draw on the resources of the Fund, in accordance with procedures and under circumstances which should be very carefully determined, to meet difficult deadlines for payments to banks that have respected the prior consultation procedures discussed above*.

International banks would thus benefit, under specific conditions, from a kind of indirect guarantee from the Fund, thereby providing a means of restoring confidence. It should be noted in passing that the help which the Fund currently provides for debt rescheduling is in many respects based on the same principle, albeit under exceptional circumstances. This proposal would merely make systematic use of an existing exceptional procedure.

Objectives

These proposals naturally encounter a number of criticisms which should be examined.

The first objection is that they would meet reservations on the part of banks for whom 'upstream' consultation procedure would be tantamount to sacrificing part of their 'sovereignty' and independence. One answer to this is that a loss of independence is already a fact of life, especially when it comes to massive debt rescheduling. The governments of debtor and creditor countries and international institutions are quite often led to force the bankers' hands.

A second objection involves the debtor countries themselves which might refuse to go along with such consultations or might prove reluctant to supply the data required to make the right diagnosis. This objection does not stand up under analysis. This time when Mexico was capable of choosing between loans offered by different banks which often took the stance of petitioners is now past. The situation today is the reverse: it is the scarcity rather than the overabundance of credit that is feared. Debtor countries are thus likely to be concerned to protect their reputation for solvency under the best conditions.

A third objection may come from the Fund and the World Bank, since they might not wish to have to share their knowledge with international banks. Their concern for confidentiality must obviously be respected, but one is entitled to wonder whether it is still meaningful today.

After all, confidentiality failed to prevent the excessive increase in international debt levels which led to the present crisis. One may well wonder

*This could be called 'facilities for debt servicing financing'.

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whether confidentiality is not the very opposite of the concern which should now be uppermost in people's minds. It is the broadest possible circulation of information about the true state of affairs in debtor countries which appears desirable in order to avoid repeating the errors of the past.

One should not overlook the fact that one major difficulty stems from the habits and traditions of the staff of international organisations which until now have been required to be discreet about publishing certain information. In addition to the institutional or political obstacles, there are psychological barriers that are just as formidable. Certain behaviour patterns will undoubtedly have to be altered to meet the new circumstances.

Another objection concerns the impossibility of increasing the resources of the IMF and the World Bank to allow for risk-sharing in the form of direct or indirect guarantees. Three points can be made in this regard.

- The first is that, although the US Congress may currently be very hostile to any increase in the resources of these agencies, attitudes may change in the future.
- The solution put forward would in the final analysis be infinitely less wasteful of resources than any of the other plans mentioned above, especially those that call for the IMF or some other institution to buy banks' bad debts.
- The purpose of prior consultation would be to reduce or even eliminate the volume of claims. If good loans are granted under proper conditions, the use of guarantee funds would be only marginal.

Advice not finance

A massive increase in IMF or World Bank resources does not seem to be desirable or necessary. It would be indeed be unfortunate if these agencies became so gigantic that they experienced troubles in maintaining their internal balance or operating correctly. In any case the IMF and the World Bank should develop their advisory function as much or more than their financial role. It is as advisers as much as lenders that they make a useful contribution to international economic recovery.

Over the last 30 years both the Fund and the Bank, by virtue of remarkably qualified staffs, have managed to acquire an unequalled store of knowledge about developing countries, the techniques of financing, and the preparation of economic and financial diagnoses. Yet this store of knowledge is not utilised generously for the benefit of the international community. The time has perhaps come to draw upon it much more fully now that a radical change in the ways and means of international financing seems to be required.

Under such conditions, one should consider whether such procedures could not be established within the framework of existing resources, without there being any need, at least in the short run, to

increase the resources of the Fund or the Bank. This would moreover make it possible to give a categorical reply to the standard objection that 'the Fund must not bail out the banks'.

As for the specific problem of the guarantee that the IMF might provide, the relevant objections may be put as follows:

- There is no need to change anything whatsoever since economic recovery, if it is sharp and long-lasting, will take care of the problem by increasing raw material prices and reducing interest rates.
- If the banks obtain any kind of guarantee, they will lose interest in making adjustments because they will no longer feel required to do so.
- Similarly, guarantees may discourage debtor countries from making efforts and their public may think it unnecessary to accept the sacrifices that an adjustment policy would demand of them.
- No one single remedy can apply everywhere inasmuch as the situation varies a great deal from one country to another. The Sudan is not Mexico.

Effectiveness

Some of these criticisms have already been answered, especially the first and last. Some additional remarks may be made, however.

As for the differences between debtor countries, the guarantees would obviously also vary so as to fit each particular case. A guarantee can be provided only to deal with an unforeseen liquidity problem and not to handle probable insolvency.

A similar reply may be given to the argument that banks would cease to be motivated. Any guarantee would be subject to making the extra effort to engage in prior consultation. On the other hand, there may indeed be a problem concerning the adjustment efforts required from debtor countries. Very serious difficulties will certainly crop up when implementing the stabilisation plans which the indebtedness of these countries will require, whatever solution is decided upon.

The new feature will be that not only the Fund but also the banks will make their help subject to respecting certain conditions. People should not delude themselves; they should realise that, whatever happens, the banks will in future not be in a position to shell out funds as easily as in the past. That is precisely the key to correcting successfully the current situation.

Finally, a worldwide recovery is not necessarily sure to occur. Even a strong and long-lasting recovery, although it would ease the problem of old debt, would not make it possible to handle the problem of new debt. It is essential that future financing be offered under conditions which allow for an increase in its economic effectiveness. Only this effort at rationalisation will allow international financing to be provided more satisfactorily than in the past and will prevent the recurrence of problems which marked the beginning of the 1980s.

TWO-WAY TRAFFIC

America's once-troubled savings and loans associations are set to become an important force in international capital markets. From this month they have been allowed to invest in seasoned Eurobonds. New issue managers expect the S&Ls to favour top quality FRN issues because of the match with their hugely successful money market and Super NOW accounts. Since the beginning of this year almost \$150 billion has flooded into the S&Ls — \$112 billion through money market accounts alone.

One result of the thrifts' new freedom will be to strengthen the position of major US investment banks in the Euromarket. They have the regional networks and distributive experience to capitalize on this new source of funds. Salomon Brothers demonstrated this two months ago with its privately-placed floating-rate issue for BF Goodrich. That was priced over Libor but placed in the US, mainly with S&Ls. The company repeated the formula with an equally successful issue for the Kingdom of Denmark: 29 thrifts came into that deal.

The boost to US investment banks won't come amiss. Last year they profited as issuers streamed from the States to the

Eurobond market. In 1982, two thirds of the issuers of all listed Eurobonds were based in the States. This year that has changed. So far, US issuers have accounted for barely a third of all new Eurobonds. And that trend looks set to continue.

The influential *Morgan Guaranty Survey* predicts that US corporations' need for external finance will remain weak this year. Morgan's economists cite "the dramatic rise in corporate profits [they are looking for an increase of over 30% this year] inventory liquidations and weak investment demand" as reasons for "the decidedly modest need for external financing". They also point out that corporations have taken advantage of the booming stock markets to restructure their balance sheets and replace debt with equity.

So far the yawning US budget deficit seems not to have deterred those institutions that want to issue debt. But that doesn't mean crowding out won't happen. David Maxwell, chairman of America's second largest borrower after the Treasury, the Federal National Mortgage Association, hinted that the possibility of being crowded out toward the end of next year had prompted Fannie Mae's efforts to start

borrowing in the Eurobond market.

But the unshackling of the thrifts is also likely to have wider and more important effects. This year has seen an unprecedented boom in floating rate note and floating rate CD issues in the United States. Most have been priced over Treasury Bill rates, again to appeal to the S&Ls and regional banks' money market accounts. This makes them substantially cheaper to the issuers than Libor-based funds — a vital point, when most of the issuers have been banks.

Regional banks have launched floating rate CD issues in the US at rates well under Libor. And last month Swiss Bank Corporation became the first European bank to issue a floating rate CD in the US. The spread it paid was a mere 55 basis points over the three-month Treasury Bill rate. At the time of issue, that was 31 basis points under Libor.

The increasing investment power of the S&Ls and the regional banks — because of the success of the money market accounts — will draw more banks to the United States for their funds. It will also erode the hegemony of Libor in bank funding. More and more, the base will be the T-Bill rate.

AID THE DEBTORS

There were as many lay-offs in the US because of declining sales to Mexico in 1983 as there have been in three years of depression in the American automobile industry. That's according to Jeffrey Garten of Lehman Brothers Kuhn Loeb at the International Monetary Conference in Brussels last month.

The point being developed was this: can the world economic recovery be fostered while exports from the industrialized countries are being limited by the austerity programmes imposed as a result of the sovereign debt crisis? Can the Third World, in particular Latin America, export its way out of crisis when its natural markets are themselves in crisis? Brazil, for example, before the crisis emerged, had fixed on four key markets for its exports: Argentina, Chile, Mexico and Nigeria. All four are now deep in their own troubles.

Even if the economic recovery does bloom fully and sweep the world back into prosperity, it will be 1984 or later before the effects filter through to the poor nations. Can ad hoc arrangements hold the fort until then? The IMF quota increase cannot come into effect until the end of 1984, and that

increase is already inadequate for the level of support needed for the problem countries.

Some of the rescue packages are already foundering. More money will be needed soon for those, like Mexico, who so far have showed determination to haul themselves back to recovery.

All this means that more cash will be needed to shore up the LDCs than will be available this year or next year. It's estimated that some \$15 to 20 billion of new commercial bank funds are required by LDCs in 1983. True, that's only 7% more than the 1982 exposure, but it's probably out of reach, as the smaller banks pull out of sovereign lending and the interbank market shrinks.

So where's the cash to come from? Not the Bank for International Settlements, for sure. Central bank governors at the IMC in Brussels displayed a common wariness of further bridging finance for countries crippled by debt.

The problem, as Fed Chairman Paul Volcker rightly identified it in the same forum, is "getting longer term credits in here from other sources".

In the present environment those longer term credits can come from only one kind of agency, an aid agency. That implies that industrial governments should be prepared to be far more generous in the coming decade than in the last two, not for any altruistic reasons but out of naked self-interest. The United Nations' target of 0.7% of GNP in official development assistance has only been met by one or two of the smaller industrial nations. It's time that record was improved, both on a bilateral basis and through multilateral bodies like the IMF and World Bank.

The alternative is to let the commercial banks sort out the mess as best they can with the indebted nations. That way, the taxpayers in the west may eventually face a higher bill — one that can't be measured in terms of dollars or pounds.

Commercial banks should not expect to be rescued from the consequences of their own lending folly, if indeed that is what they have indulged in. But they are entitled to point out that their lending to Latin America bolstered exports and jobs in their home countries.

□

support to Nigeria's Moslem

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8 The World Bank paradox

In the preceding chapters an attempt has been made to demonstrate that cultural constraints in the Third World block significant socio-economic change. Limitations of demand, as in India, constitute a further, secondary obstacle; and it follows from the social relationships that have been described that the relatively few Indian workers who may be caught up in any industrial expansion are unlikely to be paid much more than the present pittance – an officially estimated average of Rs 3,139 (£174) per year for factory workers in 1973. If widespread, socially beneficial development is to take place, it must be from the village upwards, not from urban centres, in all Third World countries – except small islands in which foreign capital and Western influence are concentrated. As a fundamental policy this principle is neglected, because it offers little or no profit to either the élite of the poor countries or the economies of the industrialized. It would certainly not benefit the West to the extent apparently imagined by Edward Heath when he said in a BBC interview that the richer countries could make the equipment to help the others; for in the only useful development that is possible – and it is doubtful whether even this will occur – the tools needed are negligible.

Few people who talk about Third World development understand what it entails. The Brandt Commission's report is an example.¹ Slogans such as 'mutual interests' and 'partnership' between North and South are accompanied by no more than a vague, token reference to the problems raised in this book.² The commission sees a new approach to international finance and reform of the monetary system as playing a major part in helping both the Third World and the West. Its recommendations are what one would expect from a body consisting of Western politicians, with little experience outside Europe, and shrewd representatives of the wealthy Third World élite. What the commission's rec-

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ommendations amount to is a transfer of wealth from the industrialized to the non-industrialized countries, to the ultimate benefit of all. But, even if we ignore the all-important cultural impediments, it may be seen that the proposal is not practicable. The amount of capital transferred could never be sufficient to provide jobs to match the expectations aroused. And if it were enough, the shortage of skilled workers and of teachers to train them would make it impossible for the funds to be assimilated constructively. As it is, large amounts of Western aid remain unused. The commission's main proposals would not alleviate poverty, but would accelerate the disturbance of Third World structures, which are unable to withstand the shocks of an aggressive, alien culture.

To see development problems as they are it will be useful to look at an example of what is happening in the villages, where most of the Third World people live. Such an opportunity is afforded by an illuminating experiment which was made in the 1970s among the Hausas of Northern Nigeria. A report on the project by the Dutch sociologist, Bert Huizinga,³ contrasts two conflicting approaches to rural development, one of which aims at helping the poor to help themselves, while the other, in practice, abandons them as a lost cause and concentrates on increasing the output of the few who are already relatively prosperous; common to both is the recognition of formidable cultural impediments. Not least, the report reveals sterile World Bank thinking.

The experiment, called the Guided Change Project (GCP), was carried out in the Zaria Emirate, Kaduna State, by the Department of Agricultural Economics and Rural Sociology of the Institute of Agricultural Research (IAR), Zaria. The GCP aimed to find the best possible use of development funds, both to raise production generally and to benefit the very small farmers, who form the majority. It had been apparent for years that successful experiments with IAR crops were not being repeated significantly in the villages. Because of this the team sought ways of fitting certain Western techniques into village life, leaving the social structure intact, for the time being. The target was the village, not the privileged or exceptional individual. This required an entirely new approach to fieldwork.

The policy that the team rejected is known as Research, Development and Diffusion (RDD). This presumes a need determined by the planner. The developer, not the receiver, takes the initiative

in designing a pro doing the physical know virtually no about achieving it ted to laziness, s aspiration; those more able than th

Huizinga and h that the failure c disinterestedness frozen by the soc that, as Polly Hill tively rich farmers poorer⁴ – a point Third World prosp economic aims of performance wou level that was dict

From the outse that have been ide lems, although for teenth century fai practices. Access r remains limited to descendants of a v British weakened t taxes and forbidd tration, torture an rise to the Hausa of patronage, soc belief, characterist the supernatural, The less fortunate mighty, to whom – luck of occult ori off to monopolize or 20 per cent carr inputs.⁶ Large num richer, under a sys kind. But the conse

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of wealth from the industries, to the ultimate benefit of the important cultural impediment is not practicable. The aid may be sufficient to provide employment. And if it were enough, the teachers to train them would be assimilated constructively. The aid remain unused. The aid does not alleviate poverty, but the Third World structures, which are an aggressive, alien culture. They are it will be useful to look at the villages, where most of the opportunity is afforded by the aid made in the 1970s among the report on the project by the contrasts two conflicting approaches of which aims at helping the other, in practice, abandons the notion of increasing the output of the poorer; common to both is the impediments. Not least, the king.

The Change Project (GCP), was initiated in Nigeria, by the Department of Sociology of the Institute of Social Studies. The GCP aimed to find the ways, both to raise production and to help the small farmers, who form the backbone of the villages. The results of successful experiments and significant in the villages. The results of fitting certain Western models to the social structure intact, for the village, not the privileged or the poor, an entirely new approach to

known as Research, Development and Extension, determines a need determined by the community, takes the initiative

in designing a programme and promoting its adoption. Apart from doing the physical work, the farmer is passive and is presumed to know virtually nothing about what he needs or how he should set about achieving it. Failure of the programme to take root is attributed to laziness, stupidity and such psychological factors as low aspiration; those who profit from it are considered to be simply more able than the rest.

Huizinga and his colleagues belong to that school which believes that the failure of the majority to participate results less from disinterestedness or innate incompetence than from their being frozen by the social structure. At the same time they recognized that, as Polly Hill found, the economic aspirations of many relatively rich farmers are vastly different from those of many of the poorer⁴ – a point of great importance in any attempt to assess Third World prospects. They realized that they could not meet the economic aims of all farmers and that the measure of the project's performance would be the extent of participation '*at the benefit level that was dictated by the strategy that the project followed*'.⁵

From the outset the team took note of certain cultural factors that have been identified by anthropologists. The Hausas are Moslems, although forcible conversion in the Fulani *jihad* of the nineteenth century failed to eliminate all their animistic beliefs and practices. Access to the highest ranks of traditional state authority remains limited to those of noble birth; by the same principle the descendants of a village chief may never become commoners. The British weakened the traditional pattern by abolishing occupational taxes and forbidding slavery and punishment by mutilation, castration, torture and death. But the attitudes and values that gave rise to the Hausa structure persist, notably in an elaborate system of patronage, socially decisive subservience to authority and a belief, characteristic of West Africa, that man is powerless before the supernatural, which constantly intervenes in human affairs. The less fortunate attribute their lot either to the will of the Almighty, to whom they frequently refer, or to their lack of *arziki* – luck of occult origin. The tradition of deference enables the better off to monopolize loans from credit organizations; and the top 10 or 20 per cent carry off 60 to 70 per cent of the scarce agricultural inputs.⁶ Large numbers of the poorer are obliged to work for the richer, under a system known as *falle*, to repay loans received in kind. But the consequences of debt can be worse than this seasonal

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bondage; in the Katsina Emirate Polly Hill found that just before a harvest in 1967, 64 per cent of sample households were suffering either 'somewhat' or 'severely' from hunger; they had sold their grain stocks to pay debts and were obliged to buy subsequently at higher prices.⁷ Yet amid all this poverty such is the respect for status that farmyard manure swept up in the smaller compounds is regularly transferred to the larger.

Looking at the general social picture in Hausaland Huizinga sees 'the development of an historically grown and culturally maintained status-stratified society into a [economic] class-stratified one',⁸ So far the process is taking place largely outside agriculture, in which traditional techniques and social patterns have undergone little change. But the combination of trading, credit arrangements and use of patronage constitutes 'an extremely efficient instrument' that enables a minority to advance economically in both village and district communities. Huizinga adds: 'The danger thus exists that the agricultural modernization process itself merely reinforces the existing tendencies towards class formation and thus accelerates the unmistakeable trend towards proletarianization of the peasant population.'

One would need to take an extremely Darwinian view of life to be happy about such a prospect. For, as has been made clear in other chapters, there is no prospect at all that this shattering of an old structure would be part of a larger development that would bring the benefits of an industrialized society. The outcome would be that a very poor majority would be almost totally dependent on a relatively rich minority – a situation similar to that which has evolved in India (see chapter 5).

The GCP sought to establish a development policy that would improve the lives of the majority, rather than worsen them, while at the same time providing the highest overall return on the funds invested. It was necessary, therefore, to overcome the constraints of the social structure. Adopting the line of C. J. Zwart, the team aimed at 'bypassing the impeding aspects of the socio-cultural system . . . without on the other hand causing an abrupt disorganization of the system'.⁹ Beyond that it appears to have been hoped that eventually such projects would themselves lead to social reconstruction by removing the underlying production constraints. In the meantime it was considered sufficient to neutralize the effects

of the present hierarchical of peasant families.

The IAR's Department of Sociology designed the economy for nearly seven experiment in small families. Words are important, since a rigid plan, but was co-techniques, to ascertain the logic of traditional twelve villages of Giwa, 7,638, during 1974–8. The team, led by Europeans, did the work. It consulted the credit arrangements, dis- ga says that their advice attitudes were indispen- perform various admin- some of the meetings had nominated men of their present. In such circumstances which in any case had of the question. Here consulting the community the team imposed ceilings should personally collect graphs to prevent both came to pay for materials opinion at this stage of in the project area do thrive.¹⁰

These consultations such as the origins, age, wives per farmer, education, belongings were spread distribution of inputs, complexity of the initial right temperament techniques, would pe-

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of the present hierarchical structure in order to involve the majority of peasant families.

The IAR's Department of Agricultural Economics and Rural Sociology designed the GCP after having studied village socio-economy for nearly seven years. The project was described as 'an experiment in small farmer development administration'. These words are important, since they emphasize that the team had no rigid plan, but was concerned, while teaching farmers Western techniques, to ascertain their felt needs and to learn more about the logic of traditional methods. The project was carried out in twelve villages of Giwa, with a total male adult population of 7,638, during 1974-8. To gain the confidence of the villagers, the team, led by Europeans, tried to involve them in all aspects of the work. It consulted them from the outset on the formulation of credit arrangements, distribution of inputs, and extension; Huizinga says that their advice and opinions and a knowledge of their attitudes were indispensable. When committees were set up to perform various administrative tasks, tradition made itself felt: at some of the meetings held to elect members, village heads simply nominated men of their choice, apparently with the approval of all present. In such circumstances the setting up of co-operatives, which in any case had already failed throughout Nigeria, was out of the question. Here the team felt obliged to intrude. Instead of consulting the community, which usually meant the village head, the team imposed ceilings on inputs, insisted that each farmer should personally collect his allocation and issued passport photographs to prevent both abuse and denial of receipt when the time came to pay for material issued. As Huizinga kindly put it: 'In our opinion at this stage of its socio-economic development village life in the project area does not allow for the cooperative spirit to thrive.'¹⁰

These consultations and the establishment of important variables such as the origins, ages and relationships of villagers, numbers of wives per farmer, education, size of landholdings and personal belongings were spread over about two years. The subsequent distribution of inputs covered two years of cropping. The complexity of the initial task alone, with its demand for men of the right temperament trained in the necessary statistical and other techniques, would perhaps sober those who appear to think that

The World Bank paradox

the effective transfer of wealth from North to South requires little more than a bank operation.

The basic Hausa social unit is the extended family, which lives in a compound consisting of huts surrounded by a fence made of guinea-corn stalks or a mud wall, to shield women from the eyes of unrelated males. It is socially prestigious for a man to have more than one wife. In a sample of villages 95 per cent of compounds had fewer than ten male adults; the largest single category was those with only one, but one compound had twenty-seven. Some compounds are partitioned to separate nuclear families. Irrespective of these subdivisions, a group may be distinguished by the fact that its members work together and eat from the same pot; the mean number of persons, including women and children, in 248 sampled pots, as sociologists call them, was 6.9 (median 6.0); the lowest was 1 and the highest 23. The compounds are grouped into wards and the wards into villages.

Since a tarred road cut through the project area, giving some villages access to markets, the inhabitants would have been more prosperous and less resistant to innovation than those more isolated. In a sample of four villages the average cultivated area per compound was 2.99 hectares (median 2.17). Twenty-two per cent of adult males, however, cultivated 36 per cent of the total area.¹¹ In the eight villages where baseline studies were made 95 per cent of households (pots) possessed (at least) one hurricane lamp, 63 per cent an iron bed, 73 per cent a cotton mattress, 42 per cent a wireless, 42 per cent a wristwatch and 60 per cent a bicycle. Many farmers did other work, such as building, smithing, carpentry, trading of a kind and Koranic studies, which some considered to be an occupation and some not. In most households at least some of the food crops were sold and women earned extra income, mostly by preparing and selling food and by spinning, weaving and embroidery. Some men were obliged to work to pay *falle* debts, but going out to earn wages was disliked because it reduced status. These activities returned a mean annual income of 89 *naira* (probably worth about £30 in real purchasing terms) per person or 151 *naira* (probably about £50) per adult, with a household consisting of an average of 6.9 persons (or 4.1 adults). But the average is misleading, since 10 per cent of households received 27 per cent of total income.¹²

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only a sketch has been given, was not to launch some grandiose scheme, regardless of the social consequences, such as is found among the glossy brochures of the World Bank. What the team wanted to find out was the most socially beneficial result that could be obtained by providing each farmer with no more than a few bags of fertilizer and packages of pesticides and seed – mostly millet, Guinea corn and groundnuts. The farmers, like most of those in Hausaland, were using the African hoe to till the soil. The team offered advice, which was sometimes rejected for sound reasons, on such matters as distances between ridges, and it explained the use of the packages; but in general it did not press any interference with traditional methods. The aim was to help the farmer solve the problems that he encountered.

After the preliminary studies, the twelve villages were divided into three groups of four – those in which farmers paid cash for inputs, those in which they bought them on credit and those that were to be provided with inputs, credit and extension advice. The membership figures show both the need for credit and a desire to improve production. In the cash villages 36 per cent of farmers joined the scheme, in the credit villages 54 per cent and in the extension-credit villages 74 per cent. The GCP seems to have neutralized social factors in villages in which credit was available, for variables such as the number of fields owned, labour expenses paid, ownership of personal items, and education had an insignificant influence on whether or not farmers joined the scheme. On the other hand higher economic level and literacy in the Hausa language, written in Arabic script, were significant in membership of the cash scheme.

The unexpected way in which the farmers used the fertilizer provided strikingly useful information and justified the GCP's exploratory, rather than merely technocratic, approach. Instead of confining it to the package crops, as the project team proposed, they applied it to pepper, tomatoes, rice, cowpeas and yams. The consequent increases in farmers' incomes were not high enough to make good reading in the usual kind of developer's report and would have been much higher if the fertilizer had been used intensively. But Huizinga and his colleagues found that less intensive use of fertilizer was more economical; returns per bag were considerably higher. The explanation of this result is that Hausa farming methods are so rudimentary that a low or medium use of

The World Bank paradox

physical inputs, especially fertilizer, achieves a higher production per unit of inputs than more intensive application; above about 100 kg of fertilizer per hectare, marginal increases decline.¹³

While the GCP provides the first hope of genuine rural advance to be offered in Nigeria, it is difficult to imagine that the considerable number of teams required for widespread development on similar lines would ever be trained. The project designers realized that their main task was to convince the government that a change in its development policy, in so far as it has one, would pay. But apart from the tendency of the urban élite to support its rural counterpart's attitudes to the lower strata, it is inconceivable, in view of what has been written in chapter 4, that a desire to help the poor, or even to raise production, would be strong enough to overcome civil service lethargy. And without enthusiasm and inspiration from the top, the scheme would not work. It is possible that managers could be trained under an arrangement like that being carried out by the UNDP in Bangkok. But even if this happened, most of the graduates would soon be in the power of district and village leaders. Probably of equal importance, but still an open question, is that Hausa subservience to authority may have a deep psychological origin.

As it is, the team's conclusion that small farmers, adequately guided, could as a whole produce more food than the larger, inevitably received a cold response from the state government, which is under the influence of the World Bank. Since 1974 the bank has been sponsoring the Funtua Agricultural Development Project (FADP), which adjoins the area in which the GCP was carried out. In a letter to the GCP dated 15 May 1978 the FADP Planning Unit said:¹⁴

I think your paper underestimates the influence of vested interests and the local hierarchy. A project on the scale of FADP would not take off at all unless we had their support. This in turn means working through the system rather than outside it. I am not sure whether your GCP approach would work on a FADP scale; purely because those in power would resent their loss of patronage. It is not our job to start social revolutions.

Elsewhere the letter said:¹⁵

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We doubt the long-term effectiveness of group extension. Without suitable glue – like the offer of credit for fertilizer – groups tend to split up. Instead we prefer the ‘trickle down’ approach from farmer to farmer, accepting that some will thereby benefit later than the others. As a consequence, we concentrate on our notorious ‘progressive’ farmers. For organizational and administrative reasons we must choose a reasonably small section at first.

This is a cynical communication. It is common knowledge that the ‘trickle down’ rarely takes place and that the RDD approach, which is what the FADP is pursuing, enables a small minority to get richer while the majority, at best, remain poor. Far from underestimating the force of patronage, the GCP succeeded in bypassing it. And if credit is all that is needed to hold groups together, the World Bank might well supply it, instead of lending huge sums for projects that are often socially destructive, like the one near Bombay, mentioned in chapter 6. As Huizinga says, the FADP men knew that their model was not working, but failed to draw the necessary professional conclusions.¹⁶

The letter is a useful document; for it helps to explain the Zenon-like paradox of the bank’s thirty-five years of proclaiming success for its yield-raising projects, on the one hand, and its incessant lament, on the other, that the end of Third World misery is no nearer. The bank’s 1979 report said:¹⁷

even if the developing countries were to manage to double their *per capita* growth rate, while the industrialized world but maintained its, it would take almost a century to close the absolute income gap between them, so great are the differences in the capital and technological base of the two groups.

The doubling of Third World growth is inconceivable; and short of disaster in the West, the inequality will continue not for a hundred, or a few hundred, years, but indefinitely.

The bank believes that the number of people living in ‘absolute poverty’, 800,000,000 in 1978, excluding those in People’s China, will be reduced to 600,000,000 by the end of the century. If these figures are not a confession of failure, they are a description of it. Even then, the bank’s projections are sometimes as overdrawn as

The World Bank paradox

would be expected from a money-lending organization, staffed by ambitious and prosperous men, which is constantly trying to extend its scope and influence. According to Professor H. W. Arndt, who in general favours the bank's approach, one of its most important forecasts – for Indonesia – 'strains credulity'.¹⁸ The bank presented its projection at a special meeting of Western countries called in May 1975 to buttress the country's finances after the notorious state oil company, Pertamina, had gone bankrupt to the tune of US \$10,500 million – a sum greater than the total 1976–7 national budget and two-thirds of the Gross Domestic Product. The company's financial collapse resulted from the chronic corruption and incompetence of its directors, whose numerous, futile enterprises included an extravagant and uneconomic steel plant, bought from hard-selling Germans in what was described as 'the biggest order of all time'. The bank sought and obtained increased aid to rescue Indonesia's ruling junta, which the United States saw as a bastion of its dwindling influence in South-East Asia. This may have been justified strategically, but it had little to do with the bank's ostensible task of 'helping to raise living standards in developing countries'.

Political interests, however, do not always, or even most often, predominate directly in bank policy. Generally the *sine qua non* is that the granting of aid, as it is called, must be consistent with Western economic needs, which are usually seen in the short term, although the overall concept purports to be long-term. Huge construction contracts provide profits and jobs for the West. That much is certain; what is left unexamined is the social and economic effects on the people among whom they are planted. Somehow it is hoped that 'the economic nucleus we are establishing will fan out through the rest of society' – words used by a World Bank man, who was asked in Jakarta what the bank was really trying to do. But for cultural reasons of various kinds the nucleus does not fan out. A few get richer while traditional society is destroyed or damaged, without anything creative being put in its place.

The World Bank's activities rest on the fallacy that Western systems can be grown in or imposed upon any culture. This is a common error; but it is a little less obtusely perpetrated in Europe than in the United States, some of whose diplomats and their families were so overwhelmed by unexpected attitudes in the Third World that in 1978 the State Department engaged a psychiatrist,

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The World Bank paradox

Dr Elmore Rigamer, to treat them for what was described as acute cultural shock. An American working for UNESCO in Jakarta astounded his European colleagues by writing to the Ministry of Education, requesting it to arrange for a mosque amplifier to be diverted, because the early morning prayers woke him up; this, he explained, left him unfit to perform his task of helping to educate Indonesians. Trifling though it is, this anecdote emphasizes the general insensitivity towards alien cultures, which blinds Westerners to the inapplicability of their development plans. The serious consequences of this defect brought criticism from Dr A. S. Chaema, Vice-Chancellor of the Punjab Agricultural University, who was on the staff of the World Bank for fourteen years. He told the author in Ludhiana that the surge of Punjab agriculture in the 1960s (see chapter 9), with which he was associated, had shown that small-scale methods were best for India. Dr Chaema said:

The World Bank do not see this. They do not try to apply it to Bihar, Eastern Uttar Pradesh, Maharashtra and so on. They try to impose a capital-intensive model. They are interested in lending; they create a borrower mentality. Everybody thinks money is cheap. This leads to inefficiency and waste. But I do not mind aid in technology and in equipment we do not make.

In its 1978 report the bank said that it had achieved a 'significant shift in the orientation of Bank lending towards the small farmer'.¹⁹ But the statement was insufficiently detailed to be satisfactory for other than public relations purposes. In Guatemala 'small' appears to include the top three per cent of landowners, each with 112 acres or more, who are to receive one-half of the credit granted under a joint FAO/World Bank programme.²⁰ The bank's attitude to the social consequences of its financial operations has already been described. In general the bank remains a bank and is obliged to minimize risk. In one of its reports, quoted in the *Economic and Political Weekly*, the bank said:²¹ 'Lending only to those with investment opportunities sufficient to produce a significant marketable surplus is perhaps the best way to reduce the level of default.' In other words, it is wise to select the less needy for credit. Such a policy is essential to the bank's solvency, but it has nothing to do with helping the world's poor. The bank's man in Zaria was simply echoing its general policy when he wrote that it

The World Bank paradox

was important to respect the 'local hierarchy'. A bank paper says: 'In many countries, avoiding opposition from powerful and influential sections of the rural community is essential if the Bank's programme is not to be subverted from within.'²²

Dr Chaema's disillusionment with Western concepts of Third World development was shared by Dr A. S. Kahlon, Dean of the Faculty of Basic Science and Humanities at the Punjab Agricultural University. He said (to the author):

I was influenced by Western ideas at Kansas University. It takes a long time after being exposed to Western models to see things differently. The basic error is that the cultural matrix is completely neglected. The difference is not marginal. In my earlier work, as an econometrician, I wrote of capital-intensive models. Most of our teaching in the university was nothing more than those models. . . . Somehow at no stage of my training was I told that those models were developed in Western conditions, particularly those in the United States, and had very little application to the economic and social conditions of developing countries. Nobody said: 'It may not work in your country'. Perhaps I should have questioned the professors; this shows failure on my part. Perhaps we didn't have much time for thinking, with so many courses. I developed rigour there, then had to apply it here. But it was a dozen years before I realized that the models did not apply.

Whichever way it is tackled, socially beneficial rural development in the Third World presents formidable problems. Even cash crops can be agriculturally counterproductive, and monetization can produce social disruption. Writing of the Ivory Coast, Alland says:²³

The Abron, however, are now perched on the edge of violent, perhaps catastrophic change. Since the introduction of cash crops forty years ago, they have decreased their fallow to ten years on the savanna and seven years in the forest. It is already too short for adequate regeneration of the land. . . . The money economy has affected the Abron in other ways as well. Most significant has been the breakdown of the lineage system and the development of private property. There is evidence that this has increased social tensions and the frequency of witchcraft.

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The World Bank paradox

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FAR EAST: INDONESIA

Indonesia tightens its belt

Richard Cowper

Jakarta

Hit by lower oil demand, Indonesia has been forced to undertake a series of stringency measures. Economic growth will be much slower than in the recent past, threatening to push the country back into the ranks of low income earners

In recent months Indonesia has had to introduce a series of crisis measures. On 30 March the government was forced to devalue the rupiah by 27.5% after more than US\$1 billion in capital fled the country in the space of less than four weeks. In the middle of May the government announced that it was postponing four of its most cherished and costly investment projects worth just over US\$5 billion in a bid to ease the growing pressure on the nation's balance of payments.

The key problem is that Indonesia's economy has become overdependent on earnings from petroleum. Last year oil and natural gas accounted for almost 85% of the country's US\$20 billion gross export earnings and 65% of the government's budgetary revenues. When the oil price was set on a seemingly endless upwards spiral Indonesia was the boom economy of south east Asia — a goldmine for foreign bankers, contractors and traders. But in 1982 the country was badly hit by slumping demand for its oil and non-oil commodities, and earlier this year a sharp decline in the international price of crude dealt the economy what is now agreed was a stunning blow.

With record international reserves in the central bank the government was able to muddle through in 1982 without a sharp change in its expansionary course. But the pressures built up steadily. Last year oil production slumped by almost 17% to 488 million barrels and exports of crude and condensate fell by a similar proportion to 319 million barrels. The result was that in 1982 Indonesia recorded its biggest ever balance of payments deficit and a sizeable shortfall in government budgetary revenues.

Economic growth slumped by more than half to a 17-year low of around 3.5%. The deficit on the current account of the balance of payments in the 1982/3 fiscal year ending in March increased almost threefold to an estimated US\$7 billion. In the last 12 months or so total foreign exchange reserves are believed to have fallen by about 40% to less than

three months of non-oil imports.

Early in the year, as bankers began to express growing concern over Indonesia's ability to finance future balance of payments deficits, the government's first reaction was to try to borrow its way out of the problem. In January Indonesia appointed Morgan Guaranty Trust of New York to arrange a US\$1 billion syndicated loan (Asia's second largest commercial credit) and in February asked Dai-Ichi Kangyo bank of Japan to lead manage a syndicated loan worth the yen equivalent of US\$325 million. This was well over the US\$1.2 billion or so raised by the Indonesian Government last year, and was part of a strategy to double straight commercial borrowing to over US\$ 2 billion in 1983.

Second thoughts

Bankers felt that such an increase in borrowing was just about within acceptable limits. Indonesia's foreign public and private debt — now estimated at around US\$23 billion — makes the country the third largest borrower in Asia after South Korea and India and according to Dr J. E. Ismael, managing director of Indonesia's central bank, the sixth or seventh largest developing country borrower in the world. But despite its high ranking Indonesia had a number of things in its favour.

BALANCE OF PAYMENTS

US \$ billion

	Visible trade			
	Exports (fob)		Imports (fob) total	Current account balance
	total	oil & LNG		
1978-79	11.4	7.4	8.4	-1.16
1979-80	17.5	11.3	9.8	+2.20
1980-81	21.8	16.2	13.2	+2.13
1981-82	23.1	18.9	18.2	-2.50
1982-83 est.	19.9	16.5	20.5	-6.80

Source: Indonesian monetary authorities and IMF.

FAR EAST: INDONESIA

INDONESIAN EXTERNAL PUBLIC DEBT
US \$ billion

	1975	1976	1977	1978	1979	1980	1981	1982 ¹
Disbursed and outstanding public debt	8.0	10.0	11.7	13.1	13.2	15.0	15.7	19.0
Debt service ²	0.5	0.8	1.3	2.1	2.1	1.8	2.0	2.5
Commercial and concessional borrowing ³	3.3	3.1	1.7	3.3	4.3	3.8	4.1	4.2
Official reserves ⁴	0.5	1.2	2.4	2.6	4.1	6.5	6.2	4.1
Debt service as % of net exports	10.3	11.4	15.9	18.4	12.0	12.0	14.0	24.0

¹ Unofficial estimates. ² Amortisation plus interest.³ On a signed commitment basis. Much of this will not be drawn down in the year of signing. For example Indonesia's disbursed and undisbursed debt at end-1981 was \$26.8 billion, of which only \$15.7 billion or 59% had actually been drawn down.⁴ Includes gold, use of IMF resources and loans from foreign commercial banks of less than one year maturity.

Source: World Bank, IMF, and Indonesian authorities.

The country is considered politically stable, has little short-term or private overseas debt and its borrowings are still widely regarded as relatively light. Indonesia's debt service ratio, measured as a proportion of exports taking oil and gas on a net basis, is now running at around 24%, less than a fifth of that being run by countries in Latin America which are being forced to reschedule. Unlike many Latin American countries Indonesia has little private overseas debt. Estimates range from US\$5 billion to US\$3 billion. A doubling of straight commercial borrowing to over US\$2 billion in 1983 was, bankers felt, an achievable target though at considerably higher rates than were achieved in 1982. Should Indonesia require more than this, however, many felt that it would meet with some considerable resistance following world-wide nervousness amongst bankers after the Latin American debt crisis and a general flight to quality.

Foreign exchange problems

As a further cut in the oil price seemed more and more likely bankers became increasingly concerned as

to whether even a doubling of commercial borrowing would be enough to finance the deficit. 'Indonesia is facing serious foreign exchange problems. The current account deficit in 1982, 1983 and 1984 will be in the US\$6 to US\$8 billion range, even assuming a modest recovery in the US economy in the second half of 1983... further measures will have to be taken', said the senior economist of one leading foreign bank in February.

Unpalatable measures

The banker was right. With official reserves down to just over US\$4 billion at the end of December Indonesia clearly could not afford a repeat performance in 1983, and when Opec was forced to accept a sharp cut in the international price of oil in March Jakarta was compelled to undertake a series of unpalatable measures to head off what everyone agrees was a looming economic crisis. The government hurriedly began to make contingency plans for a sharp cut-back in its budgetary spending, and following the appointment of a new cabinet in March, devalued the rupiah from 702.5 rupiahs to the US

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FAR EAST: INDONESIA

GROSS DOMESTIC PRODUCTION

Billion rupiahs at 1973 prices

	GDP	% growth
1978	9,483	6.9
1979	9,990	5.4
1980	10,954	9.6
1981	11,810	7.6
1982 unofficial estimate	12,220	3.5
1983 unofficial forecast	12,460	2.0

dollar to 970 rupiahs.

Many felt the devaluation was long overdue. The rupiah had been significantly overvalued for some time, tied as it was so closely to an appreciating US dollar. In the event the government was given little choice. Following the Opec price cut the currency came under intense pressure as the balance of payments outlook worsened and domestic and foreign business confidence in the economy nosedived. Predictions of a devaluation had been rife for months but in late March capital flight turned into a veritable stampede with at least US\$1 billion leaving the country under Indonesia's free foreign exchange system in a period of less than four weeks.

IMF facilities

At the same time the Indonesian government continued to consider actively the possibility of making formal request to the International Monetary Fund for loans of up to US\$600 million. In January

the IMF had agreed to lend Indonesia 69 million SDRs from the country's contribution to the IMF buffer stocks for tin and rubber, though it is as yet unclear whether this has been drawn down. The government is now debating whether to ask the IMF formally for further loans under the organisation's compensating financing facility (CFF) as well as drawing a first tranche of 25% of the 720 million SDR deposit it has with the IMF.

Jakarta has provided the IMF with export figures for the Fund to make a decision as to whether Indonesia's financing problems qualify it for a US\$389 million drawdown under the CFF facility. In addition Indonesia is now looking hard at the possibility of taking a first tranche facility of US\$194.4 million — 25% of its total IMF SDR deposit. Many believe that Jakarta may avail itself of these facilities some time later this year.

Investment postponed

The latest, and perhaps the most dramatic policy measure to be announced by the government, came on 6 May when Professor Ali Wardhana, the country's economics co-ordinating minister, told the nation that four of the country's largest investment projects were to be postponed and a host of smaller projects put under close scrutiny. Despite the fine words of 'rephrasing' it was a heavy blow to the government's ambitious plans to build up a large petrochemicals industry. Effectively put on ice were a

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BANCO DI SARDEGNA

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— AGRICULTURAL CREDIT SECTION
— MORTGAGE CREDIT SECTION
— PUBLIC WORKS CREDIT SECTION

ANNUAL REPORT: Summary 1982

	(million lire)
Total deposits (1)	4,079,317 (+ 30.72%)
— Liabilities with customers	3,266,997 (+ 27.10%)
Funds employed (2)	3,750,616 (+ 27.46%)
— Credit balances with customers	1,429,647 (+ 16.75%)
Net profit for the year	12,724 (+ 71.07%)
Funds and reserves	361,640 (+ 47.89%)
— Monetary adjustment reserves (Law n. 72 of March 19, 1983)	53,879

Branches in Sardinia 63
Other peripheral offices in Sardinia 299
Main branches outside Sardinia: Roma 2, Livorno 1, Milano 1, Genova 1.

(1) Including mortgage, other bonds in circulation, funds of credit institutions and other funds.
(2) Including loans to customers, balances with credit institutions, debentures and other minor items.

FAR EAST: INDONESIA

OIL OUTPUT AND SALES

Million barrels

	Production	Exports (crude)	Domestic consumption
1978	597	462	112
1979	580	411	124
1980	577	379	139
1981	585	383	153
1982 (preliminary)	488	319	150
1983 (unofficial forecast)	450	280	150

Exports are of crude and condensate, and do not include some 45 million barrels a year of products. Domestic consumption is for products only.

Source: Ministry of Mines and Energy, and industry sources.

US\$1.5 billion aromatics chemical plant at Plaju in south Sumatra, a US\$1.6 billion olefins petrochemicals complex in northern Sumatra, a US\$1.35 billion oil refinery at Musi in south Sumatra, and a US\$600 million alumina plant which was due to provide the feedstock to a recently completed US\$2 billion aluminium complex at Asahan, also in Sumatra.

No alternative

Contracts for all these plants had already been awarded and their postponement clearly shows that the government has been prepared to take the tough measures necessary to deal with the changed economic outlook. The project delays have been widely welcomed by both foreign and local economists who believe that a number of important gains will result. These include: a much reduced import bill which will help cut the balance of payments deficit; an essential shift away from capital-intensive low employment investment at a time when many of the nation's 155 million population is experiencing severe economic hardship; and lastly an important reduction in budgetary outlays at a time of much reduced government revenues.

Jakarta's new financial stringency seems set to depress further the state of the Indonesian economy at a time when growth is already low, but few believe that a responsible government had any real alternative. In the next couple of years both foreign and domestic investment is likely to slow and the inevitable decline in government spending, which in the past has had such an important effect on the overall level of economic growth, will also have a

GOVERNMENT FINANCE

Billion rupiahs

	Fiscal years to 31 March		
	1979	1980	1981
Revenue	4,339	7,016	10,405
Expenditure	4,461	7,175	11,504
Deficit	-122	-159	-1,099
Financed by:			
Domestic borrowing	...	2	40
Foreign borrowing	111	302	1,023
Cash balance	11	-145	36

Source: IMF

... less than 1 billion

debilitating effect. Such measures however will ensure that Indonesia does not run into the awesome problems faced by such spendthrift oil economies as Mexico.

In 1981 Indonesia managed to pull itself up into the ranks of the middle income countries as classified by the World Bank. But some now fear that the decline in the oil price could push Asia's largest oil exporter and Opec's most populous nation back into the ranks of the low income countries.

Few economists believe that growth will be more than 2% in 1983 — a sharp contrast to the average of around 7.5% recorded over the last decade. With 2 million new jobs to find each year and 3 million new mouths to feed this is bound to bring increased hardship for the 60 million or so Indonesians still living below the poverty line in this the world's fifth most populous nation. It will also mean smaller pickings for foreign bankers, contractors and traders many of whom over the last few years made enormous profits in a country which seemed to come up with a never-ending supply of multi-million dollar projects.

Amidst all the gloom, however, there is perhaps one glimmer of light. The government has now been forcibly made to realise that it has to plan the development of a much less lopsided (oil-dependent) economy and reduce its unrealistic ambitions of setting up a massive capital-intensive industrial base which left many of the nation's poor peasant farmers and urban unemployed out in the cold.



CORRESPONDENTS THROUGHOUT THE WORLD

中國農民銀行

THE FARMERS BANK
OF CHINA

HEAD OFFICE & FOREIGN DEPARTMENT
53 HUAI NING STREET, TAIPEI, TAIWAN,
REPUBLIC OF CHINA
Cable Address: "FARMERSBANK"
Telex: 21610, 11841 Tel: 3110881-9

A leading bank of Republic
of China handling all banking
transactions, nationally and
internationally.

International Banking

INTERNATIONAL DEBT

THURSDAY, FEBRUARY 17, 1983

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FI-
NANCE AND MONETARY POLICY,

Washington, D.C.

The committee met, at 9:30 a.m. in room 538, Dirksen Senate Office Building, Senator John Heinz (chairman of the subcommittee) presiding.

Present: Senators Heinz, Gorton, Mattingly, Hecht, Proxmire, Riegle, Dodd, Sasser, and Lautenberg.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Today the subcommittee will hold the third of its oversight hearings on the international financial situation and the participation of the United States in the International Monetary Fund. So far we have heard from the administration, bankers, and bank critics. Today we will receive testimony from the bank regulators. Our witnesses are distinguished, and it is an honor to have them here today.

The role of the Nation's bank regulators in the current crisis is direct and significant. Indeed, many critics have argued that the U.S. bank debt problems would not have gotten to their present dangerous stage had our bank regulators not been asleep at the switch. The primary mission of our bank regulators is the safety and soundness of our banking system. Yet, we have been told of bank after bank whose entire capital is exposed in one or two or three countries, shaking international borrowers. To say the least, therefore, this has hardly been bank regulation's finest hour.

This committee has received information that countries that are now in deep financial trouble have been using the agencies and branches of their banks to draw billions of dollars out of our Federal funds market to finance their own foreign exchange imbalances. In clear violation of the purpose of this market, the Federal funds market as it is called, those foreign agencies withdrew as much as \$10 billion, while both U.S. regulators and banks were either ignorant of these transactions or failed to respond to the risks that they posed.

On Tuesday, Mr. Martin Mayer testified and described this episode as "a disgraceful spectacle of the big New York banks and, indeed, the Federal Reserve, leaning on our regional banks to continue the dangerous practice of selling Federal funds to foreign purchasers who were using them for purposes quite illicit by the generally accepted terms and conditions of this market."

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This regulatory failure, if the record is accurate as described, is not unique. What we have is an international financial crisis brought on by a failure to stop at the prudential limits, even though the purpose of regulation is to determine just what those prudential limits are. Mexico did not get into as much financial difficulty with its first \$40 or \$50 billion of debt as it did with its last \$10 or \$20 billion of debt. Likewise, it is hard to believe that there is anything that could be called an effective country limit if what we discover, as we did on Tuesday, that our largest bank in the United States has 100 percent of its capital exposed in just one country, Brazil.

Having noted this, however, I must add that if our regulators aren't clear on the fact that the mission that we have chartered them to achieve is that of safety and soundness of our banking system, then clearly Congress is going to have to take some additional steps to make what we thought was apparently clear more clear. And several of my colleagues and I do plan to introduce legislation. Indeed, we have introduced legislation, in addition to any legislation that will come before us for the IMF increase, to direct bank regulators toward these kinds of problems. Yesterday Senator Proxmire and I did introduce a bill that targets what we believe to be three of those needs.

Let me comment briefly on that legislation. First of all, the bill would empower the Federal Reserve to establish firm guidelines on country lending limits. The legislation does not attempt to arbitrarily assign those limits itself. It would allow the Fed to do that. That is in keeping with advice we received from Secretary Regan earlier this week where he agreed that it is appropriate for Congress to require the Fed to establish loan limits but warned against Congress doing it.

Second, the bill would mandate that the Federal Reserve require banks to establish special loan loss reserves to be charged against bank capital whenever the Board determines that the aggregate amount of external debt incurred by the public and private borrowers in a country is at a level where there is a substantial likelihood that such debt cannot reasonably be expected to be repaid. Again, that would be left to the Federal Reserve Board's judgment as to when such a point is reached and what the amount of those reserves should be.

Finally, the bill calls upon the Federal Reserve to promulgate regulations to require that fees resulting from loan reschedulings should be amortized over the life of the loan rather than taken and recognized as one-shot earnings. This provision would insure that earnings statements more accurately reflect the quality of both the bank earnings and assets and would minimize the incentive for bank syndicators to continually be under pressure to make one syndication after another in order to make profits look better and better.

These provisions, I believe, will make it clear to our bank regulatory agencies, including the Fed, what congressional intentions are, while still giving them the flexibility to implement these directives according to their special knowledge and experience. I would like to emphasize that I and Senator Proxmire and the other members of this committee are open to suggestions for better ways to deal

with these issues. But my primary purpose in resolving our current crisis, we are not repeating it is not repeated.

Let me yield at this point to Senator Proxmire who I understand has an opening. Senator Proxmire has to make sure that this committee will not operate if we don't get a chance to turn on the microphones.

OPENING STATEMENT

Senator PROXMIRE. Yes, I would like to make a pitch for more spending.

Mr. Chairman, I want to make a pitch for more spending in the morning of our hearing scheduled for tomorrow concerning the foreign lending limits. I am sure that regulatory changes are going to be approved. For that reason, I am introducing the International Lending Limits Act that we have introduced.

Let me cite just a few facts about the adequacy of our present regulatory system.

First, the nine largest U.S. banks have lost their capital to the non-oil developing countries.

Second, these same nine banks have lost their capital to just three countries: Brazil, according to the Federal Reserve, and the figure is 130 percent.

At least one large U.S. bank has lost its capital loaned to Mexico alone.

Even though danger signals are flashing, U.S. banks increased their foreign exposure in the first half of 1982 by \$3.8 billion, an increase of 21 percent.

Over the last 4 years, our foreign exposure to oil LDC's at an annual rate has increased by only 9 percent.

Mr. Chairman, as we go to the answer to a very simple question: How is it possible for our banks to be exposed on foreign loans with no limits? As far as I can tell, the regulators have failed. They advised, they monitored, in fact, they did everything that is to regulate.

One reason for this abyss is the division of authority among the regulatory agencies. When authority is divided, the energy of the regulatory agencies is divided. When authority is divided for the total foreign debt portfolio, one agency can be held accountable.

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record is accurate as described, is an international financial crisis at the prudential limits, even is to determine just what those not get into as much financial difficulty of debt as it did with its last one, it is hard to believe that there is an effective country limit if when say, that our largest bank in the world has its capital exposed in just one

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with these issues. But my principal concern is that, in addition to resolving our current crisis, we must do our utmost to insure that it is not repeated.

Let me yield at this point to my colleague, Senator Proxmire, who I understand has an opening statement. And then I understand Senator Proxmire has to go to the Rules Committee to make sure that this committee will be operating at the first of March. It won't operate if we don't get any money from the Rules Committee to turn on the microphones.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Yes, I feel pretty hypocritical. I'm going to make a pitch for more spending.

Mr. Chairman, I want to congratulate you for devoting a full morning of our hearing schedule to hear from the bank regulators concerning the foreign lending issue. I think you will agree with me that regulatory changes are needed if the IMF quota increase is to be approved. For that reason, I was glad to join with you in introducing the International Bank Lending Reform Act that we have introduced.

Let me cite just a few facts that raise serious questions about the adequacy of our present regulatory system.

First, the nine largest U.S. banks have loaned 222 percent of their capital to the non-oil developing countries as of mid-1982.

Second, these same nine banks have loaned over 112 percent of their capital to just three countries—Argentina, Mexico, and Brazil, according to the Fed figures. I have seen other reports indicating the figure is 130 percent.

At least one large U.S. bank reportedly has 78 percent of its capital loaned to Mexico alone.

Even though danger signals were apparent to all but the wilfully obtuse, U.S. banks increased their exposure in Mexico during the first half of 1982 by \$3.8 billion. This represents an annual rate of increase of 21 percent.

Over the last 4 years, our banks increased their loans in the non-oil LDC's at an annual rate of 21 percent, while the capital of these banks increased by only 9 percent a year.

Mr. Chairman, as we go through these hearings, I think we must get the answer to a very simple question: Where were our regulators? How is it possible for our banks to have become so overexposed on foreign loans without the regulators blowing the whistle? As far as I can tell, the regulators were not unaware of the problem. They advised, they monitored, they cajoled, they encouraged—in fact, they did everything except what they are paid to do, and that is to regulate.

One reason for this abysmal failure of our regulatory system is the division of authority among three separate and independent agencies. When authority is divided three ways, much of the time and energy of the regulators is spent bickering among themselves. When authority is divided three ways, no agency feels responsible for the total foreign debt position of U.S. banks. And in the end, no one agency can be held accountable by the Congress.

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One of the key features of the Heinz-Proxmire legislation is that it assigns authority over international lending to a single agency—the agency that has the greatest expertise in international finance—the Federal Reserve Board. I am convinced that we will never get the job done unless we assign responsibility to one agency, give it a clear mandate to regulate foreign lending, and hold it strictly accountable.

Mr. Chairman, I look forward to hearing the testimony from today's witnesses and to developing a continuing discussion of the legislation we have put forward. I will be back shortly.

Senator HEINZ. Senator Lautenberg.

Senator LAUTENBERG. I have no opening statement.

Senator HEINZ. Senator Dodd.

Senator DODD. Nothing.

Senator HEINZ. Chairman Volcker, this is the second time the committee within about 24 hours has had a chance to welcome you. Welcome back.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Thank you. I wonder if it's worth reading even the relatively short statement I have after you have had the testimony that you have had.

Let me just pick out a few points. I outline, in the first few pages of my statement, the general approach toward this problem of pressures in the international financial system. I have gone over that before, and I'm sure others have, with this committee or with other committees.

I submitted to the committee earlier the statement that I delivered before the House Banking and Currency Committee which discussed at length some tentative ideas in connection with the supervisory area. I did not plan to review that in my preliminary statement today because you have that material.

But let me just say, in connection with this problem that has arisen, that I think much of the lending of banks over this past decade has reflected a constructive response by the financial system to the need to ease adjustments associated with the world oil crisis. International lending will continue to have to play an important role in a developing world economy.

Of course, there can be excesses, and some of the lending proceeded on assumptions that, in retrospect, seem invalid. None of us enjoys perfect foresight, and it remains central to our financial and economic system that the individual lenders reach their own credit judgments.

But it is the responsibility of government to establish and maintain ground rules and procedures that, without stifling the market, provide assurance that the stability of the system as a whole can be protected against the dangers of excessive concentration of risk, and that the element of risk is appropriately weighed. While our present supervisory approaches are aimed at that objective, the rapid development of international lending and today's problems do point to the need for careful review of present policies. Possible modified or new approaches—touched upon in my earlier state-

ment—are under intensive review. I expect to be able to report in a few weeks.

THE DANGER

At the same time, the danger of an abrupt return to a hard fact is few borrowers, and substantial debts accumulated. The process would be doomed to failure. The adjustments to earn access. What may seem logical in demanding payment from a bank in demanding payment strain on the system as a whole within it, could only be damaged.

As I noted earlier, the paring the international debt problems and the private lending organizations—have been acting points of pressures to the first center of this effort, and it is a ship.

The remainder of my statement with the IMF need for course, is a matter that I hope early date. I do not think the ers, financial, political, and escape the responsibility of particular effort, if we want interest that it succeed. It is in here this morning.

I might say, too, Mr. Chairman, of safety and soundness, and I very much welcome fully accept that. It is not areas. At the same time, it system work. There has been air. I think Congress has been looks at problems of this so suppose, before they begin. developed in full-blown form.

Let me just say in that context actions last year in other were not very happy about, considerations. I can think legal lending limits for America that you think is relevant area of export trading companies, but we soundness considerations was as banks got into that area, ly, did not reflect our concern future in that area.

Proxmire legislation is that lending to a single agency—expertise in international financial—am convinced that we will assign responsibility to one regulate foreign lending, and

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CHAIRMAN, FEDERAL
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ment—are under intensive review by the supervisory agencies, and I expect to be able to report conclusions to you in a matter of weeks.

THE DANGER OF OVERREACTION

At the same time, the danger of overreaction—of encouraging inadvertently an abrupt retreat from lending—is equally real. The hard fact is few borrowers, at home or abroad, can suddenly repay substantial debts accumulated over years. An attempt to force the process would be doomed to failure, because borrowers need time to make the adjustments to earn the funds or to restore their market access. What may seem logical and appropriate to an individual bank in demanding payment, if generalized, would place such strain on the system as a whole that it, and the individual banks within it, could only be damaged.

As I noted earlier, the parties immediately at interest in resolving the international debt problem—lenders and borrowers, governments and the private lending institutions, and international organizations—have been acting cooperatively to deal with the major points of pressures to the financial system. The IMF stands in the center of this effort, and it has responded with force and leadership.

The remainder of my statement discusses the importance of dealing with the IMF need for additional resources. And that, of course, is a matter that I hope this committee will act upon at an early date. I do not think that the United States—we are the leaders, financial, political, and economic, of the rest of the world—can escape the responsibility of leadership and participation in this particular effort, if we want it to succeed, and it is in our own interest that it succeed. It is in that context that I am delighted to be here this morning.

I might say, too, Mr. Chairman, you have emphasized the importance of safety and soundness and the responsibility of the regulators, and I very much welcome your statement in that connection. I fully accept that. It is not only relevant in this area but in other areas. At the same time, it has to be balanced against letting the system work. There has been a certain deregulation wind in the air. I think Congress has been involved in that as well. When one looks at problems of this sort, the time to worry about them is, I suppose, before they begin. It is a little late when the problem has developed in full-blown form.

Let me just say in that connection, the Congress itself took some actions last year in other areas that we in the Federal Reserve were not very happy about, in terms of future safety and soundness considerations. I can think of a very considerable expansion of the legal lending limits for American banks. That seems to be an area that you think is relevant in the international area. And in the area of export trading companies, we were not opposed to export trading companies, but we wanted to make sure that safety and soundness considerations were clear in the minds of the Congress as banks got into that area. The legislation that was passed, frankly, did not reflect our concerns as to what might develop in the future in that area.

I suspect you will be faced with legislation this year sponsored in part by the banks which are looking for additional powers. I think some of those will be well justified. I don't know precisely what they are going to ask for, but I would suggest you look at those areas with some care in connection with your obvious concern about the future implications for the safety and soundness of the banking system. I think you might want to look at the reverse, too, to nonbanking institutions, nonregulated institutions, that in a sense are getting into the banking business through the back door and going around the regulatory structure.

I think this is an area that we have to work on, and I share the concerns that you expressed at the start, not just in this area but in other areas.

Senator HEINZ. Mr. Chairman, the process you have just described from the export trading company legislation which was enacted in September or October—I think the President signed it in early October of last year—the increase of the lending limit was also something that came in very late last year—

Mr. VOLCKER. That is correct.

Senator HEINZ [continuing]. Clearly antedated the kinds of problems we are talking about with the international banks.

Mr. VOLCKER. Yes.

Senator HEINZ. When we had Secretary Regan before us on Monday, he was asked a very direct question, exactly the one you raised: With deregulation in the wind, did some of this deregulation spill over in any way into international bank lending? And he said no, absolutely not. The main spirit of deregulation, he pointed out, had been aimed at deregulating the retail depositors' kinds of concerns, and he indicated very clearly that in terms of international bank lending there had been no signals sent and no legislation sent down or acted upon, other than those two you mentioned at the very end of last year, that in his judgment had any influence on this. Would you agree or disagree with that?

ADDITIONAL LEGISLATION UNDER REVIEW

Mr. VOLCKER. If I understand you correctly, the regulators, to the best of my knowledge, have not requested any legislation heretofore on this international lending area. We have, obviously, among us, been working on this problem and, indeed, we have been rather intensively involved in recent years, reflecting some of the concerns that you suggested. Someone can look back and say—I look back myself and say—"Were we forceful enough? Were we aggressive enough?"

That is obviously a legitimate question in retrospect. I don't think it's correct to say we had no concern. We have spoken about it in public as well as in private in connection with banks. We have not asked for additional legislative authority, that is quite clear. What we have under review is whether we need additional legislative authority or not; whether we can use our other regulatory supervisory instruments is a matter which is under consideration right at the moment.

Senator HEINZ. Well, clearly, you are taking seriously the question of whether our system has resulted de facto in some kind of

failure of bank regulation, some kind of failure, with Fed or the FDIC—

Mr. VOLCKER. No, no.

Senator HEINZ [continuing]. I think it poses the general question of how can we come about in one way or another to know how to regulate the banks, the regulators, or the regulators. Of the two, which would be the better? Or the other?

Mr. VOLCKER. You say that we are not in the business of instructing the banks.

Senator HEINZ. Instructing the banks.

Mr. VOLCKER. All right. First of all, you say that everything is relative in the part of the world in which we are to play in the world economy, the United States, and the United States. One is to suppose, and how to strike a balance, a general philosophy that in the end belongs to the banks. But we exercise discretion.

I think we can learn from this experience, and from the future; that is our common goal.

Senator HEINZ. What I liked to have had better in any way, you don't admit that, you don't admit the problems. From our point of view, we understand that given the other regulators with, the conclusion would be to us.

Mr. VOLCKER. We are not. Since I have already in other points.

Senator HEINZ. I think that is the statement.

Mr. VOLCKER. I have.

Senator HEINZ. Let's say, in your view, there are four. I think that is the statement. But let's state it.

To expand a little bit, who on Tuesday testified of the Federal funds in the banks. Funds borrowed as \$445 billion on one day, in 1981-82, but they used their access to the change deficits, and so

islation this year sponsored in for additional powers. I think I don't know precisely what would suggest you look at these with your obvious concern for safety and soundness of the want to look at the reverse, too. regulated institutions, that in a business through the back door future. ve to work on, and I share the start, not just in this area but

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ON UNDER REVIEW

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are taking seriously the que- ulted de facto in some kind of

failure of bank regulation. Let's assume for the moment there is some kind of failure, without pointing fingers at whether it's at the Fed or the FDIC—

Mr. VOLCKER. No, no, that is not the point at all.

Senator HEINZ [continuing]. Or someplace, but let's just ask ourselves the general question, which is this: If there is a failure, it can come about in one of two ways. Either the regulators in fact know how to regulate but the banks didn't take the advice of the regulators, or the regulators failed to properly instruct the banks. Of the two, which would you think more nearly describes the problem?

Mr. VOLCKER. You say, "properly instruct the banks." In some sense we are not in the business or haven't conceived of ourselves in the business of instructing the banks.

Senator HEINZ. Instructed in the educational sense of the word.

Mr. VOLCKER. All right, in the educational sense of the word. First of all, you say that this international lending is a failure. Everything is relative in this world, I guess. International lending is part of the world in which we live. It has a very constructive role to play in the world economy. It can play a role to the benefit of the United States, and it has played a role to the benefit of the United States. One is talking about a sense of proportion here, I suppose, and how to strike that proportion consistent with the general philosophy that in the end the credit decisions of the banks belong to the banks. But in some cases limit can be put upon that exercise of discretion.

I think we can learn out of this experience. We are learning out of this experience, and we hope to have a good balance in the future; that is our common goal.

Senator HEINZ. What you are saying is that you would have liked to have had better foresight, you don't admit that you failed in any way, you don't admit that you don't have adequate information, you don't admit that you didn't tell the banks they had some problems. From our point of view, Mr. Chairman, I hope you understand that given the mission that we charged the Fed and the other regulators with, to insure safety and soundness, that your conclusion would to us be soft-pedaling the problem.

Mr. VOLCKER. We are not suggesting you soft-pedal the problem. Since I have already interrupted, perhaps I could make a couple of other points.

Senator HEINZ. I thought you had finished with your opening statement.

Mr. VOLCKER. I have. Go ahead.

Senator HEINZ. Let's turn to some of the specific issues. To my view, there are four. I referred to all four of them in my opening statement. But let's start with the one on Federal funds.

To expand a little bit on my reference, it was Mr. Martin Mayer who on Tuesday testified to what he thought to be the gross abuse of the Federal funds market by agencies and branches of foreign banks. Funds borrowed in that market apparently reached as high as \$445 billion on one occasion last September. According to Mr. Mayer, in 1981-82, branches of the Mexican and Brazilian banks used their access to this market to fund their nations' growing exchange deficits, and some \$10 billion seems to be involved in doing

that. He claimed that that happened, with Mexican-Brazilians paying an extra eighth.

NATION'S FINANCIAL SYSTEM IN JEOPARDY

But it seems, irrespective of what they paid, that practice seems to put our Nation's financial system in jeopardy, and clearly this is what I call overnight money. My understanding is it's not supposed to be used for financing the deficits of other countries, and my question is: Shouldn't Fed funds be clearly restricted solely to domestic purposes?

Mr. VOLCKER. I don't think you can restrict Federal funds in quite that way. Let me say I think the focus on Federal funds as a technical description of this is much too limited. But I think Mr. Mayer has put his finger on a problem, which I would refer to as the interbank deposit problem as well as the interbank lending problem. Most of this is not Federal funds; it is interbank deposits. It may be lent for 1 month, 3 months, 6 months.

There is no question that foreign banks in general have expanded rapidly in the United States in recent years, that banks from some developing countries have participated in that expansion—most of it quite recently—and that, looking at the situation now, as I see it, those banks or their United States branches and agencies were not adequately diversified, that in fact they had a large proportion of their assets in loans to their home countries. I think that that is basically the problem that Mr. Mayer was referring to.

I think, over a period of time, that does raise questions about the appropriate method of supervision of these banks; that is certainly an area of concern to me and that we will want to be looking at. I would point out that we have no direct supervisory authority over those institutions. While legally they can be supervised directly by a Federal agency, most of them are under State supervision, and that is specifically provided for in the International Banking Act, so in an immediate supervisory sense, we and the other Federal agencies are in a secondary position. This has grown up rather rapidly as part of the general policy of permitting foreign banks to operate freely in the United States.

There is another aspect that runs through all of this that needs a lot of emphasis. From the standpoint of the general banking system, it really doesn't make a lot of difference whether those banks are operating in New York, San Francisco, Los Angeles, Chicago, whether they are operating in London or the Cayman Islands. Our regulatory authority over foreign banks, speaking broadly—whether State or Federal authority—obviously runs to their operations in the United States.

If there is a matter of concern here—and I think that there is in the broader sense—it is an example of the fact that in the international banking area, to really be successful you've got to get cooperation and coordination over a large number of countries, and that obviously complicates the problem.

Senator HEINZ. Well, the first question is: Is this a sound or unsound practice to let countries that have severe foreign exchange, balance of payments, risky debt repayment problems, use the ulti-

mate in short-term borrow to finance a continuing loan.

Mr. VOLCKER. I haven't focus is probably wrong. They were short-term deposits.

Senator HEINZ. Very short. Mr. VOLCKER. But I'm not although I'm sure they American banks are. Deposits.

Senator HEINZ. This question those very short funds.

Mr. VOLCKER. I am suggesting. But the problem is the sale it or overnight Federal funds.

Senator HEINZ. Surely international lending system means things that are very.

Mr. VOLCKER. All banks is the diversification on having appropriate liquidity.

I can sit here, and ask liquidity? Was there adequate operations in the United States risky countries you know this thing is you've got to.

Senator HEINZ. I agree down this practice, because in fact, \$10 billion was of overnight deposits—

Mr. VOLCKER. That is right.

Senator HEINZ. Mr. Chairman, plain to you my concern is the cans or the Brazilians the gentinians, I guess, actually sorry, we are just not think that that might be a particular market?

Mr. VOLCKER. Yes.

Senator HEINZ. All right.

Now, your second point this. This is an international only players in the game it doesn't seem to me that in dangerous practice.

Mr. VOLCKER. Well—

Senator HEINZ. I'm just stand where I'm coming.

Finally, it seems to me appropriate authority to you—and this is my question something about this?

Mr. VOLCKER. We may, and that is certainly

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mate in short-term borrowing, overnight deposits and transactions, to finance a continuing long-term problem.

Mr. VOLCKER. I haven't got a statistical analysis, but I think your focus is probably wrong if you're talking about overnight deposits. They were short-term deposits, no doubt about that.

Senator HEINZ. Very short.

Mr. VOLCKER. But I'm not so sure they were so much overnight, although I'm sure they are in the Federal funds market like the American banks are. Basically they were financing with bank deposits.

Senator HEINZ. This question is directed principally at the use of those very short funds.

Mr. VOLCKER. I am suggesting that that focus is probably wrong. But the problem is the same, whether it's a short-term bank deposit or overnight Federal funds.

Senator HEINZ. Surely you don't agree that it's good for the international lending system to finance with very short-term instruments things that are very long-term ones.

Mr. VOLCKER. All banks, I'm afraid, do that. I think the problem is the diversification on the other side of the balance sheet and having appropriate liquidity.

I can sit here, and ask in retrospect: Was there appropriate liquidity? Was there adequate diversification on these foreign banks' operations in the United States? When they get in trouble or are risky countries you know you have a problem. But the nature of this thing is you've got to worry before they get to be risky.

Senator HEINZ. I agree with you, but I think we have to nail down this practice, because I believe it's a very dangerous one. If, in fact, \$10 billion was on loan to just two countries in the way of overnight deposits—

Mr. VOLCKER. That is not true.

Senator HEINZ. Mr. Chairman, just a minute. Let me try and explain to you my concern so you can react to it. And if, as the Mexicans or the Brazilians threatened to do on one occasion—or the Argentinians, I guess, actually did do it for a few days; they said, "I'm sorry, we are just not going to pay anything back"—would you think that that might have a somewhat chilling effect on this particular market?

Mr. VOLCKER. Yes.

Senator HEINZ. All right. That's the point.

Now, your second point was, "Well, other people will be doing this. This is an international financial situation. We are not the only players in the game. Our banks have to be competitive." But it doesn't seem to me that being competitive is a license to engage in dangerous practice.

Mr. VOLCKER. Well—

Senator HEINZ. I'm just making my observations so you understand where I'm coming from.

Finally, it seems to me you have said you don't think this is appropriate authority to do something about this, and I'm asking you—and this is my question—do you want some authority to do something about this?

Mr. VOLCKER. We may. I am not certain that we need it, but we may, and that is certainly one of the areas I want to look at.

we now have a cooperative venture among the three regulatory bank agencies. Arthur Burns, who was a long-time critic of the three-agency regulatory structure, said the system causes competition in laxity.

REGULATORS NOT FORCEFUL ENOUGH WITH BANKS

It's clear from your own statement and the GAO report that the regulators may not have been forceful enough over the years with the banks in foreign lending concentration.

What is your reaction to our proposal to provide guidelines on country risk lending in the Federal Reserve exclusively so that you don't have this division of authority?

Mr. VOLCKER. I think on the face of it putting the authority in one agency has advantages, whatever agency that may be. Looked at from that point of view, it's very straightforward. I think the only question that arises is whether you feel that that is consistent with the more general approach toward banking regulation and whether it could be fit into the existing division of authority. I think you could do it either way.

Looking at this problem in isolation, I think there are advantages in the approach of centralizing. But the question doesn't stop there; it's whether you want to accept or reject the more general banking supervisory structure, because I think we can work it—

Senator PROXMIRE. Well, we have made exceptions to the division—the bank holding companies, for example, are concentrated in the Federal Reserve Board.

Mr. VOLCKER. That is correct. There were exceptions made before.

Senator PROXMIRE. That has worked very well. I don't think anybody now argues that ought to be divided between the three agencies. I haven't heard too much of that. I suppose there is some of it.

Mr. Chairman, loans to the lesser developed countries run into the hundreds of billions of dollars. Most of the economies of these countries are in poor shape. How realistic is it to think that a program such as the IMF has, with \$40 billion of additional capital, is going to allow those debts to be repaid? Isn't it more realistic to face the fact that some of those loans will have to be written off as a loss to the banks and others?

Mr. VOLCKER. No, I don't think so, for the major borrowers we are talking about. The IMF programs and approaches and resources in and of themselves, are not going to lead to those debts being paid off; that is not the purpose of the IMF resources and the IMF lending. What will enable those loans to be moderated, if not paid off, by and large, is to have the debtors growing into a strong creditworthy position; they don't have to pay off all their debts. You want to have a climate in which those countries are so evidently creditworthy that they can finance themselves in the market, not one in which they will get themselves in difficulties in the future. You want to return to a more normal market climate with a debt burden that they can readily service. That gets you into questions, over time, of the growth of the world economy, on the one side, and their own policies on the other side.

Senator PROXMIRE. I don't get some kind of have to at least write

Mr. VOLCKER. If you then you imply an eno

Senator PROXMIRE. The world scene is 1 percent

Mr. VOLCKER. Growth but I don't think that problems. I don't think

Senator PROXMIRE. I is to face the fact that

Mr. VOLCKER. There ing, in these major c sources and have then ing these debts. I thi those debts can be ma time, there's no questi selves. The debts are n had been mounting.

Every one of those euphemistically called grams—which will be economy—that are go freer way and enable their debt or with onl those ratios of loan e can see the ratios of d want to measure it—i grams, and I think it's

Senator PROXMIRE. I when these debts coul

Mr. VOLCKER. We do the years as to how M or how Brazil would r jections that we think reasonable assumption

Senator PROXMIRE. tee for the record?

Mr. VOLCKER. To th about to add, the next

[The following info record:]

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CEFUL ENOUGH WITH BANKS

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Senator PROXMIRE. It's a matter of timing, too, isn't it? If you
don't get some kind of recovery in the next 3 or 4 years, you might
have to at least write down some of these debts and take some loss.

Mr. VOLCKER. If you project a pessimistic world economic scene,
then you imply an enormously difficult problem.

Senator PROXMIRE. Well, the OECD estimates of growth on the
world scene is 1 percent growth in the next year.

Mr. VOLCKER. Growth estimates are sluggish for the next year,
but I don't think that in itself means we can't work out of these
problems. I don't think that at all.

Senator PROXMIRE. I'm just suggesting one way to work out of it
is to face the fact that you may have to take these losses.

Mr. VOLCKER. There is always an ultimate risk, but we are talk-
ing, in these major cases, of countries that have very great re-
sources and have themselves attached very high priority to serv-
icing these debts. I think objective analysis can demonstrate that
those debts can be manageable over a period of time. They do need
time, there's no question about that, and they need to adjust them-
selves. The debts are not manageable at the rate of speed that they
had been mounting.

Every one of those countries has embarked upon a very strong,
euphemistically called, "adjustment program." And it is those pro-
grams—which will be greatly facilitated by growth in the world
economy—that are going to restore their access to markets in a
freer way and enable them to proceed without a further buildup of
their debt or with only a modest buildup of the debt. You can see
those ratios of loan exposure to banks' capital improve, and you
can see the ratios of debt service to exports, to GNP—however you
want to measure it—improve as well. It's the aim of all these pro-
grams, and I think it's preeminently possible and probable.

Senator PROXMIRE. Has there been any projections as to how and
when these debts could be paid back in a likely and orderly way?

Mr. VOLCKER. We don't have any projections that go out through
the years as to how Mexico would repay \$80 billion worth of debt,
or how Brazil would repay \$80 billion worth of debt. We have pro-
jections that we think are consistent with our own programs, and
reasonable assumptions about the world economy—

Senator PROXMIRE. Will you make those available to the commit-
tee for the record?

Mr. VOLCKER. To the extent that I can—in the short term, I was
about to add, the next year or two.

[The following information was subsequently submitted for the
record:]

Prospects for Debt Repayment,
Commitments to Balance of Payments Adjustment,
and Projections of Debt Burdens--Selected Latin American Borrowers

For a transitional period, major Latin American borrowers are likely to require an increase in their outstanding indebtedness to foreign banks. In all cases, the overall external debt of these countries is expected to grow by less than ten percent annually in 1983 and 1984. However, within this period, each of the major borrowing countries can be expected to restore orderly, unrestricted payment of debt service to their foreign creditors on a loan-by-loan basis.

Brazil experienced a current account deficit of about \$14-1/2 billion in 1982. Brazil has embarked on an IMF-approved program which is designed to reduce that deficit to \$7 billion in 1983 and \$5 billion in 1984. As a result, requirements for new foreign borrowing will fall to much lower levels, and Brazil's external debt will grow less than half as rapidly as the projected value of its exports. Taking account of declines in world interest rates that have already occurred, Brazil's debt service ratio (scheduled amortization requirements on medium- and long-term external debt plus total external interest payments divided by annual receipts from exports of goods and services and transfers) will fall from about .79 in 1982 to .62 in 1983 (which equals Brazil's average debt service ratio during 1978-81) and to a projected .55 in 1984.

Mexico's current account deficit fell from \$13 billion in 1981 to about \$6-1/2 billion in 1982. In accordance with its recently adopted stabilization program, the current account deficit was expected to decline to about \$4 billion in 1983 and 1984. Mexico's reduced needs for financing the current account, in addition to policy measures to halt the large outward capital flight witnessed in 1980-82, should reduce the growth of external debt to about

6-8 percent annually during 1982 is estimated to have been 1980 or 1981 but lower than Mexico's IMF program imply 1984.

Argentina's current account deficit rose to \$2-1/2 billion in 1982 in 1983 and 1984. While Argentina pay off external arrears to capital flight of 1980-81 ratio rose sharply from a bunching of scheduled maturities .95 in 1983 but fall to a

Senator PROXMIRE. statement, the nine billion capital out in loans to Argentina, 43.5 percent. What would be a ratio tries?

Mr. VOLCKER. That get into when you talk will notice on that to same in 1982 as it was 1977, but it is clear changed is other country year period. That is r

Senator PROXMIRE sound in 1 year but r

Mr. VOLCKER. Yes, its own payments problems. Obviously, I'm not suggesting just good in fair weather having rainy weather 1 year may not look put in that kind of l

FOREIGN COUNTRIES

Senator PROXMIRE into three categories weak, moderately strong Brazil, and Argentina and, if so, when the

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Repayment,
Payments Adjustment,
and Latin American Borrowers

Latin American borrowers are likely
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6-8 percent annually during 1983 and 1984. Mexico's debt service ratio for 1982 is estimated to have been about .61, which was considerably higher than in 1980 or 1981 but lower than during the late 1970s. The projections underlying Mexico's IMF program imply debt service ratios of about .59 in 1983 and .50 in 1984.

Argentina's current account deficit fell from \$4-1/2 billion in 1981 to \$2-1/2 billion in 1982 and is projected to fall to \$1 billion or less in 1983 and 1984. While Argentina faces additional near-term financing needs to pay off external arrears that have accumulated since April 1982, the massive capital flight of 1980-81 has subsided. Argentina's estimated debt service ratio rose sharply from about .50 in 1981 to about .95 in 1982. Because of a bunching of scheduled maturities in 1983, that ratio is likely to remain about .95 in 1983 but fall to about .60 in 1984.

Senator PROXMIRE. Now, according to Table V attached to your statement, the nine largest U.S. banks had 112.5 percent of their capital out in loans to Argentina, Brazil, and Mexico: 19.6 percent to Argentina, 43.5 percent to Brazil, and 49.4 percent to Mexico.

What would be a reasonable percentage to each of these countries?

Mr. VOLCKER. That is so difficult to judge, and it's a question you get into when you talk about an arbitrary limit on these loans. You will notice on that table that the Brazilian exposure is about the same in 1982 as it was in 1977. Now, it may have been too much in 1977, but it is clear from that kind of measure that what has changed is other conditions—not the relative exposure—in that 5-year period. That is not true of Argentina.

Senator PROXMIRE. Other conditions might make the situation sound in 1 year but not sound in later years.

Mr. VOLCKER. Yes, and the growth of the economy, the trend of its own payments position, external markets, raw materials developments. Obviously, if one thinks in terms of a lending limit—and I'm not suggesting that—one has to think of limits that are not just good in fair weather but also in rainy weather. We've been having rainy weather recently in these countries. What looks good 1 year may not look so good another year, and if you're going to put in that kind of limit you have to think of both situations.

FOREIGN COUNTRIES PLACED IN FINANCIAL CATEGORIES

Senator PROXMIRE. I noticed that foreign countries are placed into three categories based on their overall financial situation: weak, moderately strong, and strong. Can you tell us if Mexico, Brazil, and Argentina were ever classified weak under this system and, if so, when they were so classified?

Mr. VOLCKER. Let me just say the word "classified" here ordinarily has a different meaning; it's used in banking examination across the board for loss, doubtful or substandard loans.

Senator PROXMIRE. You pick the term; anything you want.

Mr. VOLCKER. It's a good enough term. I just want to avoid confusion with the use of the term "classified" in banking examination, which has a very definite meaning. This is a relative meaning, and I am informed that Brazil and Mexico were in the lower of those groups.

Senator PROXMIRE. Can you tell us when? I'm talking about "weak."

Mr. VOLCKER. Brazil for several years, Mexico more recently, and Argentina around the time of the great conflagration in the South Atlantic.

Senator PROXMIRE. How recently with Mexico? Still?

Mr. VOLCKER. Within the past year.

Senator PROXMIRE. Still classified as weak?

Mr. VOLCKER. Well, you would expect that now.

Senator PROXMIRE. Was this communicated to the banks?

Mr. VOLCKER. It's communicated to the banks in the sense that it affects the kinds of comments made in their examination report.

Senator PROXMIRE. Well, in your judgment—that's why I made that reference to Rex Harrison when I started out. My time is up, but let me just ask this question related to that.

Mr. VOLCKER. I understand your quotation from Rex Harrison. That's one of the things that would concern us.

Senator PROXMIRE. And that's why I follow up by saying, despite the fact that the country classifications developed are confidential, they know it, but the banks don't seem to pay any attention to it. That is confirmed in the GAO study.

Mr. VOLCKER. I don't think that is completely—

Senator PROXMIRE. Why is your regulation so ineffectual in moderating it on behalf of the banks?

Mr. VOLCKER. I'm not sure that is completely fair, but let's stipulate that none of us has perfect foresight in these things. The difficult problem is that something might look good 1 year that won't look so good the next year. Not everybody, including the regulators, is very good at forecasting that. That is the nature of the beast.

Senator PROXMIRE. For Mexico, in June 1980 it was 31.7 percent of capital, and 37.9 in December; 40.8 in June, 44.4 in December, 49.4 in June. And the steady increase, very big increase, occurred after they were classified as weak.

Mr. VOLCKER. There is no question there has been a big burst in lending to Mexico through 1980 and 1981 and running into 1982.

Senator HEINZ. Senator Hecht.

Senator HECHT. Senator, I'm not on your subcommittee so I will relinquish my time to all the committee members.

Senator HEINZ. Very well. I would state, though, that all members of the committee have been invited to this hearing.

Senator Sasser.

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Senator SASSER. T

Chairman Volcker and always like to h

I was reading the may have read the and in that column suppose, of Citicorp weren't going to st supply and he was the money supply i this was going to ca

It occurred to me ing that Mr. Wristo capital to one count deflation just by no tional \$8 or \$9 milli tional Monetary Fu tional system.

It troubles me w that our country ap crease the IMF reso larger debtor nation jeopardized. If we in to a debtor country, lation that the fisc resolved, and they h terity. I don't know have great difficult something about ou austerity is they've mean, I would gu ports—

Mr. VOLCKER. EXP

Senator SASSER [bled nations at a t economy going.

This is a fair and dilemma in this situ

Mr. VOLCKER. I w in a no-win situati where was the enf potent enforcer, and of your question.

There is no quest tries will reduce the major extent in the what?" arises. And derly—as orderly thought out with t tional support in ex system, or from oth and more construct

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STATEMENT OF SENATOR SASSER

Senator SASSER. Thank you, Mr. Chairman.

Chairman Volcker, I am delighted to see you again this morning and always like to hear from you in these hearings.

I was reading the Washington Post a couple of days ago, and you may have read the column, written by a distinguished columnist, and in that column he quoted Mr. Walter Wriston, the chairman, I suppose, of Citicorp., and Mr. Wriston was concerned that you weren't going to stay the course on our limiting domestic money supply and he was afraid you were going to go along and increase the money supply in an effort to bring interest rates down, and this was going to cause inflation.

It occurred to me listening to you testify this morning, and learning that Mr. Wriston's bank has loaned over 100 percent of their capital to one country, that we could certainly give him a taste of deflation just by not going along with the request to put an additional \$8 or \$9 million—billion; I am corrected—into these International Monetary Funds and other efforts to prop up the international system.

It troubles me with regard to testimony presented here today that our country appears to be an economic loser, whether we increase the IMF resources or not. If we don't support the IMF and a larger debtor nation defaults, of course, our exports are going to be jeopardized. If we increase the IMF support and the loans are made to a debtor country, these loans are generally made with the stipulation that the fiscal imbalances of the debtor country have to be resolved, and they have to get into a period of great economic austerity. I don't know how we are going to enforce that because we have great difficulty enforcing it on ourselves in an effort to do something about our budgetary problems. But part of that great austerity is they've got to limit their imports, and this is going to mean, I would guess, a rather severe limitation on U.S. imports—

Mr. VOLCKER. Exports.

Senator SASSER [continuing]. Exports to these financially troubled nations at a time when we are attempting to get our own economy going.

This is a fair analysis that we do find ourselves in an economic dilemma in this situation; isn't that correct?

Mr. VOLCKER. I would look at it differently. I don't think we are in a no-win situation, broadly interpreted. First of all, you asked where was the enforcer; the need for external credit is a pretty potent enforcer, and that leads me to the answer to the second part of your question.

There is no question that the austerity programs in these countries will reduce their imports. We have already felt that to a very major extent in the case of Mexico. The old question, "Compared to what?" arises. And I don't think there is any question that an orderly—as orderly as it can be—adjustment program, carefully thought out with the IMF, accompanied by some moderate additional support in external credit from the IMF, from the banking system, or from other governments, is going to lead to a less severe and more constructive adjustment in those countries and to earlier

resumption of growth than if you simply cut them off; in that case you have net paybacks, and you have an even sharper impact on our exports.

Senator SASSER. Well, I think that may very well be true, Mr. Chairman, but I suppose my problem with it is this: We see that our banks have lent about 113 percent of their capital to foreign countries, according to the information that the committee has furnished me, and we feel here now, or are being told—and I don't find fault with you for saying this at all—that we need to come to the aid of the IMF and the IMF can come to the aid of these countries so that these loans from our large banks can be paid and we are in essence helping these less developed countries.

OBLIGATION TO SOLVE OUR TROUBLED ECONOMY

I suppose my problem is: Don't we have an obligation to help these financially troubled sectors of our economy? You and I have talked about this many, many times before. But don't we have an equal obligation here at home to try to get our financial house in order, to try to get our interest rates down domestically?

Mr. VOLCKER. Yes.

Senator SASSER. To help our people here. And how are we going to go out in the country and tell our constituents that we are going to use taxpayers' funds, \$8 or \$9 billion, to put it into these International Monetary Funds and other agencies in an effort to keep the large banks whole but we can't really do much for them.

I had a bank fail down in my State, as you well know, and you are very familiar with the circumstances on that, and there was much made of the fact that 23 percent of this bank's operating capital was loaned to one individual. Yet, we find here today that over 100 percent of Citicorp's capital is loaned to one country, Brazil. And I have a hunch that this bank that failed down in my State had a lot more control over this one individual that they loaned 23 percent of their capital to than Citicorp does over the country of Brazil.

So we've got not just a serious economic problem here, a serious international economic problem, we've got a serious domestic political problem, I think, in trying to explain it to our people here.

Mr. VOLCKER. I recognize that. Of course, I strongly think it is in the public interest, for all the reasons that I and others have cited. But let's take the example of your bank in Tennessee. An apparatus of Government support was brought to bear on that situation. Depositors in that bank didn't lose anything, and the continuity of the banking service in Tennessee was maintained. That's the kind of apparatus we have domestically.

The IMF is not a new institution. It was set up under the leadership of the United States, and clearly in our own interests as well as in the world's interest, at the end of World War II. This is not the first time its resources will have been replenished. It will be a continuing process in the growth of the world economy, if that institution is going to fulfill the functions that were laid out at the start. It's very much in our interest. We are in a particular situation where the pressures are particularly heavy and the institution exists to deal with situations of this sort. It has to be adequately

equipped to do its job, and years, and it requires more have a really unprecedented financial area.

But I think there is a general strong in other countries, de countries—that this institution challenged now by external aggressively in the interest of but it needs the tools to do provide that.

Senator SASSER. I think w these very large loans to th at least an indiscretion an practices. Do you agree with

Mr. VOLCKER. I wouldn't all.

Senator SASSER. Well, w down in Tennessee when t their operating capital, the Federal agencies that they tices. Now, you said a mom relative, and I suppose it is conduct for domestic banke

Mr. VOLCKER. No, we do Senator SASSER. My stock everything they had.

Mr. VOLCKER. That is tru Senator SASSER. The dep going to happen to the stor tan, J. P. Morgan, First N Chicago, Chemical Bank, Midland? Are they going loans which on the surfac about the banking business

Mr. VOLCKER. I'm not heard on a number of occ of many of these banks ha with relatively high yield of popularity among many certain amount of concern place makes its own judg judgment is justified or no in the price of their stock

Senator SASSER. Thank Senator HEINZ. Senator

STATEMENT

Senator LAUTENBERG. T The theme that seems Volcker, is one of the b the way they apportion t ties. Some earlier questio

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LED ECONOMY

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problem here, a serious a serious domestic politi- to our people here.

I strongly think it is in I and others have cited. Tennessee. An appar- bear on that situation. g, and the continuity of tained. That's the kind

set up under the leader- ir own interests as well orld War II. This is not eplenished. It will be a rld economy, if that in- at were laid out at the e in a particular situa- eavy and the institution It has to be adequately

equipped to do its job, and that requires more resources over the years, and it requires more resources particularly now when we have a really unprecedented situation arising in the international financial area.

But I think there is a general feeling in the United States—very strong in other countries, developed countries as well as developing countries—that this institution has a vital role to play. It is being challenged now by external circumstances. It has moved very aggressively in the interest of the world economy and our economy, but it needs the tools to do the job, and only the Government can provide that.

Senator SASSER. I think we can agree that the banks that made these very large loans to these developing countries were guilty of at least an indiscretion and not following the soundest banking practices. Do you agree with that?

Mr. VOLCKER. I wouldn't choose those words to characterize it at all.

Senator SASSER. Well, would you agree that perhaps the bankers down in Tennessee when they were loaning out large chunks of their operating capital, the accusation was made by some of the Federal agencies that they weren't following proper banking practices. Now, you said a moment ago that everything in this world is relative, and I suppose it is, but do we have a different standard of conduct for domestic bankers and international bankers?

Mr. VOLCKER. No, we do not.

Senator SASSER. My stockholders in that bank in Knoxville lost everything they had.

Mr. VOLCKER. That is true.

Senator SASSER. The depositors were kept whole. Now, what is going to happen to the stockholders of Citicorp and Chase Manhattan, J. P. Morgan, First National Bank of Chicago, Continental of Chicago, Chemical Bank, Manufacturers, Hanovers Trust, Marine Midland? Are they going to suffer any loss as a result of these loans which on the surface to me—admittedly I don't know a lot about the banking business—don't look very sound, frankly.

Mr. VOLCKER. I'm not a bank stock analyst, but I know I've heard on a number of occasions over recent years, when the stocks of many of these banks have been trading well below book value or with relatively high yields, that one important factor in their lack of popularity among many potential and actual shareholders was a certain amount of concern over their exposure abroad. The market-place makes its own judgment about those factors. Whether that judgment is justified or not, time will tell, but I think it is reflected in the price of their stocks.

Senator SASSER. Thank you, Mr. Chairman.

Senator HEINZ. Senator Lautenberg.

STATEMENT OF SENATOR LAUTENBERG

Senator LAUTENBERG. Thank you, Mr. Chairman.

The theme that seems to thread throughout our discussion, Mr. Volcker, is one of the behavior of the very sophisticated banks in the way they apportion their loan reserves or their loan opportunities. Some earlier questioning dealt with the kind of barometers or

yardsticks that might be used in classifying these loans or risks. It looks like a scale of something like A through G, starting with "avarice" and winding up with "gluttony."

What we see is a violation, I think it's fair to say, of good practice in terms of the way these loans were made. Now the question is who pays the piper. I think Senator Sasser was referring precisely to that. And though we may be locked in, I think it's fair to say, to these commitments, certainly we have to protect our financial system against such future activities.

Would it be logical at this point, instead of continuing to capitalize these errors, to perhaps recast these loans, extend the payment terms and reduce the interest rates—instead of going through these adjustments by additional loans? If it's possible, ask the banks who have made loans to the private sectors in these countries—and I guess there are some sovereign loans, though I don't know and I'd be interested in knowing if that is correct—perhaps to take their interest income in a reduction of capital as opposed to adding to their operating income; this was suggested in the testimony of Mr. Mayer a couple of days ago.

The fact is that the penalty has not been seen in some of the bank-share prizes. Banks continue to make aggressive investments in nondirect banking areas, looking for diversion when I think their primary function is to provide capital. And I think what is happening is that our citizens are being asked to take the pain much more directly than are the financial institutions with all their professional skill and all their sophistication.

Mr. VOLCKER. I don't think our citizens will feel any pain if we are successful in this venture. Where they feel the pain is if the situation is not managed. That is the risk in this situation, and that is the overwhelming risk to which we must direct ourselves.

The possibility you referred to of how to use interest income is a fair question. These are the kinds of things that are under review. I would say I don't think it's appropriate to take this particular action in the case of some of these major countries that have been servicing their interest steadily and have displayed a willingness to undertake very forceful adjustment programs at home, and have a logical program for working themselves out of this problem. There are countries that have essentially been in default for some years, where that kind of suggestion is quite appropriate, and I think many banks follow that practice now.

COUNTRIES IN DEFAULT FOR YEARS

Senator LAUTENBERG. It was interesting that you said that countries have been in default for years. When I had the opportunity to hear some people from the Department of the Treasury make a presentation, they said no borrower had been in default. And when I asked if there were countries that were delinquent, they also responded negatively and said that we continue to adjust these programs. I guess that's a privilege reserved for nations and not individuals.

Mr. VOLCKER. The countries I am referring to are rather small countries, but they are in default.

Senator LAUTENBERG. They are clearly in default.

Mr. VOLCKER. They are. Senator LAUTENBERG. faulting, except the axe. Thank you very much. Senator HEINZ. Thank you. Senator Hecht.

Senator HECHT. Mr. you see for directors of Mr. VOLCKER. The possibility for overseeing to foreign loans.

Senator HECHT. As then, between domestic standards?

Mr. VOLCKER. Yes. some differences, but a distinction.

Senator HECHT. Have banks while these loans?

Mr. VOLCKER. These of the bank examination that sense, too, but th about. Have I directly Not in any organized ess, where the examination times they do that per-

Senator HECHT. Well examination; then the Have the directors res-

Mr. VOLCKER. I can't reacted. I don't know way. But the normal pleted, and the results and the domestic part tion—are presented to sented personally; some banks, I think it's often of some institutions.

Senator HECHT. Be that they are guilty of know that a bank has

Mr. VOLCKER. Oh, y ess as it encompasses cern in the broader se are conscious of the n to make sure that the you an answer as to v very difficult judgment sion, and it should be both with what the lin within that bank for e

Senator HECHT. No dent banking practice can have such loans in

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default.

Mr. VOLCKER. They are delinquent, anyway.

Senator LAUTENBERG. They are delinquent to the point of de-
faulting, except the axe has not come down.

Thank you very much, Mr. Chairman.

Senator HEINZ. Thank you, Senator Lautenberg.

Senator HECHT.

Senator HECHT. Mr. Volcker, what responsibility or liability do
you see for directors of these banks?

Mr. VOLCKER. The directors of the banks clearly have the respon-
sibility for overseeing the general policies of the bank with respect
to foreign loans.

Senator HECHT. As Senator Sasser said, you see no distinction,
then, between domestic and foreign lending banks, the same set of
standards?

Mr. VOLCKER. Yes. Obviously the nature of the lending creates
some differences, but as a general approach there shouldn't be any
distinction.

Senator HECHT. Have you been in contact with directors of these
banks while these loans were classified?

Mr. VOLCKER. These loans are not classified in the normal sense
of the bank examination process. Some of them may be classified in
that sense, too, but that's not what Senator Proxmire was talking
about. Have I directly been in contact with directors of the banks?
Not in any organized way. We work through an examination proc-
ess, where the examiners present an examination report. Some-
times they do that personally to the directors.

Senator HECHT. Well, domestic banks—as the FDIC makes their
examination, then they classify the different loans down the line.
Have the directors responded to any of these different reviews?

Mr. VOLCKER. I can't tell you in any precise way how they have
reacted. I don't know how you would measure that in any direct
way. But the normal practice is that an examination will be com-
pleted, and the results of that examination—including the foreign
and the domestic parts, which are all part of the same examina-
tion—are presented to the board of directors. Sometimes it's pre-
sented personally; sometimes it's presented in a letter. With larger
banks, I think it's often done personally, maybe always in the case
of some institutions.

Senator HECHT. Because the directors also have that situation
that they are guilty of acts of omission so it's their responsibility to
know that a bank has such—

Mr. VOLCKER. Oh, yes. A major purpose of the examination proc-
ess as it encompasses foreign lending is to bring this concern—con-
cern in the broader sense—to the attention of the directors so they
are conscious of the need to set limits; they are conscious of a need
to make sure that their bank is evaluating limits. That doesn't give
you an answer as to what the limits should be. That is a matter of
very difficult judgment. But it certainly should be a conscious deci-
sion, and it should be a matter the directors are concerned with,
both with what the limits may be, and with some of the procedures
within that bank for evaluating this situation.

Senator HECHT. Now, there is a term we use in banking, "pru-
dent banking practice." It is kind of inconceivable to see how they
can have such loans in the amounts—

Mr. VOLCKER. It may look that way now. We all have the great benefit of hindsight. But even with hindsight, international lending in its broadest sense, I think, has played a constructive role in the development of the world economy, in our interest and the interest of American workers and businesses. It is a question of proportion, and that is a very hard thing to judge. What looks reasonable in fair weather looks less reasonable in your eyes and in the eyes of others now. You are coming down to a question of judgment.

Senator HECHT. Thank you. No further questions.

Senator HEINZ. Thank you, Senator Hecht.

Senator Dodd.

Senator DODD. Thank you, Mr. Chairman.

Mr. Chairman, your testimony identified five general things that have to be done for what you have identified as the worst financial crisis in the postwar period. I don't know whether that was hyperbole.

Mr. VOLCKER. I said, "an unprecedented threat," and that's what I meant. I didn't say it was the worst banking crisis, but a threat to the financial system we haven't had to deal with during the postwar period.

Senator DODD. My point is this: I went down your list here, and in addition I happen to believe and will support the Administration's request for the additional authority for the IMF. I think there is no other choice under the circumstances. But that to me is the least of the problems. The two most significant questions, as far as I'm concerned, are your point one and point five in the list of five that you identified. That is, the ability of the nations who are suffering this severe problem to adopt austerity programs that have been framed by the IMF; and fifth, their ability to reduce the deficits in their balance of trade, whether they can do that under the present international economic circumstances.

FED'S ANALYSIS OF BRAZIL, MEXICO, AND ARGENTINA

I'd like you to give me, if you could, your assessment, since you have identified rather extensively the particular circumstances of Brazil, Mexico, and Argentina. What is the Fed's analysis of Mexico and Brazil and Argentina's ability to do one and five on the list of five things that you claim have to be done if this program is to be successful?

Mr. VOLCKER. Let me say I think you correctly identified one and five as the economic fundamentals. The other part is financial engineering. That is important, but in some sense perhaps less fundamental.

Obviously I am reluctant to discuss in detail these particular countries, but let me say each of them has embarked in good faith on a very strong adjustment program. All three of those countries have great strengths in their economies in different ways, demonstrating at times in the past and recently for two of those countries—"recently" meaning the last decade—great growth potential in different ways. Mexico has great oil resources. Brazil is a big oil importer. But they have made great strides in building their industries, in building their infrastructure. I think it's easy to say in retrospect—and not so difficult to say when it is going on—that they

were expanding a little faster considering they generated internal financing in the postwar period.

But do those countries have adjustments to be competitive ways—oil in Mexico, agriculture in Brazil? I think I would say they have that potential.

Senator DODD. Let me ask you what would you think within the next six months? Where do you think the prices on each of these three countries will be?

Mr. VOLCKER. You get a price on each of these three countries.

Senator DODD. That's what I want to know.

Mr. VOLCKER. It covers the stand, in Argentina that is one of the larger importers.

Senator DODD. Right, he

Mr. VOLCKER. Brazil's adjustment will be eased. Mexico's will be eased, if I may suggest. I think a monetary policy, on the import side, going down in connection with the oil price goes down, where will be improved; rates going down further. They are already indebted abroad, they are the result of that economic situation.

Senator DODD. I want to know about the border with them. I just want to know a very question, their ability to handle whether or not labor and go along with it, what potential is obviously a decreasing of Mexico's situation far more than are going to do in terms of oil and cotton. If you are going to do oil and cotton, I'd like to know what are going to have a profit happen to the price of oil.

Mr. VOLCKER. You're asking me.

Senator DODD. Yes, that's what I want to know.

Mr. VOLCKER. I think there are obviously pressures that are declining in the effective demand, further declines, but try to get some competence.

Senator DODD. But you

Mr. VOLCKER. I think the future; and there could be a significant of that for Mexico proportions where I can

way now. We all have the great hindsight, international lending played a constructive role in the in our interest and the interest s. It is a question of proportion, edge. What looks reasonable in n your eyes and in the eyes of a question of judgment. rther questions. or Hecht.

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were expanding a little fast and in ways that were unsustainable considering they generated these kinds of external deficits and ex- ternal financing in the proportions that were generated.

But do those countries have the basic strengths to make these adjustments to be competitive in world markets in their different ways—oil in Mexico, agriculture in Argentina, industrial strength in Brazil? I think I would give you an unqualified answer that yes, they have that potential.

Senator DODD. Let me ask you this: What are your estimates or what would you think will happen to oil prices in the next six months? Where do you think they will be?

Mr. VOLCKER. You get a quite different impact from declining oil prices on each of these three countries.

Senator DODD. That's why I asked the question, obviously.

Mr. VOLCKER. It covers the spectrum beautifully. As I under- stand, in Argentina that won't have much effect externally. Brazil is one of the larger importers of oil. Mexico is one of the larger ex- porters.

Senator DODD. Right, hence the question.

Mr. VOLCKER. Brazil's adjustment or external borrowing problem will be eased. Mexico's will be increased. There is a potential offset there, if I may suggest. I testified all morning yesterday on mone- tary policy, on the importance of inflation coming down and stay- ing down in connection with the outlook for interest rates. Obvious- ly, if the oil price goes down, the inflation outlook here and else- where will be improved; that is a favorable climate for interest rates going down further. And because these countries are so heav- ily indebted abroad, they benefit on the interest rate side if that is the result of that economic climate.

Senator DODD. I want to focus on Mexico. We have a 2,000-mile border with them. I just spent 10 days in Mexico and Brazil on this very question, their ability to adopt these austerity programs, whether or not labor and the political party in Mexico are going to go along with it, what potential Brazil has with their program. And obviously a decreasing oil price internationally is going to make Mexico's situation far more difficult. Their answer to what they are going to do in terms of expanding industrial capacity is tourism and cotton. If you are going to come up with \$85 billion in tourism and cotton, I'd like to know how you are going to do it. Oil prices are going to have a profound effect. What do you think is going to happen to the price of oil in Mexico?

Mr. VOLCKER. You're asking me for a forecast of oil prices?

Senator DODD. Yes, that was the question.

Mr. VOLCKER. I think I'm going to withdraw at this point. I think there are obviously pressures on the oil price, and there have been declines in the effective price of oil. I would not be surprised to see further declines, but trying to quantify that is not in my area of competence.

Senator DODD. But you see further decline in prices?

Mr. VOLCKER. I think, certainly in real terms, in the foreseeable future; and there could be declines in nominal terms. But the sig- nificance of that for Mexico is directly related to the question of proportions where I can't make a judgment.

I must say I asked that question of my friends who are much more expert than I about oil prices, and they gave me the same answer that I gave you.

Senator DODD. That is it's going to decline but they won't say—

Mr. VOLCKER. They think there is downward pressure, but they are very uncertain about what the amount might be.

Senator DODD. We don't have much time, but what we haven't discussed—we have generally been talking about sovereign loans here. I think everybody assumes that is all we are really talking about and, of course, there are a great deal of debt obligations, of course, to private companies in these countries. What we are talking about, of course, is an answer you have identified, and what was being suggested by some legislation offered by the Senator from Pennsylvania and the Senator from Wisconsin deals primarily with the sovereign loan issue, I suspect. Is that correct?

Senator PROXMIRE. It would include both loans to individual firms within a country and sovereign.

Senator DODD. I apologize.

Since it's much more difficult to deal with the private loan than the sovereign loan, do you have any suggestions on what might be done to require banks to be more judicious in the private loan category, or would you make any distinction?

DISTINCTION BETWEEN SOVEREIGN AND PRIVATE LOANS

Mr. VOLCKER. I do make a distinction in my mind, but maybe an opposite distinction than you're making. I think possibly one of the difficulties, from a supervisory standpoint, even from a banking standpoint, is that there is a certain natural discipline in lending to a private borrower. The banker knows the private borrower. It's a familiar kind of problem for the bank. Can that particular borrower repay a loan? Is it engaged in constructive investment? Is it going to have the revenues, in its own currency, to service the loan? That puts a discipline on the lending, a normal market discipline on the lending.

They have to worry about the prospects for that particular borrower.

The sovereign loan is of a different kind. You've got a different kind of credit judgment. You're talking about the capacity of the whole country. There is no market test in the same way. From the supervisory standpoint, I think the problem is, in a sense, focused more on the sovereign loan than on the private loan simply because that market discipline is either absent or is not present in the same way. I think when one looks back at this and sees this enormous growth in loans, one wonders whether the problem isn't partly related to the practice of making sovereign loans which practically didn't exist 15 years ago. It grew up very rapidly after the oil crisis. Maybe a useful discipline can be exerted in an opposite sense than what you may have been suggesting—that the principal supervisory problem lies in the sovereign loan area where a certain market discipline was absent.

Senator DODD. That's what I was suggesting.

With regard to that distinction between the sovereign and private loan, it seemed to me—and correct me if I'm wrong in this but

again I'll refer to the I have suggested where the Fed would be settling and so forth, helping lending institutions and they ought to commit

It seemed to me that was subject to some rather than the Fed. I talking about substantial the United States and termine exactly what sious other sources, it s like you to comment o

Mr. VOLCKER. You c that international ba nature, and we can't c can limit the particip strong competitive pre banks are free, so to s

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Senator DODD. I wa thing as simple as th amount of money to that to the IMF not f coordination.

Mr. VOLCKER. In co let me say the IMF in I think is very much forget now that we a called into question. ferent; everybody war ly had a problem an fact they did have a p lization agreement w what concerned that result that the pressu ment program would would not be achieve amount that the cou very eager to lend to

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Senator DODD. I'd domestic spending fr

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again I'll refer to the legislation that Senators Proxmire and Heinz
have suggested where the Fed would play a more significant role—
the Fed would be setting loan limits on a country by country basis
and so forth, helping to try and play a greater role in assisting
lending institutions and making decisions about whether or not
they ought to commit resources.

It seemed to me that maybe a better institution, although it's ob-
viously subject to some severe criticism these days, is the IMF
rather than the Fed. I'd like you to comment on this because we're
talking about substantial loans being made by other banks outside
the United States and to the extent there is a greater ability to de-
termine exactly what is happening in these countries from numer-
ous other sources, it seems to me to make a bit more sense, but I'd
like you to comment on that.

Mr. VOLCKER. You certainly put your finger on a major problem,
that international banking problems are international by their
nature, and we can't cure them by action in the United States. You
can limit the participation of our banks, obviously, but there are
strong competitive pressures working in the other direction if other
banks are free, so to speak.

I never thought, frankly, of the IMF putting on legal lending
limits in effect around the world.

Senator DODD. I wasn't suggesting that. I was thinking of some-
thing as simple as the idea that if you're going to lend a certain
amount of money to "X" country that you would have to submit
that to the IMF not for veto necessarily but at least there's some
coordination.

Mr. VOLCKER. In concept, that may not be such a bad idea. But
let me say the IMF in some instances has moved in a direction that
I think is very much related to the point that you have made. We
forget now that we are in a situation where these loans have been
called into question. Very few years ago the climate was quite dif-
ferent; everybody wanted to make these loans. The IMF occasion-
ally had a problem and perceived they had a problem—I think in
fact they did have a problem—when they would enter into a stabi-
lization agreement with a country and they would become some-
what concerned that the country would be overfinanced, with the
result that the pressure on the country to conform to the adjust-
ment program would be relieved and the purposes of the programs
would not be achieved. The IMF would want to put a limit on the
amount that the countries could borrow because everybody was
very eager to lend to them.

Now they've got the opposite problem. For the adjustment pro-
gram to succeed they need the financing and they have become in-
creasingly active in both directions and basically there is a logic in
that.

Senator DODD. I'd like to see you make that same argument in
domestic spending from time to time.

Mr. VOLCKER. In the IMF program they go about it pretty aggres-
sively. I would just comment that the IMF activity has been limit-
ed to cases where the countries have an adjustment program. By
way of making a constructive suggestion, when one looks at the in-
ternational financial problems, the question is how does one get
the Fund into the act sooner? You don't go right to the brink. We

are going right to the brink with all these countries. We would have been much better off, obviously, if these adjustment programs had started in these countries that we're dealing with a year ago or 2 years ago. The adjustment programs could have been much simpler. They wouldn't have had the same problem in financing the adjustment programs if they had brought them about earlier. But countries are very reluctant to go to the IMF until they are at the brink. If we could create some incentives in the system so that we attack these problems at an earlier date, then we would have really done something. I think we ought to look at all these supervisory proposals in that sense.

Senator DODD. Thank you.

Senator HEINZ. Senator GORTON.

Senator GORTON. Mr. Volcker, I think we are faced with a set of policy options that present something of a paradox on which I'd like your comment. We are asked to provide a substantial infusion of new capital to the IMF and I must say I find your arguments in favor of that very, very difficult to debate.

At the same time, the IMF will use that money as leverage to persuade a number of the recipients of loans from it to reduce quite substantially their imports which, in turn, one presumes will harm economic recovery in the United States which supplies most of those imports.

THE BEST OF THE BAD JOB

Is this simply an inevitable consequence, the best of a bad job? Is this something we should think of in connection with that process?

Mr. VOLCKER. I would accept your comment that it's the best of a bad job. I would rather put it more positively that the consequence of not doing it—I don't know whether this is more positive or not—is much more damaging, because if these countries get no external credit, get no assistance from the IMF, they are going to have to adjust even more abruptly, more precipitously, and in a way that gives much less promise of an early restoration of their growth.

Senator GORTON. Or of ours?

Mr. VOLCKER. Therefore, indirectly, of ours. There's no doubt at all in my mind that this is in our best interest, although you're quite right that just viewed at in comparison with the last few years their imports will be going down.

Senator GORTON. And it is absolutely necessary that they pass through that regimen?

Mr. VOLCKER. I see no alternative.

Senator GORTON. Just in one of your incidental comments and one of Senator Dodd's, you triggered my next question. We are looking at a financial situation in several of these foreign nations which is very, very serious and is compounded of a significant trade imbalance, an overwhelming trade imbalance in some respects, great imbalances in their own internal budgets, and I suppose one must always say, at least in comparison with the dollar, a high internal inflation. It seems to me that may be a pretty good description of a lot of what's going on in the United States as well.

Would your prescription for the United States be similar to the prescription which the IMF is going to impose on these other coun-

tries? Is there some absolute States of America can't run in

Mr. VOLCKER. There is none from the IMF in the past with the dollar. We have never borrowed to have an IMF adjustment borrow a large amount of money have to consult with the IMF adjustment program. We have never have borrowed from the IMF.

Senator GORTON. Is your own any different from that of the

Mr. VOLCKER. The matter of suppose in some sense it is a matter to go through the same adjustment through a recession; I hope we can reap the benefits of that have been going through.

Senator GORTON. But it's the other countries must go through

Mr. VOLCKER. Yes, and specifically of talking, and other people of monetary problem. At the heart of the programs in these particular cases on the resources in these countries in resources from the rest of the adjustment deficits.

That problem is in some broad Mexico's case the government of the GNP. They have proposed that deficit in half in a program. Similarly, the deficits in Argentina, but they have been there are being asked to make adjustments. That is the same direction go. They make our problems perhaps a lesson there.

Senator GORTON. Thank you. deal has been made of the fact amount equal to their entire countries or to other creditors

Isn't it true that since bank assets that many banks have their capital to say agricultural the computer industry or the like

Mr. VOLCKER. Yes, certainly. They wouldn't do it in an industry very much have to be kept is, in retrospect these ratios countries or have for some years just what an appropriate ratio

Senator GORTON. Thank you.

Senator HEINZ. Thank you.

Senator RIEGLE. Thank you.

these countries. We would have these adjustment programs dealing with a year ago or could have been much simpler problem in financing the problem in financing the problem about earlier. But the IMF until they are at the in the system so that we ite, then we would have to look at all these super-

we are faced with a set of a paradox on which I'd ide a substantial infusion I find your arguments in

that money as leverage to loans from it to reduce i turn, one presumes will ates which supplies most

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necessary that they pass

cidental comments and next question. We are of these foreign nations ounded of a significant imbalance in some re- nal budgets, and I sup- rison with the dollar, a : may be a pretty good : United States as well. States be similar to the se on these other coun-

tries? Is there some absolute divine guarantee that the United States of America can't run into this kind of problem?

Mr. VOLCKER. There is none at all. We have, in fact, borrowed from the IMF in the past when we had great pressure on the dollar. We have never borrowed the amount that would require us to have an IMF adjustment program. Only when you have to borrow a large amount of money relative to your quota do you have to consult with the IMF and agree with them on an adjustment program. We have never been close to that point, but we have borrowed from the IMF.

Senator GORTON. Is your own prescription for our domestic economy different from that of the IMF for these borrowing countries?

Mr. VOLCKER. The matter of degree is enormously different, but I suppose in some sense it is a matter of degree. I said we don't have to go through the same adjustment process. We have just been through a recession; I hope we are coming into a recovery now and we can reap the benefits of the disinflationary process that we've been going through.

Senator GORTON. But it's that kind of disinflation process these other countries must go through?

Mr. VOLCKER. Yes, and specifically in budgetary terms. I do a lot of talking, and other people do a lot of talking, about our budgetary problem. At the heart of all of these IMF adjustment programs in these particular cases is getting the government's demand on the resources in these countries down, so they are not sucking in resources from the rest of the world basically to finance government deficits.

That problem is in some broad sense very similar, except that in Mexico's case the government deficit last year ran 16 to 17 percent of the GNP. They have proposed and the Fund has agreed that cutting that deficit in half in a year is part of that adjustment program. Similarly, the deficits are not quite as big in Brazil and Argentina, but they have been the same order of magnitude and they are being asked to make adjustments in the same order of magnitude. That is the same direction we'd like to see the United States go. They make our problems look like a rose garden, but there's perhaps a lesson there.

Senator GORTON. Thank you. On an unrelated subject, a great deal has been made of the fact that our major banks have lent an amount equal to their entire capital stock to one or more foreign countries or to other creditors in those foreign countries.

Isn't it true that since bank capital is such a small part of total assets that many banks have also lent amounts of money equal to their capital to say agricultural loans within the United States or the computer industry or the like?

Mr. VOLCKER. Yes, certainly, if you took the whole industry. They wouldn't do it in an individual country, and I think these figures very much have to be kept in some sense of proportion. That is, in retrospect these ratios always look high for some of these countries or have for some years, but it's very hard to determine just what an appropriate ratio is.

Senator GORTON. Thank you, Mr. Chairman.

Senator HEINZ. Thank you, Senator Gorton. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Did I understand you to say earlier in response to Senator Sasser that if we do not increase IMF support, that we could really see chaos? That's a word you used and I'm just wondering if that's the context in which you used it.

Mr. VOLCKER. "Chaos?" My recollection is that I used it in relation to the conditions in those countries if they had external credit shut off.

Senator RIEGLE. Well, let me ask you the question a little differently then. If we did not approve this package, how destabilizing an event would that be? How close to "chaos" are we?

Mr. VOLCKER. It's terribly difficult to judge. Somebody asked me that question in the House hearing the other day and essentially I said I can't tell for sure. I know it would remove one more element of protection that makes the whole situation riskier. It could be very difficult. But I said I couldn't tell; if this thing goes very smoothly, maybe they will never need these additional resources. I got criticized afterwards for not making a strong enough case; I was told, "You should say that things would go to hell so that the Congress passes it." I don't want to be irresponsible about it. I want to give you my best judgment.

Senator RIEGLE. I understand and appreciate that and you have answered my question. I want to discuss Mexico later, but let's move through some other matters first.

LARGE UPFRONT FEES ON FOREIGN LOANS

Don't the U.S. banks that make these large loans abroad get large upfront fees on these loans?

Mr. VOLCKER. Yes.

Senator RIEGLE. And those fees, don't they show up in bank earnings, which are presumably the basis on which salaries are paid?

Mr. VOLCKER. My understanding is that the accounting rules are a little hazy but they make a distinction between fees to cover expenses, fees that are in the nature of a syndication fee and a fee that is essentially a substitute for interest; if it's the latter, it is spread out over the life of the loan.

I also have the impression that those rules are fuzzy enough so that there's a certain degree of flexibility on the part of the banks as to what they do, and I think individual banks probably differ. To get to the point, I would accept the proposition that if the frontend fees are artificially taken into current earnings, that probably isn't a good banking practice.

Senator RIEGLE. Well, I would hope we could change that practice and I think that it's clear that there is a higher rate of profitability on these loans. That's why these loans have been made in other countries rather than our own.

Mr. VOLCKER. Partly profitability. I think there was a certain amount of fashion involved. We have often commented frankly in the past—I speak of myself and other governors—about how low the interest rate margins were on many of these loans in earlier years when everybody was feeling very confident.

Many of the loans had pretty good front end fees but we wondered whether the interest rate itself was high enough to reflect the risk and the need for capital to support loans.

Senator RIEGLE. The bearing on it, but there's sure of the profitability.

LIST OF FOREIGN

Does the Fed have the foreign private loans? Do you have that list?

Mr. VOLCKER. Individual Senator RIEGLE. Yes, now, for example, with made to Mexico, both borrowers?

Mr. VOLCKER. Yes; Senator RIEGLE. Oh to request that we get Mr. VOLCKER. The

Senator RIEGLE. I whatever detail you also be useful for us

Mr. VOLCKER. We do provide aggregate Senator RIEGLE. T individual bank. You

Mr. VOLCKER. Yes may not be very system.

Senator RIEGLE. V to the committee?

Mr. VOLCKER. For Senator RIEGLE. V

Mr. VOLCKER. Th of this information dental.

Senator RIEGLE. that it is confidential each individual b loans by country.

Mr. VOLCKER. W tries. We have not ed groups of banks Congress some ye est banks taken t gest lenders are d

Senator RIEGLE. we have a serious haste on it. I thi would be my hop down by U.S. ban cific private loans

Mr. VOLCKER. I loans, but if it's have disclosed it

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in response to Senator Sasser support that we could really see it. I'm just wondering if that's the collection is that I used it in relation to if they had external credit

to you the question a little different. This passage, how destabilizing are we? to judge. Somebody asked me the other day and essentially I would remove one more element the situation riskier. It could be that if this thing goes very need these additional resources. I making a strong enough case; I they would go to hell so that the to be irresponsible about it. I

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ON FOREIGN LOANS

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I think there was a certain often commented frankly in governors—about how low any of these loans in earlier confident. front end fees but we won't was high enough to reflect short loans.

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Senator RIEGLE. That's why the fees may have a more direct bearing on it, but there may be other things that impact the measure of the profitability apart from the interest rate itself.

LIST OF FOREIGN GOVERNMENT AND PRIVATE LOANS

Does the Fed have a list of all the foreign government loans and the foreign private loans made by banks here in the United States? Do you have that list?

Mr. VOLCKER. Individual loans?

Senator RIEGLE. Yes. In other words, could you provide us right now, for example, with a list of all the loans major U.S. banks have made to Mexico, both to the government of Mexico and the private borrowers?

Mr. VOLCKER. Yes; we can provide those.

Senator RIEGLE. OK. I think we ought to have those and I'd like to request that we get them.

Mr. VOLCKER. They may be in my testimony before the House.

Senator RIEGLE. I would just ask that we have them. I think whatever detail you have that builds up to those aggregates would also be useful for us to be aware of.

Mr. VOLCKER. We don't provide them by individual banks, but we do provide aggregate numbers.

Senator RIEGLE. That's what I'm asking for. I'd like to see it by individual bank. You must accumulate it some way.

Mr. VOLCKER. Yes; we have a very good reporting system here. It may not be very fast, but we have a very elaborate reporting system.

Senator RIEGLE. Would there be any problem with providing that to the committee?

Mr. VOLCKER. For individual banks, yes.

Senator RIEGLE. What's the problem?

Mr. VOLCKER. The problem is that we protect the confidentiality of this information; we get it on the understanding that it's confidential.

Senator RIEGLE. Then I ask that we get it on the understanding that it is confidential and what I'm asking is the degree to which each individual bank has an aggregate amount of outstanding loans by country.

Mr. VOLCKER. We have not given information by individual countries. We have not given it by individual banks. We give it by limited groups of banks. The standard practice we agreed upon with the Congress some years ago was to go by the figures for the nine largest banks taken together, so you get an idea of what the nine biggest lenders are doing.

Senator RIEGLE. I'm not sure that's enough. Given the fact that we have a serious problem here and are being asked to act in some haste on it. I think we can talk it over with the chairman, but it would be my hope that we could get an aggregate figure broken down by U.S. banks and by foreign country without identifying specific private loans to individual customers.

Mr. VOLCKER. Maybe you can avoid the disclosure on the private loans, but if it's a single bank lending to the Government and you have disclosed its position, which is competitive, generally in the

bank supervisory process we resist disclosing this kind of information on an individual bank in detail.

Senator RIEGLE. I think this is an extraordinary situation, however; in fact so much so that we are considering putting a new limitation here on the way these loans are made, and I support that. I think we do need a sharp limitation on these private bank loans that are being made abroad in the amounts that we've seen. Granted it's hindsight in terms of the problems that have developed, but we have to learn from hindsight and that's one of the things we have to do.

AUSTERITY MEASURES QUESTIONED

Let me move to another issue. Are these austerity measures that are to accompany additional lending to foreign countries going to work? As I understand it, about 40 percent of the money that is going to be put into these countries through the IMF will come back to the United States and roughly 60 percent will make its way out to other end uses either within the country or other parts of the world. I don't know if you have seen the movement in manufactured goods in the "Trade Account" over the last year and a half, but I'll give you a quick summary—and I think every member of the Committee will be interested in this because we all have varying degrees of manufacturing in our States.

In 1981 we were running roughly a \$12 billion surplus in the manufactured goods account in the balance of payment. That began to reverse itself at breathtaking speed and continues to do so, which gets to the problem others have mentioned today. As these countries limit their imports from the United States and other places, it begins to cave in the balance of payments account here in the United States. It's turned so quickly that after running a positive balance of \$12 billion on an annual basis in 1981, we were running at the rate of a billion a month deficit in October of last year. So we have had a significant multibillion-dollar swing in that account in just over 12 months. That's an exponential rate of change and it's so dramatic that it raises the question in my mind, given our own economy problems, whether we can afford to make major new foreign loans, the bulk of which will not benefit our economy and may, as a matter of fact, have the reverse effect.

The austerity programs that have to be imposed in these countries are to the effect that they have to clamp down very sharply and block out imports. So that's a catch-22 problem that relates to our own ability to get real recovery going here.

If, for example, this deficit in manufactured goods account continues to increase at this rate as these nations try to tighten down, it appears that we may be spending an enormous price here at home, a price that has not been clearly identified.

To bring it home even more sharply, Senator Dodd was talking about how Mexico hopes to not only block our imports but to increase their exports. As I understand it, we have been negotiating with Mexico for 3 or 4 weeks in a very intense way to extend them additional credit in a variety of forms in exchange for action they take to stabilize their financial situation. And now there appears to be a very ominous stall in those proceedings because it may not be

workable. I know you're looking for evidence to support the fact that this thing is coming out of Mexico—and I would like to have your committee look at manufactured goods as the main financing a rising level of economy by every day.

Mr. VOLCKER. On that point, the marks—on our declining manufactured goods balance and on the trade account—is true. A major factor in this recession has been the opposite implication from the program, because we provide the best chance in the short run and for sustained as possible. That is in our justification for the program to avoid it being further accelerated aren't going down just the decline certainly a billion or so reduction in the premise; I agree with the program are just the opposite.

Let me just make a few comments. The negotiation is agreed on an IMF program. We have introduced adjustment is that adjustment is at great pain in the internal financial needs proceeding faster than the one part of the program has dragged out long complicated negotiation up in the final form. I expect that to be the case.

Senator RIEGLE. We are not mistaken.

Mr. VOLCKER. I expect it to be so. It turned out to be so literally in a matter of time.

Senator RIEGLE. We would like to see a comment for you to see if we could find off if we could find chunks of credit, in matter of fact, if we are going rather than having the dollars we ship, I think

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workable. I know you're nodding your head no. I hope there's hard
evidence to support the fact that that apprehension is unfounded
and this thing is coming together. But whether it is or isn't, in the
case of Mexico—and I welcome your comments there—I think we
need to have your comments on what's happening with respect to
manufactured goods as this equation tips the other way and we end
up financing a rising level of unemployment in that sector of our
own economy by every dollar that we ship out of the country this
way.

Mr. VOLCKER. On that point, let me say the premise of your re-
marks—on our declining trade balance and our declining manufac-
tured goods balance and the depressing effect that has on our econ-
omy—is true. A major factor in the decline in our own GNP during
this recession has been a decline in exports. I draw precisely the
opposite implication from that situation for the IMF legislation and
for this program, because it is through this kind of a program that
we provide the best chance for less decline than otherwise in the
short run and for sustained increase over a period of time as early
as possible. That is in one sense, from our narrow perspective, the
justification for the program, to speed and ease this process, to
avoid it being further aggravated. It's already difficult. Our exports
aren't going down just because of these particular problems, but
the decline certainly added to by these problems; there's a \$10 bil-
lion or so reduction in exports to Mexico already. I accept your
premise; I agree with it; It's true. But the implications of this pro-
gram are just the opposite of those you were drawing.

MEXICAN DEVELOPMENTS

Let me just make a couple remarks about the Mexican develop-
ments. The negotiations have been proceeding for months. Mexico
is agreed on an IMF program and has been for some time. They
have introduced adjustment measures for some months. My im-
pression is that adjustment is proceeding very rapidly in that coun-
try, at great pain in the short run. That was known, that their ex-
ternal financial needs are being reduced. If anything, it's probably
proceeding faster than we could have expected.

The one part of the program that has not been completed and
has dragged out longer than I would like to see it—it's a very com-
plicated negotiation among a thousand or so banks—is wrapping
up in the final form the commercial bank part of the credit pack-
age. I expect that to be completed in a matter of days.

Senator RIEGLE. We have missed some deadlines on that, if I'm
not mistaken.

Mr. VOLCKER. I expected it to be completed, originally, in Janu-
ary. It turned out to be more complicated, but I now look forward
to it literally in a matter of days.

Senator RIEGLE. Well, my time is up, but I offer one additional
comment for you to think about. And that is, we might be better
off if we could find a way to extend these additional billion dollar
chunks of credit, in the form of credit for American goods. As a
matter of fact, if we in fact could ship items that we were produc-
ing rather than having to hope for a 40 percent return on the dol-
lars we ship, I think we would be in better shape.

Mr. VOLCKER. I don't know where the estimate of the 40 percent return comes from. I haven't got estimates of that kind. I won't attempt to make one.

Senator RIEGLE. It came to this committee by an earlier witness.

Mr. VOLCKER. The U.S. Government is advancing some agricultural credits to Mexico. Nature was not kind to Mexico either last year, and it had poor crops, but we will be financing directly shipments of American exports of grain and, indeed, to some extent through the Export-Import Bank; that's part of this program.

Senator RIEGLE. That was Secretary Regan's estimate when he was here.

Mr. VOLCKER. I haven't seen those estimates. They are very complicated and difficult to make. In the case of Mexico—it would be different for every country—because Mexico is such a close trading partner of ours, our exports are likely to benefit from IMF assistance to a much greater extent than in some other countries. We only provide a fraction of what the IMF provides.

Our share of quotas is 19 or 20 percent—depending on whether before or after the increase, presuming there's going to be an increase—but just what currency countries draw, what currency they use at any particular time, depends upon circumstances in the marketplace with respect to that currency.

There is no pattern that's laid down for all times as to whether the Mexicans would, in effect, indirectly be borrowing dollars, marks, yen; presumably they would be borrowing some mixture in some proportion that's unknown at this point in time.

Senator RIEGLE. Thank you.

Senator HEINZ. Senator Mattingly.

Senator MATTINGLY. Thank you, Mr. Chairman.

Yesterday when you were testifying before this committee you agreed that the IMF policy in relation to the LDC's to import less and export more was sort of on the protectionist side of policy.

Mr. VOLCKER. Was sort of a what policy?

Senator MATTINGLY. Protectionist.

PROTECTIONIST POLICY

Mr. VOLCKER. No.

Senator MATTINGLY. It's not?

Mr. VOLCKER. No. I think in our colloquy yesterday, I pointed out that a premise in entering into this kind of program is to encourage more open markets; that is basically in the Fund's charter, that they are there, among other purposes, to encourage open trading and payments arrangements. Typically, in these adjustment programs they look toward countries removing restrictions, not increasing them.

Senator MATTINGLY. But the IMF says to import less and export more.

Mr. VOLCKER. Through the reflection of general economic policy, not through trade restrictions.

Senator MATTINGLY. Well, that doesn't mean anything. What do you mean by general economic policies?

Mr. VOLCKER. It's not protectionist. They are not saying give preference to Mexican industry, to put controls on Mexican trade.

They are saying, "Y have to cut back." measures.

Senator MATTINGLY. have any impact on t

Mr. VOLCKER. If th in the world is going add up to zero theore cal discrepancy.

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Senator MATTINGLY. term that?

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Senator MATTINGLY. conditionality of lo sidies and standard international trade

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are not saying give ls on Mexican trade.

They are saying, "You have been living above your means; you have to cut back." But they are not saying adopt protectionist measures.

Senator MATTINGLY. In other words, that policy doesn't even have any impact on the industrialized countries?

Mr. VOLCKER. If they improve their trade balance somebody else in the world is going to have a worse trade balance. It's all got to add up to zero theoretically. It doesn't in fact; there's a big statistical discrepancy.

Senator MATTINGLY. That's right.

Mr. VOLCKER. We are all trading with the statistical discrepancy.

Senator MATTINGLY. But all the mumbo-jumbo of the IMF saying they want the countries to lower their imports it is going to have an impact on the industrial countries.

Mr. VOLCKER. That is right. It's just not protectionist.

Senator MATTINGLY. It's not protectionist. OK. What would we term that?

Mr. VOLCKER. We would term that an adjustment process.

Senator MATTINGLY. That sounds like the tax bill last year we used enhancement.

Mr. VOLCKER. No. Senator, for several years, up until 18 months ago, our trade balance was improving quite dramatically. That wasn't protectionist. We were improving our trade balance. We were getting more competitive.

Senator MATTINGLY. Do you believe the U.S. could use the tool of conditionality of loans to reduce trade restrictions like export subsidies and standard requirements which American exports face in international trade markets?

Mr. VOLCKER. I think that sometimes can be a lever. That's what the IMF does; the best way to do that is do it through a multilateral institution. If you've got an institution that can represent not just the United States, but the collective interests of the world, and it is putting that kind of pressure on a borrowing country, there's no better way to do it.

Senator MATTINGLY. What instrument is that, the GATT?

Mr. VOLCKER. The GATT is concerned about that in setting up the structure of trading rules. The IMF has special leverage because they come in with money. The IMF hasn't got leverage if the country isn't borrowing, but when the country has an adjustment program, that is one of the concerns of the Fund.

Senator MATTINGLY. Is there any way you could write in a conditionality whereas the money—I know the money the IMF is giving to a country should not be used for a subsidy. I mean, they could not acquire money to subsidize exports.

Mr. VOLCKER. I don't know how you trace the money, but the IMF—

Senator MATTINGLY. I guess that's what I'm getting at. What I'm fearful of is that we will give to the IMF funding and they will in turn give money to whatever country it may be—Brazil—and there's no way to say that money going to Brazil is not going to reach other funds in Brazil to in fact subsidize exports in that country.

Mr. VOLCKER. In some sense, that is true, but you also can be sure that in these programs the IMF is putting on pressure to

reduce that, and they have got a certain leverage. The only direct experience I've had as a Government official in dealing with the IMF on the other side of the table is when they come around to consult with the United States. We are not borrowing from them. We don't have conditional programs. They don't have that kind of leverage over us because we haven't been in that kind of difficulty. But I'll tell you, when you sit at that table, the IMF comes in and says, "What about our trade restrictions; what about our subsidies; are we doing all we can to get rid of them?" It is a standard question, a standard approach that they take with every country, and they can take it more effectively under these circumstances.

Senator MATTINGLY. It may have worked in the past prior to us getting into the trade problems we have now internationally where everybody wants to export more and import less and subsidize it. I would wish you would put the power of your thinking behind what we are trying to get at here, trying to write some conditions into these loans to preclude the usage of those moneys in such a way because I think it's a necessity if we're ever going to settle this in Congress that's just one item that we're going to have to consider.

Mr. VOLCKER. I appreciate your concerns, but I hope I have made clear that I think the whole thrust of the IMF effort is consistent with your concerns.

Senator MATTINGLY. Well, I appreciate your point of view. I'm not quite sure I have that same comfortable, warm feeling coming out of IMF.

Mr. VOLCKER. Let me provide some more material then.

[The following information was subsequently submitted for the record:]

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Background Material on
External Trade and Payments Restrictions
in IMF Balance of Payments Adjustment Programs

The major aim of an IMF-supported adjustment program is to assist a country to bring about a configuration of its balance of payments considered sustainable over time. In this context, what is known as "IMF conditionality" refers to the practice of providing financial assistance only when, in the IMF's judgement, the country involved has formulated and is committed to implementing adjustment policies designed to reestablish a viable balance of payments position. Depending upon circumstances of the individual country, the particular set of policies designed to achieve this objective is likely to contain measures to restrain aggregate domestic demand (through reducing fiscal deficits and restraining growth of money and credit), to improve the efficiency of domestic resource allocation and thereby lay the basis for higher growth in output (by reducing or eliminating price controls and subsidies, reducing external trade and payments restrictions, and moving toward the establishment of positive real interest rates), to improve and maintain external competitiveness (through appropriate exchange rate policies), and to foster net capital inflows (through maintenance of an adequate level of interest rates, appropriate exchange rates, and an overall mix of policies that will attract foreign funds and encourage the retention of domestic savings for use in domestic investment).

If successfully implemented, such policies can be expected to bring about adjustment in the balance of payments through a reduction in the current account deficit (i.e., the net balance of exports and imports of goods and services) to a level that can be sustained through expected future net inflows of capital on terms compatible with the development prospects of the country

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and without resort to trade and payments restrictions. Such adjustment may, but does not necessarily, entail a temporary reduction of imports. In fact, of the nine largest IMF-supported programs (involving more than SDR 500 million in IMF resources) currently in effect (Argentina, India, Mexico, Pakistan, Turkey, Yugoslavia, Chile, Peru, and Romania), the programs for the first six of these, when approved, anticipated an increase in the value of imports in the first year of the program compared with the prior year. Even in programs that anticipate a temporary decline in imports, IMF financial assistance and other financing that might not otherwise have become available without an IMF-supported program help to cushion the adjustment process and to avoid an even larger decline in imports that might have otherwise occurred as a consequence of harsher and more abrupt adjustment policies. Moreover, the adjustment approach advocated by the IMF attempts to establish a basis for sustained growth of the economy and avoids strictly deflationary policies that may adversely affect investment and fail to stimulate the required shift of resources to the external sector.

As part of conditionality, the IMF places strong emphasis on the reduction and elimination of external trade and payments restrictions. This aspect of conditionality is based upon Article I of the IMF Articles of Agreement which lists explicitly among the purposes of the IMF, the facilitation of "the expansion and balanced growth of international trade" and "the elimination of foreign exchange restrictions which hamper the growth of world trade." In fact, as one of the standard conditions for making drawings that are phased over the life of an IMF program, a member must agree not to impose new, or to intensify existing, trade and payments restrictions. But the

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Senator MATTINGLY.
Senator HEINZ. Chair
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IMF often goes beyond the proscription against imposing further restrictions by actively encouraging members to reduce or eliminate existing restrictions. In some cases (e.g., in the IMF programs of Pakistan and India approved in 1981), a substantial liberalization of restrictions on imports constitutes an explicit major element in approval of IMF-supported balance-of-payments adjustment programs. The IMF also encourages members to reduce or eliminate subsidies that tend to stimulate exports and/or imports because of their distorting influence on resource allocation and their contributions to budgetary deficits.

In addition to the influence exercised through the provision of balance of payments assistance, the IMF actively encourages the reduction and elimination of restrictions or artificial incentives affecting current transactions or payments, or capital flows, through its surveillance over exchange rate policies of member countries, both for industrial and developing countries. These surveillance responsibilities flow from Articles I and IV of the Articles of Agreement which obligate member countries to maintain orderly exchange arrangements, to avoid competitive exchange depreciation, and to promote a stable system of exchange rates.

Senator MATTINGLY. I wish you would. Thank you very much.

Senator HEINZ. Chairman Volcker, we appreciate you being here. I have one last question for you before we call on Mr. Conover and Mr. Isaac and it's a little different from the ones you've received so far.

MORE CAUTIOUS WITH FUTURE INTERNATIONAL LENDING

As you know, there are some experts that argue that the current situation with the overexposure in countries like Brazil, Argentina, and Mexico are going to make the banks, particularly the big money center banks, more cautious in the future with their international lending.

I wonder if we really have any experience from the past that sheds any light on that because it seems to me that if official assistance through the IMF helps the largest debtor countries out of their difficulties, then banks in fact not only will not suffer any loss in earnings but indeed they are going to experience, as I understand the vicissitudes of rescheduling, they are going to actually experience increases in their earnings. And why isn't that an incentive for banks to say, "Well, say, this didn't work out so badly last time; as a matter of fact we extended a lot of credit we shouldn't have extended and along came the international rescue posse and we got a higher interest rate on our loans. Gee, that is a

great way to do business. I can hardly wait for the next international crisis to come along. Our profits went up."

Mr. VOLCKER. I well understand your concern, and that's the basic reason why I think it is perfectly legitimate to raise these supervisory questions as to how we approach these problems and what the reserve needs are and how to deal with front-end fees on loans. How do we get the right balance of incentives and disincentives here? I think, in fact, the banks will be more cautious and should be more cautious over a period of time, but let me conclude, by saying—

Senator HEINZ. You're not going to get away quite that easily.

Mr. VOLCKER. I would be happy to stay, but I think there is a danger in overreaction. As I said in my statement, the most dangerous thing we face today is not an excess of exuberance on the part of the banks—

Senator HEINZ. Or the bank regulators.

Mr. VOLCKER. The danger we face is in everybody running for cover so fast that they're mutually destructive. We have to work within that framework. We want a balance here.

Senator HEINZ. Chairman Volcker, I don't think anybody is suggesting that we ought to make it tougher for banks to do what they have to do in terms of not pulling the plug on any of these countries. Of course that's not what anybody responsible is saying, that we want to put something on the books or we want to tell you to do something that will cause all these banks to pull out of these syndications that will shatter the international financial system.

But what I'm asking you is, don't you think we ought to give you direction to establish a prospective system of loan loss reserves against nonperforming loans in the future so that rather than having an increase in profit when there's an international financial crisis that we come forward with \$8.4 billion to surmount, that indeed there is some recognition on the bottom line of the bank that things didn't really work out all that well.

Mr. VOLCKER. I will answer your question in two ways. I think the sense of the Congress—your giving us a general sense of direction and mandate in this area—is desirable. The specifics of an arrangement of that sort—and I think you're touching upon an area that we are looking at very hard, a promising area—the specifics, I'd like to reserve on.

Senator HEINZ. But you think that it is not inconceivable that we might want to do something in that area.

Mr. VOLCKER. Whether you want to put anything explicitly in the law, I don't know.

Senator HEINZ. I used that word "we," I didn't necessarily mean just Congress. I meant regulators and Congress together.

Mr. VOLCKER. In fact, in this area we have been making studies. The regulatory agencies together began looking into this matter a year ago.

Senator HEINZ. Chairman Volcker, thank you very much. We appreciate your fortitude in continuing to appear before this committee.

Mr. VOLCKER. I enjoy it.

[Complete statements of Mr. Volcker follow:]

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US BANKS

New capital rules

US bank regulators, under pressure from Congress to tighten their supervision of US banks' international business, have issued new minimum capital guidelines for all US banks and ended the special treatment accorded US multinational banks which have until now been allowed to observe lower than average ratios.

The new guidelines were greeted with little fanfare in the financial community mainly because the banks have been building up their capital base recently and the new ratios are not regarded as overly onerous for the handful of banks — Bank of America, Citicorp, Chase Manhattan included — which are at present under the minimum permissible level. Nevertheless, Salomon Brothers' Henry Kaufman observed that the new ratios could have 'far-reaching implications' particularly if they are used to achieve monetary policy objectives.

The new guidelines issued on 13 July establish a 5% minimum ratio of primary capital to total assets for the 17 biggest banks and also expand the definition of secondary capital for the purposes of calculating capital adequacy. In the past the 17 so-called multinational banks have been looked at individually but they are now going to be required to meet the same minimum capital requirements as the regional banks (defined as all other banks with over \$1 billion in assets).

Community banks, defined as those with less than \$1 billion, are required to have a primary capital to assets ratio of 6%. The bank regulators have also laid down ratios for total capital to assets. These are 6.5% for the multinational and regional banks and 7.0% for community banks. When individual

banks fall below these levels they trigger specific supervisory responses.

If their capital ratios fall into the 5.5% to 6.5% zone the regulators will 'presume that the institutions may be undercapitalised', and will closely monitor the situation. If a bank's ratios fall below 5.5% the agencies' response is tougher still.

The regulators say the guidelines will be applied in a flexible manner with exceptions as appropriate. Nevertheless the new rules are

potentially embarrassing for some of the best known names in the US banking community whose ratios are not up to scratch. Over the last 18 months the average primary capital ratio for these banks has been raised from 4.63% to 5.53% through the issue of \$450 million of common stock, \$2.9 billion of preferred stock and \$1.3 billion of mandatory convertible securities.

Given the buoyant US stock market those banks not in compliance with the new guidelines should be able to raise the extra capital without much difficulty especially since their capital retentions are growing faster than their balance sheets at present. ●

MONEY FUNDS

Raging success

Only six months after their long-awaited introduction, the money-market deposit accounts offered by US banks and savings and loan associations have become such a raging success that they are now recognised as one of the most popular savings vehicles ever created.

More than \$360 billion has flowed into the banks, savings and loans and mutual savings associations offering the new money market deposit accounts since they were first offered last 14 December. The growth of the new accounts has slackened somewhat in recent weeks compared with the explosive pace set at the beginning of this year — when they were raking in \$35 billion a week — but the Federal Reserve estimates that current flows are averaging a respectable \$1 billion a week in new funds.

Many bankers are now predicting that the new accounts will eclipse chequing accounts and certificates

of deposit as the primary source of new money for US banks, but the flood of money-market deposits has created a new dilemma for banks that are having trouble turning that windfall into profits.

In fact, the sheer volume of the inflows has limited the choice of banks, which are unable to put the money to work because it must remain parked in short-term instruments. The challenge for the banks is to narrow the gap between assets and liabilities while trying to widen the spread between the cost of the funds and the yields they bring in.

At a time when loan demand has become sluggish as a result of high interest rates and when banks are jittery about tying up money in long-term loans, some banks have put the blame on the new accounts for a dip in first quarter profits. Smaller banks which rely heavily on consumer deposits for money to lend tend to feel the pinch more acutely than the larger banks, which have fared better because the

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centage of a bank's capital can be exposed in any one country should be the subject of debate, but there has to be a reasonable limit. Other changes in regulation, appropriate reserve ratios, evaluation of assets, will undoubtedly be the subject of further examination.

Should commercial banks lend to foreign governments on a long-term basis, or should this be handled on a government-to-government basis? This is a difficult question and has to be examined. I would argue that, in the case of Communist governments such as Eastern Europe and the Soviet Union such credits are of strategic value and should be handled government-to-government. They should become a part of our strategic negotiations with the Soviet Union. There are presently over \$80 billion of credits outstanding to Eastern European countries and the Soviet Union; they have to be rolled over and substantial additional credits provided over the next few years. Estimates have been made of another \$40-\$50 billion of new credits needed over the next 5 years. We should, together with our European allies, propose a long-term re-financing plan for Eastern Europe in which the Soviet Union would join us and would provide half the credits and assume half the commitments. We should withhold rescheduling past debts, much less providing new credits, in the meantime. If this means a bankruptcy of Poland in the meantime, I would take this as an acceptable cost and our respective central banks can insure the viability of the banks involved, mainly the Germans. In a general sense, long-term loans are not the province of banks but, rather of insurance companies and the public markets. If loans to foreign governments, by definition, are long-term loans, it seems to me to raise a fundamental question.

One last question concerns OPEC. The Western democracies are now paying for the third time the OPEC price increases of the 1970's. We paid directly by transferring hundreds of billions in price increases. We paid indirectly by the resulting inflation. We are now paying, for the third time, by, one way or another, paying off the debts of the Third World countries which were originally entered into to pay for oil. OPEC may have less cash flow than it had two years ago, but their wealth and their credit is ample. This wealth must be mobilized to help in this refinancing effort. OPEC has enough at stake in the well-being of the West, and we have enough combined leverage militarily and politically, to bring about such a negotiation.

I apologize to the Committee for having drifted far from the original question. I believe, however, that the issues I have raised are relevant to your basic deliberations about increased U.S. support to the IMF. I support such increase, unequivocally. However, I am convinced that, basic to any long-term resolution of the current world debt problem, are:

- (a) Coordinated, aggressive economic growth policies among western nations;
- (b) An orderly international monetary system whereby the main trading currencies are maintained within given ranges;
- (c) A long-term, low-interest, refinancing of a significant part of the world-debt;
- (d) Participation by OPEC and the Soviet Union in the financial burdens of such an approach;
- (e) Maintenance of liberal trade policies throughout the world.

I am not naive enough to think that this is an easy program. It requires political leadership and vision of a high order, beginning with the United States. So did the Marshall Plan, NATO and Bretton Woods. However, only a world-wide program can solve a world-wide problem. There are obviously many variations to this theme; I see no acceptable alternative to the concept. The United States, Europe and Japan must, jointly, lead the world back to prosperity.

Senator MATHIAS. Thank you, Mr. Rohatyn.
Mr. Cline?

STATEMENT OF WILLIAM R. CLINE, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, D.C.

Mr. CLINE. Thank you, Mr. Chairman.

Of the \$500 billion owed by developing countries today—or \$700 billion if one includes Eastern Europe and short-term debt, approximately \$375 billion is owed to private banks.

There are two debt problems today. The first is that the inability to service this debt could cause bank crises and international monetary crises.

The second is that debt servicing difficulties can slow the growth in developing countries, reduce the exports from industrial countries to developing countries, slow the growth in industrial countries and contribute to worldwide recession.

The problem stems from higher oil prices in 1973-74 and 1979-80, and from higher interest rates in 1981-82 in particular. The real interest rate on LIBOR lending, that is deducting inflation, went from a minus 2 percent in 1973-77 to a plus 11 percent in 1981-82. Every 1 percentage point increase in interest rates costs the developing countries \$3 billion in debt service.

Global recession has also been a cause, with lower commodity prices and collapsing export markets. Domestic policies have been part of the problem. Argentina and Chile maintained highly unrealistic exchange rates. Mexico failed to adjust.

More generally, there has been a shift from world inflation to world disinflation. And in this environment the debt no longer is cheap. And finally, there has been a structural flaw in the lending process with an over-reliance on medium-term development projects.

Psychology, in addition to economic causes, has been crucial. The shocks of near default in Poland, of Argentina's debt disruption, and particularly of Mexico's suspension of payment in August, spilled over into international capital markets causing a drying up of loans to Brazil; a general cutback in international lending on an abrupt basis that has essentially precipitated the current crisis. To some extent, this cutback was inevitable because bank lending has been growing at 20 percent whereas bank capital has only been growing at 10 percent a year.

I would like to focus first of all on system stability. The underlying creditworthiness of developing countries has been eroding despite some indicators suggesting the contrary. The ratio of debt to exports has been relatively constant, but if one examines the debt service burden, that has been rising rather sharply. If one looks at the real debt service ratio, in other words deducting the inflationary erosion of the debt but otherwise considering the ratio of interest and the principal repayment to exports, that has risen from 9 percent in 1975-77, to 17 percent in 1981-82. Higher real interest rates, primarily as the result of U.S. monetary and fiscal policy mismatch, have been the driving force in this process.

A simpler way of looking at the extent of the problem is to list the countries that are in trouble. In table 1 of my written testimony you will see a listing of countries by the amount of their bank debt. And if one simply considers Argentina, Brazil, Mexico, Poland, Chile, and Yugoslavia—all of whom have had debt difficulties—more than half of bank debt held by developing countries is in jeopardy at this time.

To be sure, this bank debt could not possibly disappear overnight. On the other hand, a disruption could be a severe shock to the system. Consider the following possibility: If Argentina, Brazil and Mexico were jointly to miss 1 year's payment of principal and interest, and if they were to do so in a way whereby the banks were forced to write off those missed payments—which is unlikely but nevertheless not impossible, especially if banks reached the point where they are unprepared to make additional loans—then

the result would be \$14 billion—and their 1-year profit of \$27 billion. In other words, wiped out.

The effect of their exposure in leveraging of bank about \$150 billion

Senator MATHIAS making, that they Mr. CLINE. Yes;

Mr. ROHATYN. Senator. [Laughter]

Mr. CLINE. It is "super debtors" of Argentina, Venezuela, and Senator MATHIAS "super debtors."

Mr. CLINE. I will

The recent meeting the rescue mission role of the IMF in This is basically a motive to get out if in. And by having antisocial incentives we have to consider ment responsible for

Now beyond the the risk is not so volatile. In Mexico best of cases, and not impossible—that a strong likelihood package will not and Brazil will have will lend it?

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the result would be for the nine largest U.S. banks a loss of nearly \$14 billion—and that is in 1 year. That may be compared with their 1-year profits of about \$4.5 billion and their capital of about \$27 billion. In other words, one-third of their capital would be wiped out.

The effect of that would be that the banks would have to reduce their exposure in other loans by a 16-to-1 multiple because of the leveraging of banks, and that lending would have to contract by about \$150 billion—at least potentially—for these banks.

Senator MATHIAS. That is the point that Mr. Rohatyn was making, that they would not function normally.

Mr. CLINE. Yes; that is right.

Mr. ROHATYN. That is probably the understatement of the week, Senator. [Laughter.]

Mr. CLINE. It is crucial, then, to keep the largest debtors, the "super debtors" on tract. This includes at the least Brazil, Mexico, Argentina, Venezuela, and Poland.

Senator MATHIAS. I think you have just coined a word, the "super debtors."

Mr. CLINE. I will use it again. [Laughter.]

The recent measures have been encouraging. I will not rehearse the rescue missions but I will highlight one feature, and that is the role of the IMF in essentially coercion of new lending from banks. This is basically desirable because individual banks have an incentive to get out if they do not think other banks are going to come in. And by having a unifying factor it is possible to overcome that antisocial incentive. There is a dark side, however, which I think we have to consider. Will the banks in the future hold the Government responsible for potential future losses?

Now beyond that, despite the present calm, I would suggest that the risk is not past. In Argentina the political situation is highly volatile. In Mexico it will be difficult to meet the targets in the best of cases, and if there is a collapse in the price of oil—which is not impossible—the results would be devastating. In Brazil there is a strong likelihood that the balance-of-trade targets in the IMF package will not be met. And it is fairly likely that both Mexico and Brazil will have to return in mid-1983 for more money. Who will lend it?

The banks are at their limits and the IMF is already at its ceiling for lending to Mexico and Brazil. More fundamentally, if we get through 1983—I think the probability is still very good that we will without a severe crisis—a prolonged international recession could mean that Mexico, Brazil, and others decide by 1984 and after that the domestic growth sacrifices that they have to make to continue servicing their debt are not worth it. They are, in the cases of Mexico and Brazil, both likely to have a minus 2-percent growth or worse in 1983, and they may be unprepared to continue this for future years.

The second problem is, of course, the LDC growth problem. Essentially, one has a low probability-high cost risk of system collapse. But the other problem is a very high probability of a less dramatic cost problem of slower growth generally.

LDC growth has declined from 5 to 6 percent to 2 percent in 1981. The growth is going down, imports are going down. Morgan

Guaranty Bank has calculated that the \$25 billion cutback in bank lending to developing countries which is now anticipated will cause a 1½ percentage decline in developing country growth, and that in turn will cause a reduction in exports from the industrial countries that will cause industrial country growth to decline by half a percentage point.

So, the second part of the problem—though less traumatic—is extremely painful and in a word it adds up to propagation of international recession.

Let me turn to policy. The first policy that we must follow is expansion in the industrial countries. And for this purpose I would refer you to a pamphlet put out by the Institute for International Economics reporting a policy statement by 26 economists from 14 countries which advocates a program of coordinated expansion on an international basis, emphasizing monetary policy in the United States and different mixes in other countries. We feel that there is little risk of reigniting inflation at this time with high idle capacity and high unemployment.

Second, reduction in the interest rate is crucial. We have had already some relief. The 5 percentage-point decline in interest rates will save perhaps \$11 billion for the developing countries in 1983. It is important to try to get further declines in the interest rate.

Third, a less overvalued dollar is important. An overvalued dollar tends to depress the dollar prices of commodities and therefore the dollar value of exports to developing countries, while at the same time the dollar value of debt continues to rise.

Fourth, it is crucial that banks continue to lend. Expansion of 8 to 10 percent in their exposure to developing countries is essential.

Fifth, developing countries themselves have to adjust.

Let me focus on some of the policy measures affecting the International Monetary Fund. It is essential, in my view, to obtain the 50-percent increase in quotas for the International Monetary Fund—that is now generally agreed—and to establish the \$20 billion emergency fund. The International Monetary Fund is really the key institution for guarding against international financial collapse.

Now, it is understandable that some Americans would ask, "Why put more money into the IMF or in the developing countries when we have high unemployment at home and when this will simply be 'bailing out' the banks?"

First of all, the reality is that an international financial collapse will cause far more unemployment inside the United States than we now have. To scrimp on the IMF is equivalent to a decision by a homeowner to save money by discontinuing the premiums on his fire insurance.

The cost is virtually negligible in budgetary terms. IMF quotas do not come against the budget. And in the case of the World Bank it would be possible to expand capital without requiring paid in, that could be callable capital.

On the charge of whether the IMF bails out the banks, we have heard—I think quite accurately—the IMF has been bailing in the banks with its historically new preconditions that the banks make new lending in the cases of Argentina, Brazil, and Mexico.

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What about bank irresponsibility? If the banks were irresponsi-
ble, why does the public owe them anything?

I would submit that there are only a few cases—perhaps Zaire
and Peru in the mid-1970's—where excessive, irresponsible lending
is a case that can plausibly be made. On Brazil there is general
agreement that the lending has been for sound development. Even
in the case of Mexico there were signs at various points in early
1982 that policies were being changed, that perhaps the oil problem
might be temporary. And it is only with the luxury of hindsight
that it is easy to say that there was excessive or even irresponsible
lending in Mexico. So I do not generally subscribe to the thesis of
vastly irresponsible bank lending.

Policy measures should include an expansion of the World Bank
lending and a change in World Bank policy toward much greater
emphasis on structural adjustment lending for fast disbursement.

Other crucial changes are the following: Even if quotas are in-
creased by 50 percent in the IMF, and even with a \$20 billion
emergency fund, IMF resources may prove to be too small. We
should be prepared to support IMF borrowing in private capital
markets and from individual governments such as Saudi Arabia. In
addition, the IMF must be prepared to go beyond its own internal
ceilings on lending to individual countries, in the cases of the
"super debtors" that must be kept on track if the system is not to
be in severe jeopardy.

That means in the middle of this year, for example, if Mexico
and Brazil need more funds and the banks are not prepared to pro-
vide them, then even though the IMF is already at its ceiling with
respect to these two countries it should be prepared to exceed the
ceiling. For this purpose, the new emergency fund is the logical ve-
hicle.

What about more radical policy changes? There has been some
talk about the need for a new institution to bridge countries over
from the time they get into trouble to the time that they have an
IMF agreement. I consider this a red herring. It is basically a prob-
lem that concerns the "super debtors" on a case-by-case basis.
Other countries are too small to affect the system and can be safely
allowed to go into arrears until an agreement with the IMF is
reached.

Some have proposed a general moratorium. This is completely in-
feasible. It would be devastating to the banks as even the calcula-
tions for a 1-year moratorium in the case of the major debtors
would illustrate.

The possibility of an official intermediary such as the World
Bank or the IMF buying up bank debt at 90 cents on the dollar and
taking over LDC debt, may be worth considering as a contingency.
But I would point out that it would require very high capital con-
tributions and guarantees, and that we have to consider whether
the public is prepared to make such contributions at this time.

More generally, any sweeping reform runs the risk of continuing
the guilt-by-association that has already caused too much trouble.

It seems to me that we should conceptualize the current situa-
tion as a need to return to a voluntary capital flow process, and I
think we have a good chance of doing that. We must remember
that the large banks want to be in countries like Brazil and Mexico

over the longer term. We are not in a situation where we have gone from day of voluntary lending to night of never any voluntary lending in the future.

It is not clear to me at all that we want across-the-board reforms that are going to insure that voluntary lending does not happen in the future.

Other reforms I would suggest would include the tightening of lender-of-last-resort coverage—as the Banco Ambrosiano problem illustrates. In the longer run, we need tighter prudential treatment of rescheduled loans—although that would be counterproductive at the moment because it would further discourage bank lending.

And in the longer run it is crucial, it seems to me, to reduce bank exposure to developing countries as a fraction of their capital. The Western financial system now is too vulnerable to developing country debt.

This objective will require either more official lending which will be difficult, or the development of new vehicles for capital flows to developing countries. Direct foreign investment can play some role and conceivably increased borrowing on the bond market can help.

Replacing the banks as the principal vehicle for capital flows to developing countries will be the principal international financial challenge of the 1980's.

Of all of these policies, let me return to what I think is the most fundamental, and this is expansionary policies to reactivate the international economy.

Thank you.

[Mr. Cline's prepared statement follows:]

PREPARED STATEMENT OF WILLIAM R. CLINE

EXTERNAL DEBT AND GLOBAL FINANCIAL STABILITY

The external debt of non-oil developing countries today stands at over \$500 billion; the total is approximately \$700 billion if short-term debt and debt of Eastern Europe are included. Commercial banks account for \$375 billion of this total. Total debt of these countries has multiplied approximately six-fold from 1973, and nearly tripled in real terms. Today there are essentially two components to the debt problem. The first is that a breakdown in the orderly servicing of this large debt could cause severe pressures on private banks and the international financial system. The second is that the need for developing countries to cut back on imports in order to meet heavy debt payments in the face of shrinking supply of new bank lending may cause sharp reductions not only in their own economic growth but also in that of industrial countries that export to them.

World credit markets have suffered the shocks of near default in Poland, debt servicing disruptions in Argentina since the Falklands War in the spring of 1982, a dramatic suspension of principal payments by Mexico in August of 1982, and an extremely severe liquidity crisis in Brazil at the end of 1982. Because these four countries include the largest outstanding debts, the threat to the system has been substantial. For the present at least the crises seem to have been overcome. For Mexico, Brazil, and Argentina the official and financial communities have mounted successful rescue operations involving emergency lending from the U.S. Treasury and other central banks, country agreements with the International Monetary Fund involving not only new loans but also commitments to domestic adjustment, and co-ordinated packages of lending from the private banks. But the system is by no means out of danger, and the current breathing space should be used for the design of a longer run policy capable of dealing with possible renewed threats in the future.

The large amount of countries stems from the fact that the debt is a result of the debt causes of the debt again in 1979-80; the global recession 6 percent of imports today. Because of and loose fiscal policy rate on outstanding in 1981-82; deduct +3 percent over that fluctuate with interest rates now coming (net of extra) recession has driven down; it has cut back on economic crises; countries have devastated from such newly in.

Higher oil prices causes of high debt chose a high-risk, Argentina and Chile in a room; and Mexico financing up huge budgets. Nonetheless, most countries has gone for.

A broad theme of world economic environments that seemed to be rates—the true cost of export markets. This rather than a record part of the development precarious.

In addition, today since the mid-1970's, primarily because of needs. For a time a markets for rising to but in retrospect it is countries too dependent on development projects, dependent on sovereign that of development rollovers of previous as soon as that confidence short and medium longer automatic.

Bank confidence has a phase of this revolution were precipitated most extreme shock ed primarily from the peso made possible

¹ High nominal rates result was a cash flow as payments were immediate well; there was little inflation.

² For funds borrowed (Rate) plus 1 percent on nominal terms, and from

³ Jeffrey D. Sachs, "The Brookings Papers on Economic

ORIGINS OF THE DEBT PROBLEM

The large amount of external debt owed by developing and Eastern European countries stems from three central economic forces; the recent erosion in the viability of that debt is in addition influenced by psychological factors. The economic causes of the debt problem have been the sharp rise in oil prices in 1973-74 and again in 1979-80; the extremely high level of interest rates beginning in 1979;¹ and the global recession of 1980-82. Because of higher prices oil imports have risen from 6 percent of imports of net oil-importing developing countries in 1973 to 20 percent today. Because of higher interest rates, caused largely by the mix of tight money and loose fiscal policy adopted in the United States in 1981-82, the average interest rate on outstanding long term debt rose from 4.5 percent in 1973-77 to 8.5 percent in 1981-82; deducting (U.S.) inflation the real interest rate rose from -6 percent to +3 percent over the same period.² The bulk of external debt bears interest rates that fluctuate with international interest rates; one percentage point increase in interest rates now costs developing countries over \$3 billion in additional debt servicing (net of extra earnings on foreign exchange reserves). For its part, global recession has driven down commodity prices to the lowest real levels since the depression; it has cut back growth of export markets in industrial countries, and the special economic crises of countries such as Nigeria and several Latin American countries have devastated the new markets for manufactured exports to these countries from such newly industrialized countries as Brazil.

Higher oil prices, higher interest rates, and world recession are all external causes of high debt, but there have also been domestic causes. Brazil consciously chose a high-risk, high-growth strategy that depended on rapid debt build-up; Argentina and Chile held on to an overvalued exchange rate that caused debt to mushroom; and Mexico failed to adjust to a much softer market for its oil exports, running up huge budget deficits rather than make painful cuts before an election. Nonetheless, most careful studies indicate that the bulk of borrowing by developing countries has gone for productive investment.³

A broad theme of the debt problem is that there has been a sea-change in the world economic environment from inflation to disinflation, making borrowing decisions that seemed prudent in the late 1970's look risky in retrospect as real interest rates—the true cost of borrowing—have risen sharply just as recession has shrunk export markets. Thus it is basically a change in international economic conditions rather than a record of irresponsibility either on the part of the banks or on the part of the developing countries that has made the international debt situation so precarious.

In addition, today's problems stem from the structural inadequacy of capital flows since the mid-1970's. Developing countries relied increasingly on private bank flows, primarily because official flows did not rise fast enough to keep pace with borrowing needs. For a time analysts and policy-makers congratulated the private financial markets for rising to meet the challenge posed by the oil-finance recycling problem, but in retrospect it is all too clear that this response not only made the developing countries too dependent on short- and medium-term loans to finance long-term development projects, but it also made the banking system in industrial countries too dependent on sovereign risk. The mismatch between the maturity of lending and that of development projects caused no problem as long as bank confidence permitted rollovers of previous loans, but as became painfully clear in the last few months, as soon as that confidence faltered that heavy reliance on private bank lending of short and medium maturity caused a severe squeeze because rollovers were no longer automatic.

Bank confidence has indeed suffered a severe reversal. It is striking that the initial phase of this reversal was highly political: the Polish and Argentine debt disruptions were precipitated by political events with international dimensions. The most extreme shock to confidence came from the Mexican disruption, which resulted primarily from economic and domestic political causes combined with a run on the peso made possible only by Mexico's commitment to free exchange convertibil-

¹ High nominal rates in 1979-89 were offset by inflationary erosion of debt, although the result was a cash flow squeeze (the benefit of debt erosion was in the future but higher interest payments were immediate). But by 1981-82 interest rates were extremely high in real terms as well; there was little inflationary erosion of debt to compensate for high interest rates.

² For funds borrowed commercially at a typical rate of LIBOR (London Interbank Offered Rate) plus 1 percent spread, the corresponding rise was from 8.8 percent to 16.8 percent, in nominal terms, and from -1.6 percent to 11.3 percent in real terms.

³ Jeffrey D. Sachs, "The Current Account and Macroeconomic Adjustment in the 1970's," Brookings Papers on Economic Activity (1:1981, pp. 201-68).

ity, a rarity among developing countries. By September 1982, the damage to confidence had been done. Loans to Brazil began to dry up. Although there was some further erosion in economic creditworthiness of Brazil and other developing countries in 1982, largely because of declining exports, I would say that the greater part of the debt problem for Brazil and several other countries is now attributable to the psychological erosion of private bank confidence, whereas fundamental economics is responsible only to a limited degree. If 1982 could be rerun without the Mexico crisis, Brazil would very probably have experienced no borrowing difficulty. In a word, the banks overreacted.

In some sense this reaction was probably inevitable. Bank exposure to non-OPEC countries has been growing at 20 percent annually since the late 1970's, but bank capital has only been growing at 10 percent. In 1982 the rate of new bank lending fell by perhaps half (final data are not yet available) * and annual new lending at only half the 1981 rate (approximately \$20 to \$25 billion instead of \$50 billion to non-OPEC developing countries), or even less, is widely expected to be the new rate for the near term. This sharp cutback has been driven by the reversal in bank psychology. At least to some extent it has the features of a classic panic or financial bubble, whereby the "manic" phase of rapid expansion gives way at some point, usually upon some specific signal such as a business failure, to a phase of panic. For the world credit markets, the Mexican crisis was the signal marking the critical turning point.

SYSTEM STABILITY

To examine the first aspect of the debt problem—the risk to the international financial system—it is necessary to begin with a stock-taking of the extent of erosion of LDC creditworthiness. Ironically, by some measures the erosion has been limited. The ratio of external debt to exports for non-oil developing countries remained approximately constant at 100 percent from 1975 through 1981, although it almost certainly rose in 1982 with the decline in the dollar value of exports. However, because of rising interest rates the ratio of debt service (interest and principal) to exports of goods and services rose from 15.2 percent in 1975–77 to 26.6 percent in 1981–82 (including interest on short term debt). Deducting for inflationary erosion of debt, the rise in the "real" debt service ratio was even sharper: from 8.7 percent in 1975–77 to 16.8 percent in 1981–82.*

A catalogue of major debtors provides even more direct evidence of erosion. Table 1 lists the 20 largest borrowers of external bank funds. One year ago Argentina, Mexico, and Brazil had not experienced debt servicing disruptions; now they have. Together with Poland, Chile, and Yugoslavia, which have also had debt servicing suspensions or face severe servicing difficulties, they account for 58 percent of bank debt owed by the 20 largest debtors among the developing countries and Eastern Europe. Considering that some smaller countries such as Costa Rica are also in trouble, somewhat more than half of the total bank debt of developing and Eastern European countries now stands in some jeopardy over the near term. This calculation omits other countries even though they have high debt service ratios: Venezuela and Colombia because of unusually high foreign assets, and the Philippines and Malaysia because they are geographically removed from the Latin American sphere of current psychological contamination in credit markets.

* After rising by \$47 billion 1981, developing-country exposure of the Group of 10 banks monitored by the Bank for International Settlements rose by only \$16.8 billion in the first half of 1982, probably declined in the third quarter, and probably rose only moderately if at all in the fourth quarter. For Latin America, total capital inflows fell from \$42 billion in 1981 to \$19 billion in 1982; CEPAL News, January 1983.

* Charles P. Kindleberger, "Manias, Panics, and Crashes: A History of Financial Crisis" (New York: Basic Books, 1978), Ch. 2. In this case the object of the bubble is financial assets in LDCs, rather than shares in the South Sea Company or Dutch tulip bulbs.

* International Monetary Fund, "World Economic Outlook" (Washington, 1982), and special calculations of short-term debt from Bank for International Settlements data.

TABLE 1.—DE

1. Mexico.....
2. Brazil.....
3. Venezuela.....
4. Argentina.....
5. South Korea.....
6. Poland.....
7. Chile.....
8. Philippines.....
9. Yugoslavia.....
10. German Democratic Rep.....
11. Algeria.....
12. Hungary.....
13. Indonesia.....
14. Nigeria.....
15. Taiwan.....
16. Israel.....
17. Colombia.....
18. Egypt.....
19. Malaysia.....
20. Peru.....

Subtotal.....

Total, LDCs * and

* Group of 10.
 * Including short-term principal.
 * Including Yugoslavia; exclude
 * Excluding U.S.S.R.

NA = Not available.
 Source: Bank for International

Obviously not even. Even if forced to write-off; and even off a fraction of missed, except in failures occur in

Nevertheless, a t to the banks and tina, and Brazil are ity. But consider wi principal and inter qualify as a bonafid plausibly or prudum on interest and equal to one-third account of offsettin cause insolvency—e would mean that th in order to reestabl There would thus l

* These three countr fined is only \$27 billion \$3.4 billion in interest, debt payments for 1983 contrast, 1981 profits o taxes. Thus a loss of \$1 items generating taxes

TABLE 1.—DEBT OWED TO INDUSTRIAL COUNTRY¹ BANKS BY DEVELOPING AND EASTERN EUROPEAN COUNTRIES, JUNE 1982

	Debt (billions)	Debt service ² as percent of exports of goods and services
1. Mexico.....	\$64.4	129
2. Brazil.....	55.3	122
3. Venezuela.....	27.2	95
4. Argentina.....	25.3	179
5. South Korea.....	20.0	53
6. Poland.....	13.8	NA
7. Chile.....	11.8	116
8. Philippines.....	11.4	91
9. Yugoslavia.....	10.0	46
10. German Democratic Republic.....	9.4	NA
11. Algeria.....	7.7	39
12. Hungary.....	6.4	NA
13. Indonesia.....	8.2	27
14. Nigeria.....	6.7	20
15. Taiwan.....	6.4	21
16. Israel.....	6.1	NA
17. Colombia.....	5.5	94
18. Egypt.....	5.4	48
19. Malaysia.....	5.3	90
20. Peru.....	5.2	48
Subtotal.....	311.5	
Total, LDCs ³ and Eastern Europe ⁴	374.9	

¹ Group of 10.² Including short-term principal.³ Including Yugoslavia; excluding Middle-Eastern capital surplus oil exporting countries.⁴ Excluding U.S.S.R.

NA = Not available.

Source: Bank for International Settlements and World Financial Markets, October 1982.

Obviously not even half of bank loans to these countries will disappear over night. Even if forced to interrupt payments, countries can reschedule debts, avoiding bank write-offs; and even if reschedulings come unglued, banks would only have to write-off a fraction of loans—not the full amounts—corresponding to the payments missed, except in the politically unlikely event of a formal debt repudiation. Debt failures occur in slow motion.

Nevertheless, a temporary but severe disruption of debt servicing could be costly to the banks and to stability of the financial system. At the moment, Mexico, Argentina, and Brazil are on track with debt restructurings of varying degrees of formality. But consider what would happen if all three missed just one year's payment of principal and interest and did so in a form of involuntary moratorium that did not qualify as a bonafide debt rescheduling and whereby the payments missed could not plausibly or prudently be maintained on the books of the banks. A 1-year moratorium on interest and principal by Argentina, Brazil and Mexico would cause losses equal to one-third of the capital of the nine largest U.S. banks even after taking account of offsetting profits on other loans.⁷ While this cut in capital would not cause insolvency—except perhaps for one with heavy domestic losses as well—it would mean that the banks would have to begin to reduce their total loans sharply in order to reestablish the 6 percent capital ratio to loans required by regulations. There would thus be a multiple reduction in loans. Potentially the nine largest

⁷ These three countries owe \$30.5 billion to the nine largest banks, whose capital broadly defined is only \$27 billion. Together the three countries owe the nine largest banks approximately \$3.4 billion in interest, \$6.9 billion in short term debt payments, and \$3.4 billion in long term debt payments for 1983, before recent restructurings. The total owed is \$13.7 billion for 1983. By contrast, 1981 profits of these banks were \$2.8 billion net, or approximately \$4.3 billion before taxes. Thus a loss of \$13.7 billion would cause total losses of \$9.3 billion, and without offsetting items generating taxes these losses would have to be fully absorbed out of capital.

damage to confidence there was some developing countries the greater part attributable to the real economics is out the Mexico difficulty. In a

re to non-OPEC 1970's, but bank w bank lending new lending at of \$50 billion to be the new rate al in bank psynic or financial at some point, phase of panic.⁵ ting the critical

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banks would have to cut their loans outstanding by approximately \$150 billion as the result of a loss of one-third of their capital from 1 year's loss of principal and interest from Argentina, Brazil and Mexico under conditions where these losses had to be written off. Even if the Federal Reserve loosened the capital backing of loans temporarily, the potential would exist for economic shock waves through reduced credit availability to American business and more unemployment. And Argentina, Brazil, and Mexico are less than half of the problem. Loans to these countries account for 113 percent of capital of the nine largest banks; loans to all developing countries and Eastern Europe account for approximately 250 percent of their capital. For all U.S. banks the ratio of loans to non-oil developing countries plus Eastern Europe stands at 160 percent, somewhat lower but not greatly so.

So far the system has avoided this kind of international financial shock. From the standpoint of the global financial system it is crucial to keep a handful of the largest debtors from default: Brazil, Mexico, Argentina, Venezuela, and Poland. The system could absorb a number of defaults by smaller debtors, but default or moratoria by three or four of the largest could cause the kind of systemic shock just described. The so far successful rescue packages for Argentina, Brazil, and Mexico are all the more important for this reason, and they give cause for encouragement. I need not rehearse the sequence of international efforts by central banks, and the terms and magnitude of the IMF agreements, that have temporarily kept these three super-debtors on track. One feature, however, warrants highlighting. For the first time the International Monetary Fund has required private banks to increase their exposure as a precondition of lending programs, offering them the alternative of putting in new money or suffering country default on the old money. This change is of historical significance. There is a well known problem whereby each bank acting in isolation may be forced to try to take its money out if it thinks other banks will do so even if individually it would prefer to continue lending, and by acting as coordinator the IMF has reduced this problem of counterproductive action in isolation (although some of the smaller banks may still try to cut and run). There is an interesting question, however, of whether the IMF's coercion doesn't establish some bank claim to future public sector support, much as appears to be the case with respect to German banks' perception of government responsibility following public cajoling of additional lending to Poland.

The temporary success of keeping the super-debtors from default is by no means guaranteed to hold for the future. In Argentina the political fabric is so strained, in part because of the issue of "disappeared" civilians, that performance under the IMF agreement is in doubt, even though in purely economic terms Argentina's external balances are relatively promising. Mexico may have some political difficulty implementing its austerity plan, could fall short of balance of payments targets, and is subject to a possible drop in oil prices (in today's weak market) that would completely unravel the financial program. It is relatively likely that Brazil will be unable to fully meet its ambitious plan to raise the trade surplus, and that as a result it will have to return in mid-1983 to ask the banks to provide additional new money beyond the amount already coaxed out of them by the International Monetary Fund. More fundamentally, if the international recession does not turn into recovery soon, the choice for Mexico and Brazil by 1984 could be between accepting further, austerity-induced loss of income on the one hand and some form of debt moratorium on the other. The longer the international recession, the greater the cumulative domestic income loss, the more likely an eventual political decision in favor of moratorium. To complete the picture of downside risk, it is not clear how far the banks are prepared to attempt to rescue old money by adding new. The 121 largest international banks lending to Brazil have been asked (and to date most have agreed) to increase exposure by \$4.4 billion in 1983, or by 12.5 percent, a rate already in excess of capital growth; how much more will they be prepared to add?

In all of the recent major debt crises there has been a disturbing trend toward involuntary or forced rescheduling. Mexico unilaterally announced postponement of principal in August; late in the year Argentina unilaterally announced medium-term postponement of payment of approximately one-third of its private debt in so-called "swap" accounts (that had entered the country with favorable guarantees that were perhaps implausible even from the start). Brazil, which has intensely tried to distance itself from the temporary debt suspensions of Mexico and Argentina, took a step toward rescheduling on a basis that was involuntary to banks when, after announcing plans to postpone 1983 principal but before obtaining bank agreement, it unilaterally announced these payments would be postponed.

There are two basic problems in this gradual slide toward rescheduling on a basis that is involuntary to the banks. First, for Brazil especially, postponement of principal is not adequate given the wide gap between export earnings and imports plus

heavy interest required to clear formal rescheduling dry up badly the arm-twist model). The value of rescuing them for long should probably be doubted that they paid essential suspect.

From the standpoint for now has ample cause for second dimension more uniform financial collapse cost of a slow countries achieving trial countries dens cut their worse. For Latin fell by approximately 2 percent or ports to deal growth can be

Morgan Guaranty participated will cut induced reductions by one-half than understate of confidence in with 32 percent States will suffer crunch in external

The IMF has reduced imports and consequences and redeveloping countries. The missing industrial countries are not necessary

Whether there and financing decisions are how severe the more dramatic public policy.

Reactivation of instrument for dealing with trial countries well as some would argue that inflation

* World Financial
* In this context, systematically continuing austerity measures in economic conditions in see John Williamson International Economics

nately \$150 billion as loss of principal and where these losses had capital backing of loans moves through reduced payment. And Argentina, to these countries accounts to all developing countries plus Eastern

so. social shock. From the handful of the large, Poland. The default or moratorium shock just devastates, and Mexico are for encouragement. Industrial banks, and the temporarily kept these highlighting. For the banks to increase them the alternative money. This change whereby each bank if it thinks other due lending, and by interproductive action (and run). There isn't establish to be the case responsibility following

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heavy interest payments. Instead, large continued infusions of new lending are required to close the external accounts. And if Brazil moves more completely to a formal rescheduling whereby bank rollovers are involuntary, the result will be to dry up badly needed new lending even more completely, leaving no alternative but the arm-twisting of involuntary new lending to cover interest (along the Polish model). The second problem with this trend is that it makes maintenance of full value of rescheduled loans on the books of the banks more suspect. As an agenda item for longer term reforms, even rescheduled principal with servicing of interest should probably be subject to some loan provisioning because of the inherent evidence that the original loan is not meeting expectations; when even the interest is paid essentially through involuntary new loans, nonprovisioning becomes even more suspect.

DEVELOPING COUNTRY GROWTH

From the standpoint of global stability the international financial system at least for now has avoided the shock of default by the superdebtors, although there is ample cause for concern about the eventual outcome of the rescue package. On the second dimension of the debt problem, developing country growth, the record is more uniformly negative. There is low probability and very high cost of a world financial collapse caused by LDC debt; there is high probability albeit less dramatic cost of a slowdown in LDC growth caused by the debt burden. Non-oil developing countries achieved average growth of 5 to 6 percent in the late 1970's (when industrial countries were growing more slowly), but finally world recession and debt burdens cut their growth to only 2.5 percent in 1981, and for 1982 the results were even worse. For Latin America real production grew only 1.5 percent in 1981 and actually fell by approximately 1 percent in 1982. Despite official statements to the contrary, adjustment programs in Mexico and Brazil are highly likely to reduce output by 2 percent or more in 1983. More generally, as developing countries cut back imports to deal with stagnant export markets and declining capital inflows, their growth can be expected to fall.

Morgan Guaranty Bank has estimated that the halving of new bank lending anticipated will cut developing country growth by 1½ percentage points, and that the induced reduction in industrial country exports will cut growth in industrial countries by one-half percentage point.⁸ These estimates are more probably overstated than understated, but they are on the right order of magnitude. In a word, the crisis of confidence in bank lending is contributing substantially to global recession. And, with 32 percent of its exports going to the non-oil developing countries, the United States will suffer reduced growth as the side-effect of LDC cutbacks caused by the crunch in external financing.

The IMF has been criticized for recommending austerity policies that involve reduced imports and income in individual countries, while failing to add up the consequences and realize that it spells global recession. But adjustment is required in developing countries, with more slowly growing imports and more rapidly growing exports. The missing element in the global equation is more rapid economic growth in industrial countries, so that LDC export expansion is feasible and that the global sums are not negative.⁹

Whether there will be a quiet crisis of slower LDC growth as the result of debt and financing difficulties is not in dispute: it is already occurring. The only questions are how severe this quiet crisis will be, and whether it will be accompanied by the more dramatic wrenchings of a global financial crisis. The answers will hinge of public policy.

POLICY IMPLICATIONS

Reactivation of the international economy is by far the most important policy instrument for dealing with the problem of international debt. Faster growth in industrial countries would mean more buoyant markets for developing country exports as well as some recovery in commodity prices. I radically disagree with those who argue that inflation is the only way out of the debt problem. Another wave of rapid

⁸ *World Financial Markets*, October 1982.

⁹ In this context, there is some inconsistency in the IMF prescriptions insofar as they have systematically continued to emphasize restrictive policies in industrial countries in addition to austerity measures in developing countries. For a statement of the need to consider global economic conditions in IMF programs, as well as an analysis of the need for increased IMF quotas, see John Williamson, *The Lending Policies of the International Monetary Fund*, Institute for International Economics, Policy Analyses in International Economics No. 1, August 1982.

inflation would merely raise world interest rates on LDC debt and make a subsequent recession even more severe. Fortunately, there is now ample room for more expansionary policies in industrial countries without re-igniting inflation. Industrial capacity utilization is extremely low, unemployment is at record highs for the postwar period, and grains are in excess supply. In the United States a continuation of the recently more expansive monetary policy, with the goal of bringing interest rates down by perhaps another 2 percentage points, is essential; and while fiscal policy needs to be tightened for later years, for the next year tightening would be undesirable. In other countries differing mixes of policies are desirable; but overall what is needed is an internationally coordinated move to more expansionary policies to bring the world economy out of the most devastating recession since the 1930's.¹⁰ Unless this international economic reactivation can be achieved, the likelihood is substantial that sooner or later major debt moratoria and financial crises will arrive.

Lower interest rates are especially crucial for overcoming the LDC debt problem. The decline of approximately 5 percentage points in United States and Eurodollar interest rate in the last 6 months will provide some much needed relief; if rates stay at current levels, developing countries should have a reduction of approximately \$11 billion in their interest payment in 1983 (taking account of a higher debt base and lower earnings on reserves), offsetting perhaps one-third to one-half of expected cut-back in bank lending. It is imperative that this decline in interest rates be maintained and, if possible, pushed considerably further.

A less overvalued dollar would also contribute substantially to improvement in the debt situation. The overvalued dollar has tended to reduce the dollar price of commodities, and raise the ratio of largely dollar-denominated debt to the dollar value of exports. In addition, many developing countries tie their exchange rates to the dollar, so that overvaluation of the dollar causes an additional stimulus to their imports and causes depressant to their exports.

It is also crucial that the private banks continue to lend new funds to the developing countries. For the near term an appropriate target for expansion is probably 8 to 10 percent of exposure, more in line with capital growth than the heady expansion of the late 1970's but a positive growth that avoids the likely financial crises that would result from attempts to freeze or even reduce exposure. The regional banks and some European banks have shown more reluctance to continue lending than the largest U.S. banks, primarily because individually they view themselves as too small to precipitate a crisis by their own action. It is important that these smaller banks continue to lend along with the larger banks, because in the aggregate they are large enough to make a great deal of difference.¹¹ Public authorities can facilitate continued lending by their regulatory decisions on loan status and in some cases by moral suasion. The IMF should continue its new approach of encouraging banks to continue lending in particular stabilization programs.

For their part, the developing countries should pursue adjustment programs, typically emphasizing more realistic exchange rates, lower budget deficits, and less reliance on external borrowing. They should seek maximum emphasis on efficient shifting of resources toward production of exports and import substitutes, as opposed to general recessionary reduction in resource utilization, in order to achieve external adjustment at the lowest cost in terms of real output. Typically this process will require labor cooperation in the setting of real wages so that devaluation is not frustrated by a wage-price spiral.

At the international level it is essential that IMF resources be increased by at least the 50 percent now under consideration, and that in addition the "emergency fund" of \$20 billion in the General Arrangements to Borrow with the IMF also be established. It cannot be emphasized too strongly that at the present time the International Monetary Fund is the paramount vehicle available for ensuring that sovereign debt problems do not lead to international financial collapse.

It is perhaps understandable that some Americans question increasing IMF resources, or other lending to foreign countries, when unemployment at home is so high, and when there is considerable suspicion that such measures merely serve to "bail out the banks." The reality, however, is that there is no safeguard in the system against international financial collapse, there could be far more unemployed

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¹⁰ See Institute for International Economics, *Promoting World Recovery: A Statement on Global Economic Strategy*, Washington, D.C., December 1982.

¹¹ Thus, while the 9 largest U.S. banks account for 58 percent of loans to Latin America, the smallest 143 of the 167 banks covered by Federal Reserve reporting account for 22 percent. Federal Reserve, County Exposure Lending Survey, June 1982.

on America's streets. Even the limited moratoria I have outlined for Argentina, Mexico and Brazil could imply a sharp increase in U.S. unemployment.

Essentially the IMF provides insurance against world financial collapse. Just as it is the worst form of false economy to cut the household budget by discontinuing premiums on fire insurance, it would be seriously misguided to economize by failing to maintain adequate international financial insurance.¹²

With respect to the fairness of bailing out the banks, the first point to consider is that with the new IMF policy the banks are being forced to take up their fair share of the burden; the IMF is "bailing in" the banks. The more fundamental point is that the banks are such a strategic foundation to the economy that a severe blow to the banks cannot help but injure the entire economy.

A related critique is that measures to bail out the banks are misguided because the current problem is the result of their irresponsible lending, and that they should be made to pay the penalty for that irresponsibility. Aside from some isolated cases, however, such as those of Zaire and Peru in the 1970's, it is difficult to identify bank irresponsibility. Consider Brazil. Almost no one would argue that its massive debt is the result of irresponsible overlending by greedy bankers to an incompetent regime. Instead, there is general agreement that Brazil's policies have generally warranted the bank lending it has received. Even in Mexico the softer oil market was initially seen as temporary, and devaluation early in 1982 was a sign of positive policy reform; overlending by banks to Mexico is a critique that requires the advantage of hindsight.

In short, it is essential to raise the resources of the International Monetary Fund, and this measure should not be thwarted by naive arguments that our resources should be kept at home or that the government should not bail out the banks. A parallel line of action would be to expand the lending capacity of the World Bank and other multilateral banks. For this policy to have much impact on the current debt situation, however, it would be necessary for these institutions to become much more flexible in their own internal practices in moving toward fast-disbursing "structural adjustment" loans rather than keeping the bulk of their lending in project loans that require several years for actual disbursement.

There are other changes in the system that may also be required. Even with a 50 percent quota increase, IMF resources may prove inadequate. If so, or if the need arises before the increases are implemented, the IMF should be encouraged to borrow the required funds from private capital markets or from individual official lenders (as has been done in the past in IMF borrowing from Saudi Arabia). Similarly, there must be flexibility at the country level in IMF lending. If one of the key super-debtors is unable to meet initial balance of payments targets it may be necessary for the IMF to lend additional amounts above and beyond the current limit of 450 percent of IMF quota. The logical vehicle for this purpose would be the newly expanded General Arrangements to Borrow; if it is to be a truly effective "emergency fund" it should be fully flexible. The basic point is that it is crucial to the system to avoid moratorium by a super debtor, and as the IMF is essentially the lender of last resort in the system it must be prepared to go beyond traditional norms if the situation requires it.

With this broad set of policy guidelines, it should be possible to navigate the dangerous waters of the next 2 or 3 years. Essentially this strategy is one of case by case treatment of debt problems with willingness on the parts of the industrial country governments, the IMF, the developing country in question, and the private banks to act forcefully to meet the evolving situation.

An alternative approach would be to pursue much more radical change on the basis of the argument that the external debt of developing and the Eastern European countries is clearly unsustainable and that substantial portions of it must somehow be written off and/or absorbed by official institutions. A mild reform that has received some attention would be to create some new vehicle or institution to bridge the period between the country's imminent difficulty and the reaching of agreement on IMF lending. In my view, not much energy should be spent on this problem. From the standpoint of the system it is only of significance for a few super-debtors, and they can be (and have been) handled individually; other countries can simply be allowed to go into arrears temporarily, because their individual debts are too small to affect the system.

More radical proposals include some form of generalized moratorium for a period of years. The calculations I have presented earlier for a 1-year moratorium just by Argentina, Brazil, and Mexico should be sufficient to demonstrate that any general-

¹² And in budgetary terms there is no cost from increasing IMF quotas.

ized moratoriums could be devastating to the banks and to the international financial system.

Another proposal has been that the IMF, World Bank, or perhaps some new institution would purchase LDC debt from the private banks at a discount—perhaps 90 cents on the dollar—and become an intermediary between the banks and the developing countries. This approach warrants consideration, but it would involve very high capital contributions or guarantees to the intermediating agency in order that it have the credibility to be able to issue reliable paper to the banks in exchange for their claims on developing countries. If the full amount of outstanding loans were “funded” in this way, instead of just annual payments coming due, the capital requirements could be huge.

A general problem with any sweeping reforms such as these is that they would indiscriminately lump together all developing countries as equally uncreditworthy, whereas many countries (especially in Asia) still have the capacity to maintain orderly debt servicing on their own. There has already been too much guilt by association in international lending, as Mexico's crisis spilled over to much of Latin America and Poland's to Eastern Europe; it could be a mistake to institutionalize the phenomenon by approaching LDC debt on a sweeping, multi-country basis.

There are other system reforms that do require close attention. The Banco Ambrosiano affair is another piece of evidence that more complete “Lender of Last Resort” coverage is necessary in the banking system. All offshore centers could require that parent banks accept legal responsibility for their subsidiaries. In addition, in the long run it would be desirable to have tighter prudential treatment of rescheduled loans requiring some provisioning of these loans. There is a short run conflict here with the objective of keeping new lending moving to developing countries at the present time, however. Also over the longer run it would be desirable for the system to reduce the exposure of banks to sovereign risk relative to their total capital. It is not prudent to have the entire U.S. banking system so vulnerable to default by a handful of developing countries. The central challenge in this longer term program is to develop an alternative vehicle for capital flows to developing countries, other than bank lending. The developmental need for these flows will exist for decades. But the sharp rise in bank lending as their vehicle was almost certainly an unsustainable historical episode of the 1970's. Now it is the turn of some other channel to take up a rising share. Recent experience suggests pessimism about the willingness of industrial country governments to return to greater reliance on official flows. Conceivably greater emphasis on the floating of bonds could be developed once capital market confidence has been restored, and more active flows of direct investment could also help. But the challenge of finding a replacement for bank lending will not be easy to meet.

In sum, an essential policy package for dealing with the problem of international debt includes reactivation of the world economy through internationally coordinated policies of expansion, lower interest rates, correction of misalignments of the dollar, continued bank lending, LDC adjustment, prompt adoption of the 50 percent increase in IMF quotes and the enlarged IMF emergency fund, perhaps expanded structural adjustment by the World Bank, and a willingness to deal with major threats to the system by allowing the IMF to borrow from private capital markets and to exceed its internal country lending ceilings if necessary. It would be counterproductive at this time to abandon this gradualist, case by case approach for sweeping reforms involving widespread moratoria or official refinancings of developing country debt. If the approach proposed here is followed, it should be possible to get through 1983 without major debt disruptions; but this relatively optimistic prospect cannot be expected to hold through 1984 and beyond unless the world economy recovers from its severe recession.

Senator MATHIAS. Thank you, gentlemen.

Let me start with a question of Mr. Rohatyn. You pointed to the possibility of a repudiation by one or more developing countries. Do you want to expand that thought any, as unhappy and grim as it is? Do you have any candidates?

Mr. ROHATYN. Unfortunately, Mr. Chairman, there are probably too many candidates. I mean, it does not really take a great leap of the imagination to think that if you have another year or 18 months, or 2 years of no growth, essentially and of rescheduled debt that simply keeps piling interest on top of debt—

Senator MATHIAS. Plus the rescheduling fees.

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Mr. ROHATYN. Plus the rescheduling fees.

Senator MATHIAS. Fees.

Mr. ROHATYN. Plural yes, Senator.

Of what appears to, say, the average Mexican as IMF or foreign-bank imposed austerity and further reductions in standards of living to repay foreign banks—I mean, it would not take any great propaganda effort to create that image where it becomes both politically impossible to continue on this course and where it might become economically viable to even consider repudiation and live off your raw materials. I mean, Mexico has oil. Whether the price is \$15, \$20, or \$25, it can probably live off its oil for a while.

And where both political and economic imperatives create a logic and a dynamic of its own, countries have repudiated their foreign debts in history.

I am not saying that this is likely, but it seems to me that on the scale of 0 to 10 it is not negligible. It is one of these things where maybe the risk is less than 50 percent, but if it happens the impact is devastating. And therefore I just do not think it can be overlooked.

Senator MATHIAS. As one component of this problem you have mentioned stabilization of exchange rates.

Mr. ROHATYN. Yes, Senator.

Senator MATHIAS. How do you do that without negating our concepts of free capital markets, free flow?

Mr. ROHATYN. You can have free-flowing markets, Senator, within the constraints of exchange rates that are not allowed to fluctuate beyond certain bands.

Senator MATHIAS. So you are talking about, really, stabilizing at the outer limits.

Mr. ROHATYN. Well, take the European monetary system where you have the so-called snake and where the various central banks maintain the limits of exchange movements to a certain band.

Senator MATHIAS. I never fully understood the snake, I must say.

Mr. ROHATYN. It is an arcane art, Senator, and I am not sure it is worth your while to really spend a lot of time on it.

But it would mean that there would be an agreement among the central banks not to permit the main trading currencies—the yen, the dollar, the pound sterling and the Deutsche mark—to go beyond certain limits without the central banks as a matter of fact intervening in the foreign exchange markets to maintain them there.

Now, what it does is require a commitment to intervention, which is philosophically now what the current thinking is. It also implicitly requires coordination of monetary policies, otherwise you have different kinds of problems.

But you do need something, it seems to me, to prevent a situation where the yen can be 280 to the dollar one day and 6 months later it is 200 because when those situations occur what it does is, it stops all industrial investment because you do not know where to put up your facilities and how to handle your commitments, et cetera.

I do not think that is a tolerable situation and I do not believe that you can talk rationally about industrial coordinated growth

without addressing the problem of uncontrolled foreign exchange fluctuations. I just do not think it can happen.

Senator MATHIAS. I have a lot of interest in this particular part of the problem. But would your solution require a new financial institution, a new international association of some kind?

Mr. ROHATYN. I do not believe so, Senator. I think that there are enough mechanisms of cooperation among the various central banks and the international organizations presently existing so that that particular situation could be handled. It would simply require a commitment, swap arrangements, other arrangements among the central banks, and policies among the Western governments to make this happen.

I mean, tomorrow the Federal Reserve can go into the market and buy yen, and put the yen at 200. It may cost \$10 billion, \$15 billion, or \$20 billion. It can be done.

Senator MATHIAS. Who ought to take the lead in that?

Mr. ROHATYN. Clearly the United States, Senator. The United States is the leading world power and the dollar is the standard currency, the standard reserve currency. Only the United States can take the lead.

But it would have to be done as part of a plan with the United Kingdom, with Germany, possibly with France, certainly with Japan. And it would have to aim at a certain coordination of policy.

Senator MATHIAS. Mr. Cline, in your very interesting paper you come to the conclusion of saying that you do not subscribe to the thesis of irresponsible lending. Is that right?

Mr. ROHATYN. Yes, sir.

Senator MATHIAS. What about irresponsible borrowers in the sense that borrowing nations may have adopted irresponsible economic policies?

Mr. ROHATYN. I think there are clearly instances of that, and I cited in fact the over-valued exchange rate of Chile and Argentina; the very much delayed adjustment measures in Mexico once it was realized that the oil market was softer than they had anticipated. Even so, the budget deficits kept rising because the country was going into an election.

So, there are certainly cases—and important cases—of improper domestic policies. But it seems to me as the central broad reason for the current problem one cannot attribute irresponsible policy either on the side of the lenders or the borrowers as a principal cause.

Instead, the principal cause has been the worst global recession since the Great Depression, extremely high interest rates, and international economic factors.

Senator MATHIAS. Senator Proxmire?

Senator PROXMIRE. Mr. Rohatyn, in testimony before the Senate Banking Committee on February 23, 1982—less than a year ago—regarding the Polish debt situation you said:

I hold firmly to the view that Poland should be declared bankrupt and that the rescheduling of Poland's debts as well as those of other Eastern European countries, such as Romania, be suspended. That new credits to Eastern Europe should not be made available by the Western banking system at this time. That the financial and economic burden of the satellite states be placed squarely upon the Soviet Union.

And that future credits be presently under negotiations.

Now, in today's prepared statement

We should, together plan for Eastern Europe half the credits and

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Mr. ROHATYN. I believe that the negotiations with our interest and growth

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Senator PROX. you did not say financial and economic squarely upon to Eastern Europe negotiation, including

Mr. ROHATYN. Senator PROX. about linking the

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And that future credits to Eastern Europe become linked to the total range of issues
presently under negotiation with the Soviet Union, possibly even with arms limita-
tions.

Now, in today's statement there is a new feeling. In your pre-
pared statement you say:

We should, together with our European allies, propose a long-term refinancing
plan for Eastern Europe in which the Soviet Union would join us and would provide
half the credits and assume half the commitments.

What accounts for your change of opinion?

Mr. ROHATYN. Senator, I have not changed my view. I still be-
lieve that the bankruptcy of Poland ought to be the first step in a
negotiation with the Soviet Union. I think that it is ultimately in
our interest and in the interest of Western Europe to have normal-
ized and growing trade relations with Eastern Europe.

But I think that should only happen as part of a package in
which the Soviets contributes at least 50 percent. So, I do not be-
lieve it is inconsistent with the position I took in front of your com-
mittee a year ago. I still hold to the same position. I just view that
as an extension of that position.

Senator PROXMIRE. When you appeared before our committee
you did not say anything about 50 percent. You said, "that the fi-
nancial and economic burden of the satellite states be placed
squarely upon the Soviet Union," and so forth, "and future credits
to Eastern Europe become linked to the total range of issues under
negotiation, including even arms limitation."

Mr. ROHATYN. Yes.

Senator PROXMIRE. There is nothing in your statement here
about linking this to arms limitation.

Mr. ROHATYN. Well, maybe it is because I shortened it. I abso-
lutely do, Senator. I absolutely do. I think one of the problems—as
a matter of fact, we keep talking about the world's economy and
the recovery of the Third World, et cetera. And at the same time
we are merrily going along burdening the world with \$800 billion
of arms sales every year, or arms investments. I think that is total-
ly inconsistent.

I most certainly would link the two, Senator.

Senator MATHIAS. Amen.

Mr. ROHATYN. I would also say that when we begin to look at
credits to less developed countries, we might question seriously
whether those credits should be made available when at the same
time they are being used for massive arms purchases that do noth-
ing for the development of these countries.

I mean, there is more involved here than accounting entries and
I think that we have to look at it as such.

Senator PROXMIRE. Well, I think it is if not a different, certainly
a more substantial expansion of your views that we got a year ago.

Mr. ROHATYN. I think that is quite possible, Senator. But I will
settle for 50 percent from the Soviet Union, Senator, any time.

Senator PROXMIRE. Well, I think the Eastern European countries
would be happy that there is that modification of views on the part
of a very influential adviser to our Government.

Mr. ROHATYN. Senator, if I am an influential adviser to this Gov-
ernment that has escaped the notice of this Government. [Laugh-
ter.]

Senator PROXMIRE. It certainly has not escaped my notice. You win most of our battles one way or the other.

Mr. ROHATYN. Thank you, Senator.

Senator PROXMIRE. You come in through the back door, the side door, the window if you do not come in through the front door. [Laughter.]

But somehow, Felix Rohatyn's views are so often adopted.

Senator MATHIAS. I think he would like to think that he comes down the chimney. [Laughter.]

Senator PROXMIRE. Well, he is Santa Claus all right, ask New York about that. [Laughter.]

Mr. Cline, in your statement you say, "The IMF should be encouraged to borrow the required funds from private capital markets or from official lenders" under some circumstances, additional funds.

Now, why cannot the IMF if it can borrow these funds, borrow what they need from private capital markets instead of getting additional contributions from governments, including the United States? Could it do that?

Mr. CLINE. I think although it could try to do that, the basic principle is one of the risk-reward ratio for an investor. As an investor evaluates any potential investment he looks in some sense at the capital assets of that particular entity. And an increase in the quotas is a way of increasing the resources on hand for the Fund. That, in the first instance, should be done.

Senator PROXMIRE. I understand that, but it would make it easier for them to borrow if we contributed.

Mr. CLINE. Yes.

Senator PROXMIRE. And other countries contributed. But has there been any analysis as to whether or not they could borrow what they need absent our making this additional contribution?

Mr. CLINE. I am not aware of concrete analyses. I think the general sense is that the potential dimensions of the borrowing that is going to be involved in the next 2 or 3 years would be such that with the Fund coming into the markets for those kinds of amounts, without an increase in the quota, would raise questions about the kinds of rates that would have to be paid and the willingness of the capital markets to make those funds available.

Senator PROXMIRE. Mr. Cline and Mr. Rohatyn both, I think it is fair to say that the financial community generally supported the administration's economic policy. There may have been a few mavericks but by and large there was enthusiastic support for the Reagan policies.

Now we are in a recession. The administration forecasts only 1.4 percent growth this year. Yet it says the international community now agrees that world recovery is necessary to solve the debt problem, and everyone is calling for a U.S. growth policy right now.

Do you believe we can get a sustained, adequate recovery under present policies?

Mr. CLINE. I think we are moving in the right direction. I think the decline in the interest rate in the last 6 months is a crucial contribution. We need to continue to move in that direction. The Federal Reserve, in my opinion, should continue to follow a policy that brings interest rates down.

On the fiscal side, the budget deficit at the present rate could choke off recovery. I think the panelists that over the last 3 years, otherwise, the fiscal package with the 3 years, otherwise, billion deficits—encouraging interest rates up.

Senator PROXMIRE. Is that an act? Somehow in 3 years, otherwise, billion deficits—encouraging interest rates up.

At the same time, it seems to me we are looking for growth in our country.

Mr. CLINE. I think we are. I do think calls for fiscal restraint if we jump into fiscal perhaps part of 1982. There is really no all else is held constant, higher taxes will stimulate growth.

So, there is a very strong notion of monetary policy in the very short term, I think, when we will be at the end of the year.

Senator MATHIAS. Mr. Cline just to the point, in that rather than the interest rate, what is the interest rate he made in his statement?

The reality, however, is that the international financial community is not in the streets. Even the limit on the dollar and Brazil could imply a very strong monetary policy.

Mr. CLINE. Yes; that is the following. The prospects for growth are good. And then one sees the budget deficit down the side street. It is a good chance for a recovery.

Basically, what is the interest rate? It is greatly heightened. And I think this is a very important announcement now.

If one sees the interest rate, it is not the cause of the problem. In fact, it is only as the proximate cause of the problem.

Senator PROXMIRE. Mr. Cline, do you agree that a change in the composition of the IMF would produce a convincing case for the IMF quota?

On the fiscal side, it seems to me, the key has to be sort of holding pat at the present because increased taxes at the present time could choke off recovery. But here I would agree with the earlier panelists that over the longer run we have to have a more credible fiscal package with lower deficits.

Senator PROXMIRE. Is that not a very difficult and chancy balancing act? Somehow we have to narrow the deficit over the next 2 or 3 years, otherwise we will be getting into \$180, \$200, maybe \$300 billion deficits—enormous pressure on the capital markets, pushing interest rates up.

At the same time, we want to follow an expansive policy. It seems to me we are in a very difficult if not impossible situation for growth in our country and therefore in the world.

Mr. CLINE. I think there is no doubt that that is precisely where we are. I do think that the nuance which is involved is that the calls for fiscal restraint have to obey a very careful timing because if we jump into fiscal restraint immediately—and this is 1983 and perhaps part of 1984 anyway—we do risk jeopardizing the recovery. There is really no economic theory which can demonstrate that if all else is held constant, and particularly monetary policy, that higher taxes will stimulate rather than restrain the economy.

So, there is a very fine balancing act and it involves this combination of monetary expansion with no change in fiscal policy in the very short term, but a more controlled budget in the outyears when we will be at higher employment, hopefully.

Senator MATHIAS. Could I intervene here because I would like Mr. Cline just to try to assess, if he would, the degree of importance in that rather somber picture he has just given us, the statement he made in his prepared testimony that:

The reality, however, is that if there is no safeguard system in the system against international financial collapse, there could be far more unemployed on America's streets. Even the limited moratoria I have outlined within for Argentina, Mexico, and Brazil could imply a sharp increase in U.S. unemployment.

Mr. CLINE. Yes; well, I think the way to integrate these is essentially the following: One looks at the domestic U.S. economy and the prospects for growth, given monetary and fiscal developments. And then one sees the international debt problem sort of coming down the side street. The two meet at the corner, and there is a good chance for a collision.

Basically, whatever risk we have of recession in this country is greatly heightened by the fragile international economic situation. And I think this is coming out in the administration's policy pronouncements now.

If one sees the administration talking about a move to expansion, it is not the cause of high unemployment figures at home that it cites. In fact, it is citing the risk of financial collapse internationally as the proximate cause for that modification.

Senator PROXMIRE. Mr. Rohatyn, may I ask you along that same line, do you agree that Congress should insist that the administration change the course of its economic policy as a condition for approval of the increase in the IMF quota? Saying that if it does not produce a convincing program for achieving growth, that action on the IMF quota at best be a stopgap measure and we might just

have to increase it again in the future and it could not succeed without policies that will permit us to grow?

Mr. ROHATYN. Senator, there is no question in my mind that unless we have growth and unless we have significantly more growth than the 1.4 percent presently forecast in what I understand to be the current economic forecast in this country, that this process of rescheduling Third World debt and IMF assistance, no matter what it is conditioned on, is a bridge that goes no place.

And therefore, the two have to be viewed as two sides of the same coin. Whether you condition one on the other, that is a matter for your discretion.

Senator PROXMIRE. Can you suggest policies we might follow that would help us achieve a better than 1.4 percent growth, say a doubling of that growth, a growth of 3 percent, something of that kind?

Mr. ROHATYN. Well, Senator, I am not an economist. I think that we are in a situation that is very murky because most of the actions one can take create counterproductive results in many areas. I think the balance is exceedingly delicate.

It seems to me that the ultimate aim quickly has to be to reduce interest rates very rapidly and very forcefully.

At the same time, I do not believe that we should aim at brutally reducing the current deficit because I think that would make the recession deeper.

So, I think there will have to be a delicate balancing between having a credible budget policy that over the long run brings deficits down significantly—probably through a phased-in tax of the kind that John Heimann was talking about. I would support a big gasoline tax phased in over a period of time to do that.

Probably reductions in military spending growth and slowing down entitlement growth combined with, as I said, drastic interest rate reductions very quickly. And probably a program of Government-assisted investments, since investment has collapsed in this country.

Three-quarters of this country needs rebuilding physically, and I see no reason why we should not do that and put people to work doing it. Three-quarters of our older industrial establishment needs restructuring, and I see no reason why we should not go about doing that.

So I do believe there are a series of actions, probably of a much more interventionist type than anything anybody is talking about right now.

Senator PROXMIRE. All of the suggestions you just listed would require—unless I misunderstand them—substantial increases in Federal Government spending or lending.

Mr. ROHATYN. Not necessarily, Senator.

Senator PROXMIRE. And therefore contradict the position taken before this same committee earlier by former Secretaries of the Treasury Fowler and Blumenthal, and Charles Schultze who was here at the same time, who seemed to go in the other direction.

Mr. ROHATYN. I do not think it would require larger amounts of Government spending, Senator. It might require shifting spending patterns around.

Senator PROXMIRE.

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Senator PROXMIRE. To reconstruct our economy, to build it up, you say that we have had enormous shortfalls—and I agree, we have that, certainly in steel, for example, and in many other areas.

Would that not require some kind of major Government lending? Mr. ROHATYN. It might require major Government credit assistance. That might be paid off with this gasoline tax that I suggested phasing in over a period of time.

Senator PROXMIRE. How big a gasoline tax?

Mr. ROHATYN. Oh, I would go somewhat between 25 and 50 cents a gallon.

Senator, I did not tell you that this would be nice or pleasant.

Senator PROXMIRE. I want to say that Felix Rohatyn or many others, Members of Congress and so forth, we could take that easily, especially if you run to work.

But for people in my State who drive to work, make \$10,000 to \$15,000 a year and drive 30 to 40 miles in an old clinker, that is the way they get to work—

Mr. ROHATYN. But you can exempt people. You can give credits to people below a certain income level and make people pay who want to own 8-cylinder cars or BMW's, or whatever.

Senator PROXMIRE. You have argued that the Third World debt be stretched out at reduced rates. Suppose the banks do not agree? After all, most of this debt is private bank debt.

Would you favor holding up any IMF credits until such an agreement is in place as a way of using that leverage with the banks?

Mr. ROHATYN. No; I do not think that is practical, Senator. I think the reality of these debts is that they are long-term debts. What I am suggesting is that, again as part of a multilateral agreement with our other industrial partners, we consider setting up some kind of a multinational institution, or do this as part of an IMF or World Bank that would acquire these loans from the banks.

Senator PROXMIRE. How can a bank do this? Banks, after all, are in business to be able to pay dividends to stockholders and make profits, and so forth. How can they do that if they cut the interest they charge below the market rate?

Mr. ROHATYN. They would have a reduction in income. That might be better, however, than having a writedown on the principal amount of the loan if ultimately those loans are not repaid.

I am suggesting a structure which would provide the banks with a more secure, long-term credit at lower interest rates in exchange for what they have, which seems to me relatively high-risk loans at high interest rates.

I think as part of the package you could also relieve the banks—because you would be relieving the borrowers—of large amounts of interest burdens. Right now you would be relieving the banks of an equivalent amount of additional lending that they would have to make otherwise.

I think economically you can make a very rational package out of this. Whether you can negotiate the various pieces of it is another question.

Senator PROXMIRE. Your principal recommendation appears to be a long-term, low-interest rescheduling of loans to Communist countries, less developed countries.

Looking at it strictly from the Government standpoint, the IMF, the World Bank, and so forth, would not such low-interest loans constitute a subsidy? And if so, why should we subsidize foreign borrowers at the expense of the unemployed, the homebuilders, and the farmers in this country?

Mr. ROHATYN. It is no more of a subsidy than asking banks to reschedule loans that are in default. I mean, every one of these actions is a subsidy and you are doing it for two reasons, essentially. One is to keep our banking system solvent.

Second, to keep the possibility of exporting to these countries in an interrelated system. If the Third World cannot function and cannot service its debts and cannot buy our products, we are going to have more unemployed.

Senator PROXMIRE. That is a very strong case and every witness that so far has appeared has strongly favored that. But we have not had any witnesses who represent the people out in America who need money, too.

They say exactly the same thing, only there we can see it more vividly. The people who are farmers, or who are home buyers, or car buyers—or sellers of these commodities—they say, "We are going to go down. We have been in dire trouble because we simply cannot get low-interest loans. We need those low-interest loans."

As interest starts going up again, which I think it is very likely to as we recover, we are going to get that pressure again.

How can I explain to a constituent in Wisconsin why we should make a subsidized low-interest loan to Mexico, or especially to Bulgaria, and then give them some kind of vague notion, "Well, there are going to be more jobs in Oshkosh."

Mr. ROHATYN. Well, you are giving subsidies in any case, Senator, when you provide money to the IMF. What you are doing is financing the rest of the world.

I think we ought to have low-interest loans in this country as well as rescheduling some of these loans on a low-interest rate in the rest of the world, and second, in terms of protecting jobs in American industry.

I am on the board of a company that manufactures automobiles in Kanosha, Wis. So I believe that you and I have similar constituencies. In this particular case I would argue that you can do a great deal by insisting on a change in the monetary currency system where you can keep these currencies within rational rates.

Senator PROXMIRE. You are not just proposing low interest for loans abroad but for domestic loans, too.

Mr. ROHATYN. I beg your pardon?

Senator PROXMIRE. You are proposing subsidized low-interest loans.

Mr. ROHATYN. No, I am not, Senator. You asked me if I had any views on changes in domestic policy that would create growth. I said, lower interest rates as a result of some other policies so that you will not discriminate, necessarily, among a rescheduling of Third World debt and what you can provide for somebody at home who wants to buy a car or a house.

Senator PROXMIRE. I have a number of other questions but the hour is late. You have been very patient. You have certainly been

an excellent p
much.

The chairma
Prime Minister
February 1.

Thank you v
[Whereupon,
vene at 10 a.m.,

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an excellent panel. We are deeply in your debt. Thank you very much.

The chairman, unfortunately, had to go to greet the Japanese Prime Minister, and he asked me to adjourn the committee until February 1.

Thank you very, very much for your excellent testimony.
[Whereupon, at 12:40 p.m., the subcommittee adjourned, to reconvene at 10 a.m., Tuesday, February 1, 1983.]

point, the IMF, low-interest loans subsidize foreign homebuilders,

asking banks to one of these actions, essentially.

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7. *Latin American External Debt*

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1970s. Private loans have been of far shorter maturity. Even in the best of worlds—as in 1973 when the Brazilian government could set a minimum term of 10 years in the flush of a debt-led “economic miracle”—the average length of private debt remained much lower. In the debt adjustment phase, when pressing capital needs made the countries once again the more ardent suitors, maturities sometimes shortened to as few as 5 years, settling now closer to 8 once again. Brazil’s well-documented experience is illustrative of the fluctuation. Average maturity declined from 5.6 years in 1970 to 4.7 in 1972 as Euro-market borrowing accelerated. It rose again to 5.6 in 1974 because the term of private debt lengthened. In 1977, the average reached a new low of 4.3 years as considerable borrowing occurred under less favorable terms [see Batista (1980)].

Short maturities limit gains from inflation. They levy high continuing service charges against export earnings and increase the vulnerability of debtors to fluctuations in exchange receipts. The constant need to refinance outstanding loans allows a narrow margin for error.

At the same time, private capital markets have themselves become more variable. International lending rates have become less predictable and increasingly dependent upon the internal monetary policies pursued by the industrial countries. The 1980 roller coaster is a good example. Current interest rates apply to past as well as present borrowing. Consequently, a one-percentage-point change in nominal interest rates can provoke a swing in the regional balance of payments of almost \$1 billion. Oil price increases actually tilt the trade balance for the region as a whole favorably and, excluding Venezuela, cancel out.

These characteristics of private capital markets combine to reduce the benefit to developing-country borrowers. Higher interest costs, shorter maturity, and greater uncertainty expose debtors to a greater short-term risk and at the same time lower the long-term net gain. A strategy of indebtedness under private auspices is therefore distinct from reliance on official lending. The next section will elaborate on this theme, by contrasting the long-term returns on investment of loans with the liquidity problem posed in the short term.

III. THE RATE OF RETURN TO EXTERNAL BORROWING

One of the principal arguments offered in favor of the debt option preferred by many Latin American countries in the past decade is that money was cheap, the consequence of efficient financial intermediation and unanticipated inflation. This impression of low, even negative, real interest rates depends very much on the deflator chosen. Table 2 sets out the pre-

TABLE 2
Euro-Dollar Real Interest Rates^a

Year	Euro-dollar deposit rate	U.S. GNP deflator (annual increase)	Export price deflator (annual increase)	Brazil spreads	All developing country spreads
1969	9.8	5.0			
1970	8.5	5.4	4.5	4.0	
1971	6.6	5.1	10.9	3.0	
1972	5.5	4.1	-3.9	2.0	
1973	9.2	5.8	8.2	1.25	
1974	11.0	9.7	37.7	0.7	
1975	7.0	9.6	35.6	1.2	1.1
1976	5.6	5.2	1.0	1.7	1.7
1977	6.0	5.9	14.0	1.9	1.7
1978	8.7	7.4	24.6	2.0	1.6
1979	12.0	8.8	-8.5	1.6	1.2
1980 ^b	14.3	9.0	10.8	1.0	0.9
			15.4	1.50	

^a Values are expressed as percentages. Sources: For Euro-dollar rate, IMF (1980a); for U.S. GNP Deflator, 1969-1978—U.S. Bureau of the Census, *Statistical Abstract*, 1979, 1980—IMF (1980b); for western hemisphere export unit value (excluding petroleum)—IMF (1980a); for Brazil spreads—Batista (1980), and *World Financial Markets* (1980); for all developing country spreads—World Bank (1980).

^b Estimated.

vailing Euro-dollar deposit rate (fractionally different from the offer rate), the variable spread (for Brazil specifically, and all developing countries), the U.S. GNP deflator, and a Latin American export price deflator. With the exception of 1975, the real rate calculated with the GNP deflator has been consistently positive. In the early 1970s, prior to the oil crisis, it averaged around 1.5%. The real rate fell in the mid-1970s as increased nominal charges failed to keep pace with raging inflation and rose again subsequently as the OPEC surplus diminished and its investment in other assets increased. In 1980, the average real rate approximated 5%.

The pattern of real rates measured in constant export terms is quite different. Because prices of exports (and imports) rose much more rapidly during this period than the GNP deflator, the export-deflated rate is very much lower, being especially negative in 1974 and 1974. Because prices of exports are more variable, real rates fluctuate widely.

Neither of these deflators is adequate to measure the real cost of the debt because neither *numéraire* captures accurately the value of the for-

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TABLE 3

Cost of Brazilian Capital Inflows, 1970-1979^a

Real interest rate 1981-1995	U.S. GNP deflator	Trade price deflator
-1	1.9	-3.0
1	2.5	-2.4
3	3.1	-1.9
5	3.7	-1.3

^a Values are expressed as percentages. Source: U.S. GNP deflator and import/export prices—IMF (1980a).

foreign exchange acquired and repaid. A related problem is that private debt is contracted and repaid at different times. Whatever the past pattern of interest rates, real costs actually incurred cannot be calculated without reference to future interest rates and the path of amortization.

I have, therefore, incorporated a different deflation procedure and explicit allowance for the future in calculating an internal cost implicit in the actual capital inflows received by Brazil in the 1970s.⁴ Because detailed information on inflows and amortization, actual and projected, is not available for the region as a whole, the estimate is country specific. The importance of Brazil in Latin American and world debt is so large and the similarity in country borrowing costs so great that the results are of wider interest.

Table 3 presents eight different estimates for the cost of Brazilian borrowing during the decade of the 1970s, assuming two different nominal interest rates for the repayment period 1981-1995, 9 and 13%, and two different rates of future inflation, 8 and 10%. Three conclusions can be drawn.

One is that the choice of deflator makes a difference of about 5 per-

⁴ The inflows are the gross medium- and long-term loans received between 1970 and 1979; the outflows are amortization and interest payments accruing from those loans until 1995 (when a small residual amortization remains due). For the period 1970-1979, these outflows are estimated by subtracting service on the old debt obtained from the amortization schedules on debt outstanding at year end 1969, and corresponding interest payments adjusted for current rates, from current service payments. Future amortization is given for the debt outstanding as of December 1979; interest payments are estimated under different rate assumptions. The inflows are corrected to constant dollars by an import price index and the outflows by an export price index. Thus the initial capital inflows are measured in terms of real imports and the subsequent repayments in terms of real exports. All data are from the *Bolletim*, Banco Central do Brasil.

centage points in determining the cost. The trade deflator, eroding the value of dollars much more than the GNP deflator, indicates a negative real cost for foreign debt contracted during the period. This presumes that export prices will not rise more rapidly than the GNP deflator in the future. Were they to continue to do so, the cost differential would widen further. Conversely, if the export index increased less rapidly, the divergence would narrow.

In the second instance, the cost calculation is sensitive to the future real interest rate. Each percentage point increase in those rates raises the cost on past debt by about a smaller, 0.3 percentage point. The impact is attenuated because the actual costs incurred in the 1970s remain unchanged. The rate of return is a weighted average of such past experience and the future. From Table 3 it appears that the real rate implicit in the 1970s was a little less than 3% for the GNP deflator and about -4% for the trade deflator.

The third conclusion is the most basic. Regardless of deflator and future real interest rates, debt was a bargain in the 1970s. Average real rates even as high as 3% compare favorably with historic norms. And there is good reason to prefer a trade deflator. However weighted, it will yield much lower costs. Real returns in Brazil—to applications in infrastructure, alternative energy sources, and directly productive investment—have been demonstrably greater. The large share of capital in Brazilian income and a relatively low capital-output ratio implies real rates that are considerably higher.⁵

Properly speaking, therefore, there is no debt problem. The debt in the long run could adequately repay itself. Negative costs, of course, make such a formulation even more evident. Yet, there is generalized concern about the magnitude of the debt, and not least, about the Brazilian debt.

That worry is well-founded. It derives from the twofold requirement that the debt be continuously serviced in the short term and paid in foreign exchange. The problem therefore centers around the short-term elasticity of capital supply and the medium-term prospects for exports. The larger the service obligations, owing to short maturities and high nominal interest rates, the more susceptible are countries to a liquidity crisis and the ensuing adjustment costs.

⁵ The marginal rate of return can be expressed as $r = (O/K)\beta$, where β is the share of capital and O/K the output-capital ratio. The share of capital in Brazilian value added is about 0.4, and the present marginal capital-output ratio, 3.5. Letting the latter approximate the average, which in the "miracle" years was lower, the estimated real rate is 11%. What counts is the order of magnitude, which, given the Brazilian growth rate, capital share, and investment ratio, must substantially exceed the cost of debt.

7. Latin America

In sum, long-term debt is a guarantee of the foreigner's right to the benefits of growth until returns are exhausted. If loans are not available, the expense of borrowing is likely to be high. Rapid growth, but not a debt trap. The short-term transformation of the economy, the capacity to export, and the growth through a growing economy.

An adequate supply of capital is assured in the present. In addition, nominal growth shows little sign of slowing down. Inflation, deteriorating terms of trade, together these factors have made loans in the 1980s a fundamental limit. The continuing supply of capital is not limited. Debt in the long run is not a problem.

We expand upon the positive terms the new Latin American debt crisis in Brazil.

IV. PROSPECTS

The dynamic of growth requires a constant flow of merchandise exports. The merchandise balance requires a constant flow of real-economy commodities to the future—is a constant flow of ratios or similar derived estimates of growth.

Albert Fishlow

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In sum, long-term positive returns on borrowed resources do not guarantee the foreign exchange when needed in the short term. The time profiles of benefits and costs are likely to diverge, requiring continued financing until returns are realized over a longer horizon. If additional external loans are not available, short-term obligations may not be met, or only at the expense of other imports and consequently of economic growth. Exports are unlikely to satisfy immediate foreign-exchange needs even with rapid growth. But they are also an essential element to avoiding a debt trap. The short-term liquidity problem has its counterpart in a medium-term transformation problem: the capacity to divert increased productive capacity to export. Debt can only be repaid, or its rate of growth slowed, through a growing merchandise surplus.

An adequate supply of new loans and liberal access to markets are not assured in the present difficult international economic environment. In addition, nominal rates of interest in 1980 and 1981 are at peak levels and show little sign of consistent decline. They are likely to lag behind reductions in inflation. Oil-poor countries have the gloomy prospect of deteriorating terms of trade as future oil prices outstrip export prices. Together these factors could cause a real debt problem: the costs of the new loans in the 1980s necessary to meet the short-term liquidity requirements of the debt of the 1970s could very well begin to outstrip real returns. A fundamental limitation of a model of debt finance is that it requires a *continuing* supply of credit on favorable terms for its advantages to be realized. Debt in the 1970s could turn out to be more expensive than it seemed.

We expand upon this theme in the next section, examining in quantitative terms the near- and medium-term foreign-exchange requirements of Latin American debtor countries, with special emphasis on the case of Brazil.

IV. PROJECTIONS OF LATIN AMERICAN FINANCING NEEDS

The dynamic of the debt is best understood quantitatively by embedding its required continuing service within a structure that also projects the merchandise balance. The simplest model for so doing is one that relates import requirements to product growth. Despite its abstraction from real-economy complexity, such an approach—because of its orientation to the future—is more informative than reliance upon static debt service ratios or similar measures. It also is more accurate than regression-derived estimates of current account deficits that ignore the mounting role

WHERE THE BANKS PUT THEIR BAD DEBTS

*Accounting methods vary;
so do legal requirements.*
By Roger Taillon

The financial statements of banks are affected by differences between countries in the accounting treatment of problem, or non-performing, loans. A non-performing loan is any loan on which interest or principal is not (or is not expected to be) paid in full and on time. This includes loans on which there has been outright default, whether declared by the bank or not; loans on which a moratorium has been declared; loans which have been rescheduled; and loans which have been converted into stock because of the borrower's difficulties. Loans which remain current are regarded as non-performing if there is substantial doubt about the ability of the borrower to continue to pay — if, for example, the borrower has defaulted on other loans.

This broad definition leaves room for subjective judgement on whether a particular loan is non-performing. For example, is a loan non-performing if it is only 30 days overdue and the bank expects the borrower to catch up on the payments? Is rescheduling a normal extension of maturity, or the result of the borrower's difficulties? Do the terms of the rescheduled loan fully reflect the risk of lending to the borrower? If payments are current and the loan is well secured, but the borrower has defaulted on unsecured loans, will the borrower remain current on this particular loan?

Some banks recognize loans as non-performing according to strict numerical standards. Many US banks consider any loan over 90 days overdue non-performing, and put it in a non-accrual status. Other banks have a totally subjective process, and still others use numerical standards as a guide, though the final decision is subjective. For some types of loans, such as rescheduled loans, the criteria must almost always be subjective.

Once a loan is recognized as non-performing, interest that already has been, or is to be accrued, must be dealt with. Previously accrued but unpaid interest can be reversed out of interest income and the accrual of interest stopped. This is the method in the United States. US banks continue to accrue interest on loans to Mexico, but some have placed certain private loans to Mexico on non-accrual.

German (and some other) banks accrue interest, but make specific loan loss provisions of an equal amount. In Italy, separate provision is set up for unpaid interest.

All three methods have the same impact

on net income, but distort inter-country comparisons of interest margins and loan losses. The US system lowers interest income but does not affect the loan loss provision or charge-off figure; the German system increases loan loss provisions, and perhaps ultimately charge-offs, while leaving interest income at a higher level until the loan is charged off. The Italian method leaves interest income, loan loss provisions and charge-offs all unaffected.

If the non-accrual method is used, a further decision must be made as to what to do with interest actually received on loans on a non-accrual status. Some banks take the cash interest received as interest income. Others use cash received to reduce the principal amount of the loan (for book purposes, not for the borrower's benefit) either for all non-accrual loans or for those where it considers collateral insufficient.

For rescheduled and renegotiated loans, virtually all banks recognize interest according to the new terms either on a cash or an accrual basis. Although these loans might be written down or provided for if loss of principal is expected, they are not normally adjusted to bring the effective yield up to a realistic risk-adjusted rate. The same is true with foreclosed assets and shares received in exchange for debt. The practice of writing down assets to provide a more realistic yield was tried in a few isolated instances by US banks in the mid-1970s, but never became widespread, though it seems to make economic sense.

For losses of principal, banks in most countries establish provisions, which may be specific or general, according to the laws of the country. Loan losses may be charged to these provisions, or directly to earnings.

The method used in most European countries is to establish general provisions to the extent tax laws allow, and specific provisions based on estimated losses on loans regarded as problems. Loans are normally charged off against the specific, not the general, provisions when the final amount of a loss has been determined (usually when bankruptcy or reorganization proceedings have been completed). One of the advantages of this system is flexibility. A provision appears to be a less drastic measure than a write-off, so many banks will make generous provisions relatively early after a borrower's problems have been discovered, particularly if they can gain tax advantages by so doing.

The less common method, which is used in the US, is to make partial charge-offs of loans where there is a significant risk of loss of principal. The loans are reviewed periodically. An additional charge-off may be made, or, if the borrower's condition is improving, there may be a write-back of the loan. If a bank is conservatively applying this method of accounting for loan losses,

the ratio of recoveries or write-backs to charge-offs should be much greater than for a bank using the specific provision method. How are problem loans treated in other countries? In Great Britain banks set up two types of provision for loan losses, specific and general. The treatment is similar to that of banks in a number of other European countries, except that the British clearing banks provide a higher level of disclosure.

There has been some discussion about the appropriateness of the general provision — some people see this as a reserve, which is not allowed under British accounting standards. But the view that it is *not* a reserve seems to have prevailed and all major banks continue to make them or have resumed doing so.

For specific sovereign risk, British banks are now allowed to make tax deductible provisions and some are doing so.

In Germany two kinds of tax-deductible loan loss provisions are made: general provisions based on a formula established by tax authorities and the Bundesbank, and specific provisions. Non-tax deductible general provisions, considered by most banks to be a type of loan loss provision, can be made above the formula amount at each bank's discretion. The balance sheet amount to provisions is not disclosed, and the income statement amount can be combined with provisions for reductions in value of securities holdings and reduced by realized securities gains, according to the principle of compensation. The specific provisions are the banks' estimates, made on conservative lines, of probable losses on problem loans. Provisions have been made for risk on certain country credits. Unpaid interest is provided for and ultimately charged against the specific provision.

In France, banks can make tax-deductible specific provisions against short-term loans, and have a choice between a 0.5% formula provision and specific provisions against medium and long-term loans. In recent years, most major banks have chosen the specific provision, as it has been larger. Although the three largest French commercial banks have been state-owned since 1946, and all major ones now are, banks have made their own decisions about provisions, subject to a periodic tax audit. They have been making substantial provisions against country risk for years.

Because of Securities and Exchange Commission (SEC) regulations, US bank holding companies provide the fullest disclosure of problem loans. Bank holding companies disclose the totals of loans on non-accrual, other loans over 90 days overdue, renegotiated loans and foreclosed assets. Most banks use the 90-day standard to place the loans on non-accrual, although this is not required. Adequacy of loan loss

The author is vice president, international ratings, at Standard and Poor's.

BANKING/ACCOUNTING

provisions, or reserves as they are called in the US, is determined by the bank and its auditors. The reserves are generally larger for book purposes.

The tax-allowed reserves have decreased as a percentage of loans since a 1969 tax law change, and in 1983 dropped to 0.6% of loans. The reserves are, technically, general. The SEC requires an allocation of the reserve to different categories of loans, but this is not the same as true specific provisions, and any portion of the reserve is available for losses on any loan.

When banks recognize a probable loss on a loan, they are supposed to charge off all, or a portion of, the loan. Although bankers sometimes speak of "reserving" for a particular loan, this is no more than an internal allocation of the general reserve, and is usually done only on an interim basis. US bank holding companies are required to disclose major exposures to problem sovereign credits, but few have included these in their non-performing loan total, or charged off any portion of the loans. The reason why banks have differed about private sector companies is that some of these companies — in Mexico, for example — have been prevented from paying interest on loans by government bans on foreign exchange.

Canadian banks will make specific loan loss provisions when they think it is appro-

priate, but they will also charge off loans directly. The total of the net increase in the specific provision and the direct charge-offs each year is considered to be a bank's loan loss experience. Loan losses are charged to income based on a five-year moving average of loan loss experience divided by loans, which is then applied to the year's average loans. The difference between a year's loan loss experience and the amount charged to income based on the five-year moving average formula is taken from, or added to, a reserve for contingencies. The reserve for contingencies is nourished by an allocation from net income. Because loan loss experience has been rising in recent years, the charge to income has tended to be significantly less than actual loss at most banks. Canadian banks cease to accrue interest when its payment is in doubt.

In Japan, as in the US, the loan loss provision allowable for tax purposes has been decreasing as a percentage of loans. Technically banks are not required to decrease the balance sheet amount of these provisions from previous levels, but some have done so, apparently with official encouragement. Non tax-deductible provisions are also allowed, but, to date, the provisions for book purposes have not been very different from the provisions for tax purposes. Most of the provisions are general, and Japanese banks are required

immediately to charge off all loans classified as loss by the regulators and the estimated loss on those classified as doubtful. These charge-offs are made directly from the income statement, as an expense item, and not out of the provision.

Specific provisions can be made, but only where the loss cannot be closely estimated, and the loan should be written off, in whole or in part, soon thereafter. Specific provisions are not differentiated from general provisions in the income statement, except that, because of the decrease in provisions allowable for tax purposes, very few banks have made any general provisions in recent years. When a loan on which a specific provision has been made is written off it is written off against the specific provision rather than directly through the income statement.

The Ministry of Finance recently decided to require a third type of provision, for sovereign risk, which in effect will be somewhere between general and specific. At present it is not tax-deductible. It is to be established as 1 to 5% of loans to countries experiencing repayment difficulties, with the individual banks formally responsible for working out the percentage.

Individual banks will decide which countries are in difficulties, but they have to use criteria established by the Ministry of Finance.

New Issue

This announcement appears as a matter of record only.

March 1983

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(Incorporated with limited liability in the Netherlands)

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Risks in International Bank Lending

1. COUNTRY RISK

The large increase in international bank lending since 1973-74 has been accompanied by significant changes in the nature as well as the relative magnitudes of such activity from the standpoints of both borrowers and lenders. One of the distinguishing characteristics of many international loans during this period has been their purpose — the funding of current account deficits. Countries have resorted to overseas borrowing on an unprecedented scale to cushion the impact of adverse changes in their external circumstances — notably spiraling energy costs — and to finance industrialization and economic development programs. The result, for a number of borrowers, particularly some LDCs, has been a rapid increase in debt burdens, aggravated by high interest rates. For example, the ratio of debt service to export earnings for ten major LDC exporters of manufactured goods is estimated to have jumped from 13 per cent to 21 per cent between 1974 and 1981¹. The outstanding debt owed to banks by four groups of major borrowers — smaller European countries, OPEC, Eastern Europe and non-oil LDCs totalled nearly \$400 billion at the end of 1980.²

Moreover, whereas balance-of-payments financing needs were formerly viewed as short-term, cyclical, liquidity problems, current payments imbalances are often structural in nature. As a result, many borrowing countries now face periods of basic structural readjustments. Thus, greater demands are being placed on domestic management capabilities of borrowing countries to devise and implement the necessary economic adjustment programs.

While borrowers' debt burdens have grown, so have the relative magnitudes of banks' international loans in loan portfolios. Recent U.S. data

¹ IMF: *World Economic Outlook*, June 1981, p. 135.

² BIS Annual Report, 1981, p. 105.

highlight the growing importance of LDC borrowers: the aggregate exposure of the nine largest U.S. banks to LDCs has increased from 1 1/2 times total capital in 1977 to more than double capital in 1980, and by the end of 1980 there were 80 instances of U.S. banks with exposure to single LDCs greater than 30 percent of capital funds. More generally, foreign assets and liabilities now account for a large proportion of total assets and liabilities of the banking systems of many OECD countries: for the OECD as a whole, the ratio nearly doubled during the 1970s, from 12 per cent to about 22 per cent.

Risks and Concerns

The extension of credit across national borders in non-local currencies complicates the traditional assessment of a borrower's ability to repay because "country risk" is a factor. Under the rubric of "country risk," most analysts distinguish "transfer risk" from "political risk".³ "Transfer risk" is the danger that a country may impose restrictions on remittances of capital, dividends or interest payments to foreign investors as part of its economic policy. In addition, repayment may be endangered by political developments, like civil or local wars.

Recently, concern about country risk has increased. There is a general belief that, at the same time as more and more banks are involved in international lending and the relative magnitude of the international portions of loan portfolios has been growing, the actual risk inherent in such activity has grown. At the same time, there is skepticism about the efficacy of approaches that banks have taken to country risk assessment.

The concerns suggest two lines of inquiry:

- 1) Have the risks of international lending increased? If so, how?
- 2) How are banks managing those risks? What is the supervisor's role?

³ A few definitions of terms may be useful to the reader.

Country risk is taken to refer to the possibility that sovereign borrowers of a particular country may be unable or unwilling, and other borrowers unable, to fulfill their foreign obligations for reasons beyond the usual risks which arise in relation to all lending.

Country risk assessment, following on from the above, refers to the methods used (by lending banks in particular) to evaluate the risk of an interruption in the servicing or repayment of obligations by borrowers of a particular country.

Country exposure is taken to refer to an individual bank's or banking group's exposure in its total claims on borrowers in individual foreign countries. Measures of exposure to a particular country may take account of guarantees or other factors that could shift risk to a different country from that of the borrower.

Country indebtedness is taken to refer, in an international context, to the sum total of external borrowing by a particular country from all sources.

Sovereign risk arises from the special risk associated with a sovereign loan, which is a loan to, or guaranteed by, a government (and some government-guaranteed bodies). The special significance of such lending lies in the risk that it might prove impossible to secure redress through legal action i.e. the borrower might claim immunity from process or might not abide by a judgment.

The second area, that of risk of subsidiary questions:

- What techniques of
- Is country risk asses
- Are some banks bet

Gauging the Overall Risks

The most frequently used measure of the loan loss record which particular categories of lending by international banks engaged in international lending. loss statistics for the large: measure, the record appears far lower for international than for domestic lending. The record has been improving. loan losses as a percent of total assets record 0.39 per cent in 1976 losses relative to total losses: cent in 1977 to 15.3 per cent the less direct costs of rescuing those indirect costs in many quality have not been high.

The views expressed in the riskiness of international banking. Lenders expected a 'substantial' lending over the next five years: 'no significant change' or a 'reduction' in lending involving large sums of money seen as the most serious threat.

How Banks Assess Country Risk

Existing systems for assessing country risk are complex from bank to bank that nearly all banks have incorporated such analysis (it also confirmed the country risk assessments by independent banks).⁴ However, the economic and the political

⁴ "How Bankers See the World Financial Crisis"

⁵ Appendix I summarizes nine systems used by Canadian, and European banks.

The second area, that of risk management practices, in turn raises a series of subsidiary questions:

- What techniques of risk management and/or reduction are employed?
- Is country risk assessment effective? What are its flaws?
- Are some banks better positioned than others to assess country risk?

Gauging the Overall Risks

The most frequently used indicator of the risk of bank lending activity is the loan loss record which can be used to assess risks in relation to particular categories of lending. Across-the-board data for major international banks engaged in international lending are not available, but the loan loss statistics for the largest U.S. banks may be representative. By this measure, the record appears to be reassuring since loan losses have been far lower for international than for domestic activities. Moreover, the loss record has been improving. For the ten largest U.S. banks, international net loan losses as a percent of average international loans dropped from a record 0.39 per cent in 1976 to 0.10 per cent in 1980. International net loan losses relative to total losses have also dropped, from a peak of 29.3 per cent in 1977 to 15.3 per cent in 1980. However, such statistics do not reflect the less direct costs of reschedulings to banks. Although most banks say those indirect costs in management time, liquidity, income and portfolio quality have not been high to date, many believe those costs may grow.

The views expressed in the accompanying banking survey⁴ on future riskiness of international bank lending were mixed: 40 per cent of respondents expected a 'substantial increase' in the riskiness of international lending over the next five years to the end of 1986, but a majority expected 'no significant change' or a 'modest increase'. A large number of reschedulings involving large sums or a default by a major country borrower were seen as the most serious threats to the system.

How Banks Assess Country Risk and Manage Exposures

Existing systems for assessing country risk vary in approach and complexity from bank to bank. The study group's bank survey confirmed that nearly all banks have increased the resources dedicated to country risk analysis (it also confirmed that smaller banks rely more than larger ones on country risk assessments by others, such as syndicate leaders and correspondent banks).⁵ However, there are acknowledged problems with both the economic and the political sides of country risk assessment systems.

⁴ "How Bankers See the World Financial Market", Group of Thirty, May 1982.

⁵ Appendix I summarizes nine systems which have been used or are in use at some major U.S., Canadian, and European banks.

The more serious problems on the economic side stem from the deficiencies of the data. True, the quality of data has improved somewhat in recent years, and additional efforts at improvement are currently under way. (For example the IMF and BIS have recently been discussing efforts to expand and improve banking information.) Nevertheless, there remain some significant deficiencies in both the quality and availability of the data.⁴

Lags in data reporting can be quite serious, sometimes rendering the available statistics virtually useless. There is much evidence that many banks simply did not know the magnitude of the debts of either Turkey or Poland, before the crises in those countries erupted.

Even assuming reliable and current economic data, however, there are still differences of opinion regarding how well banks use and interpret the data. There are past instances, for example, of banks' enthusiasm for lending being based on a country's natural resource endowments without a concomitant realistic appraisal of the country's ability to *manage* its natural resources. Currently, most country risk analysis systems utilize a number of economic indicators to develop measures that serve as indicators of country risk. While the ratio of debt service to exports is widely acknowledged as an important measure, opinions differ as to the significance of a number of other measures often used to predict the ability to service debt.

Recently, banks have placed increased emphasis on assessing political and social factors in borrowing countries. A number of banks have hired political experts and incorporated political considerations in their analysis in new ways, including attempts to develop lists of socio-political "early warning indicators." However, such judgments are no doubt even more problematical than economic analysis. Despite new attempts to take political factors into account, such analysis has often failed to detect important trends, such as political developments which, for example, in the case of Poland, may have contributed to the need to reschedule.

In the end, of course, even very sophisticated country risk assessments may be overridden by other considerations. Final action may run the range from voluntary decisions, based for example on perceptions of marketing opportunities, to those that are less than fully voluntary. Examples in the latter category would include situations where the bank is afraid of jeopardizing a large existing exposure if it withholds new loans or instances of strong external pressure from the bank's home government arising from foreign policy motivations: one quarter of banks responding to our survey believed that lending had been significantly affected by such pressures. Also, since a bank's competitive status depends importantly on the regard

⁴ Country debt service data, for instance, do not capture all annual amortization requirements; military debt, which is often large, is usually excluded from official statistics; and statistics on short-term debt (up to one year) are frequently deficient.

of others in the system, some cooperating with other lenders out of a sense of responsibility in the international lending market.

Competitive pressures in assessments and engage in improving country lending, competitive that new money will continue even though signs of economic instance, in the cases of Peru beginning to feel more cautious able to sustain the inflow of funds excessive debt.

Debates about the efficacy of systems notwithstanding, banks undue risk concentrations in means by which banks reduce particular lender. These include with multilateral institutions, agencies, or securing home government support banks or agencies.

Most importantly, banks trying loan portfolio diversification, international risk exposure. Nearly all tries, sometimes as a proportion of total assets. To arrive at limits, elaborate country risk analyses. Most banks can follow strategies monitor quite closely their countries.

Supervisory Practices

Supervisory practices also risk. In general, the principal role of individual bank carry out the task responsibility and to satisfy their evaluates country risk and monitor not entirely clear how and to authorities currently fulfill this role bank's country risk systems does. Also, supervisors follow more conditions of risk in their banking system ing statistical reports on country

of others in the system, some banks may feel pressured by the desirability of cooperating with other lenders. Finally, some banks may act, at least in part, out of a sense of responsibility to help maintain the longer-run stability of international lending markets.

Competitive pressures may lead banks to override country risk assessments and engage in imprudent lending. Particularly in the early stages of country lending, competitive behavior tends to dominate. This can mean that new money will continue to pour into a country once it is "in vogue," even though signs of economic difficulty may already be evident. For instance, in the cases of Peru, Turkey and Poland, even when banks were beginning to feel more cautious about further lending, those countries were able to sustain the inflow of funds. In such ways, a country can accumulate excessive debt.

Debates about the efficacy and actual use of country risk assessment systems notwithstanding, banks can and do protect themselves from undue risk concentrations in a number of ways. For example, there are means by which banks reduce or spread the risks of involvement with a particular lender. These include syndication of large loans, co-financing with multilateral institutions, insuring loans with either private or public agencies, or securing home government guarantees through national export banks or agencies.

Most importantly, banks typically follow policies and practices promoting loan portfolio diversification as the main method of managing international risk exposure. Nearly all banks set lending limits to individual countries, sometimes as a proportion of capital and reserves or of external or total assets. To arrive at limits, subjective judgments (whether derived from elaborate country risk analyses or not) are translated into objective ceilings. Most banks can follow strategies that allow them to allocate, measure, and monitor quite closely their country risk exposures.

Supervisory Practices

Supervisory practices also play a part in the management of country risk. In general, the principal role of the supervisory authorities is to help the individual bank carry out the task of country risk assessment on its own responsibility and to satisfy themselves about the ways in which the bank evaluates country risk and monitors its own exposure to each country. It is not entirely clear how and to what degree various national regulatory authorities currently fulfill this role. However, bank supervisory evaluation of bank's country risk systems does appear to be becoming more widespread. Also, supervisors follow more closely than formerly trends and concentrations of risk in their banking systems, and/or at individual banks, by collecting statistical reports on country exposure. In the U.S., because of the nature

and history of bank supervision, supervisory authorities make an independent judgment regarding the risk in lending to particular countries.

The practice is not much in evidence elsewhere; but many countries apply requirements designed to prevent undue risk concentrations. (A description of supervisory systems in a number of G-10 countries is at present being prepared by Richard Dale of the Brookings Institution, to be published later this year as part of the overall work of The Group of Thirty. Meanwhile, a brief overview of relevant national regulatory arrangements is supplied in Appendix D).

Conclusions

There have been no major disasters for the international banking system arising from the growth in international lending activities. However, our survey confirms that most bankers believe that risks have increased and will increase more rapidly in the future. Evaluating the degree to which this may be true is of course no simple matter. For instance, there are factors which appear to mitigate the relative burden of debt for some borrowers. These include growing GDPs, higher levels of reserves, and above all improvements in economic policy-making in most debtor countries enhancing their own ability to adjust to changes in external circumstances. Yet the rapid growth and relatively high level of international indebtedness has certainly increased borrowers' vulnerability to exogenous events which could impair their ability to service debt. At the same time, the growth in the ratio of international to domestic assets in bank portfolios suggests that the system's vulnerability to 'shocks' may also have increased.

The concerns generated by aggregate figures on debtor condition and country exposure are often exaggerated. A variety of official support functions are already in place. To the extent that ultimate country lending risks are borne by government or multilateral institutions which lend directly, co-finance with banks, subsidize, insure or guarantee bank loans, the actual risk of commercial banks is at least partly underwritten.

More significantly, borrowers represent a range of risks, and banks manage their exposures with the intention of avoiding undue concentrations of risk. Especially in the last several years, banks and their supervisors have devoted considerable effort to improving management of international loan portfolios. The question remains as to whether these efforts are fully adequate at a time when the system has probably become more vulnerable to shocks — and perhaps more likely to experience them. Weighing these partly conflicting considerations, the study group believes the following observations are relevant:

1) Banks' decision-making sometimes appears to take place against a background of insufficient factual information. This is partly because

there remain serious in assessments are based. are particularly deficient quality, timeliness and a lenders.

2) To this end, me plored. Many members centralization of data anal decisions, however, shol

3) Risk assessment There is evidence that c banking market has some borrowers, leading subse

4) The study group be concerned with review. it is not yet possible to re such reviews. It is also th principle, supervisors shoi assessments to the banks (U.S. supervisors, who are r judgments).

2. RESCHEDULING

The number and magnitude of official debt reschedulings have increased considerably in the last few years. Involving 13 countries have been a party in renegotiations. Peru, Nicaragua, Sudan, Jamaica, Rumania, Costa Rica, and others. In these reschedulings have been \$421 million for Sudan and \$3 billion for Nicaragua and \$3 billion for repayments of capital due aggregate debt owed to banks of different order of magnitude.

there remain serious inadequacies in the data upon which country risk assessments are based. International debt data for short-term borrowing are particularly deficient. Further efforts should be made to improve the quality, timeliness and availability of the basic economic data available to lenders.

2) To this end, means for centralizing data collection could be explored. Many members of the study group believe that some degree of centralization of data analysis would be also be appropriate. Judgments and decisions, however, should be left to individual banks.

3) Risk assessments may be influenced by other considerations. There is evidence that competition for business within the international banking market has sometimes resulted in excessive debt accumulation by borrowers, leading subsequently to debt servicing problems.

4) The study group believes that bank supervisory authorities should be concerned with reviewing country risk management systems. However, it is not yet possible to reach firm conclusions about the effectiveness of such reviews. It is also the opinion of the study group that, as a general principle, supervisors should leave the task of actually making country risk assessments to the banks (while recognizing the special circumstances of U.S. supervisors, who are required by law and practice to make loan quality judgments).

2. RESCHEDULING

The number and magnitudes of country debt rescheduling have increased considerably in the last six years. Since 1956, there have been 53 official debt reschedulings involving 20 countries. Twenty-two of these involving 13 countries have occurred since 1975. In the recent past, banks have been a party in renegotiations with seven countries — Turkey, Zaire, Peru, Nicaragua, Sudan, Jamaica, Poland. Discussions are currently under way with Rumania, Costa Rica, Senegal and Liberia. The amounts involved in these reschedulings have varied greatly: \$518 million for Peru in 1978, \$421 million for Sudan and \$1.3 billion for Zaire in 1979, \$580 million for Nicaragua and \$3 billion for Turkey in 1980. Rescheduling of Poland's debt repayments of capital due in 1981 alone involved \$2.2. billion. (Poland's aggregate debt owed to banks outside Comecon, at about \$17 billion, is a different order of magnitude from that of any other country previously

involved in rescheduling).⁷ Most of the banks' exposure to loans subject to rescheduling so far, however, have been relatively small in relation to their capital or earnings.

Concerns

The possibility of a substantially larger rescheduling, or a series of them, involving large numbers of banks, has created concern whether processes presently used will be adequate for the debt rescheduling of the 1980s. First, the rescheduling process is not codified and involves large numbers of participants — official creditors, banks and other private lenders, multilateral institutions, the borrower, and sometimes, investment bankers who are advisors to the borrowers. Second, increasingly serious consequences may arise from the conflict between creditors' responses and debtors' needs.

Again, the result of the G-30 survey are pertinent to these issues. Asked whether existing *ad hoc* arrangements would be adequate to deal with more frequent reschedulings involving larger amounts than in the past, 17 per cent said no, 54 per cent were uncertain, and 29 per cent said yes (i.e., were content with existing arrangements).

The concerns point to two sets of questions:

- 1) What are the arrangements usually adopted for rescheduling, their strengths, weaknesses, and risks?
- 2) What have the terms of rescheduling been? What have the consequences been for lenders and borrowers?

The Rescheduling Process

The rescheduling of official debt is handled by the Paris Club, an *ad hoc* group of western official creditors which, since 1956, has met informally when needed under the chairmanship of the French Treasury. Although there are no formal rules, the Paris Club has over the years adopted a set of unwritten procedures. The common practice is that the request for a meeting is initiated by the debtor country; generally the creditors have agreed to convene only after payments arrears have already occurred; and an agreement is concluded after the borrower has agreed to an IMF stabilization program. Since the only debt eligible for consideration is government obligations, the practice has been to include as participants at the meetings only the borrower and the principal OECD government

⁷ Under an agreement signed in April, 1982, repayments of the \$2.2 billion in capital that fell due in 1981 is to start in December 1985 and end in December 1988, with the interest rate for the sum rescheduled set at 1.75 per cent over LIBOR.

creditors. Observers may include the World Bank, the OECD and UNCTAD. The amount eligible for rescheduling is the official debt over a 2-3 year period.

Because of the changing composition of banks, banks have increasingly become the main creditors. Hence troubled country borrowings are now handled by the Paris Club or private banks or both.

There is no standard mechanism for dealing with creditors; each case has required a separate arrangement. The numbers of bank creditors of different nationalities have been large and varied. In the case of Nicaragua, over 200 banks. A small number of lead banks, a steering committee that actually makes decisions on behalf of the group may be selected jointly.

Bank reschedulings have been handled by the Paris Club. Payments have been taken from 6 month loans. Numerous loan syndications have been formed. Collection of basic data on outstanding debt has been a number of times the negotiations have been delayed. Club rescheduling discussions have been added to delay.

Even though banks begin to be more active, it appears imminent, there is still a need for the banks to pull in different directions. There is no agreement on coherent strategy for debt rescheduling by extending a balance of payments agreement was undercut when some other countries were given term credit lines to Peru. Division of labor has to be along national lines. The division of labor including relative levels of export and import pressures from home governments and/or capital requirements.

In most reschedulings the borrower is imposing needed economic adjustments. Since 1966 the Paris Club has rescheduled debt. The borrower has agreed to an IMF program. Sometimes made their rescheduling subject to the conditions of IMF conditions. In the

creditors. Observers may include other government creditors, the IMF, World Bank, the OECD and UNCTAD. The unwritten rules extend also to the amount eligible for rescheduling (about 80 per cent of consolidated official debt over a 2-3 year period) and the repayment terms.

Because of the changing composition of developing country debt, banks have increasingly become involved in the rescheduling process. Hence troubled country borrowers may have to seek relief from the Paris Club or private banks or both.

There is no standard mechanism for rescheduling debt to private creditors; each case has required than an entirely new process be stated. The numbers of bank creditors involved in recent reschedulings and their nationalities have been large and growing — 115 banks from 12 countries in the case of Nicaragua, over 200 creditors for Turkey, and 500 for Poland. A small number of lead banks, usually a dozen or fewer, have formed a steering committee that actually participates in discussions. The members of the group may be selected by the borrower or the major creditors or jointly.

Bank reschedulings have been costly and time-consuming. Arrangements have taken from 6 months to 4 years to complete. Participants in the numerous loan syndications have had to be contacted; sometimes primary collection of basic data on outstanding loans has been necessary. A number of times the negotiations have had to be coordinated with parallel Paris Club rescheduling discussions. Procedural quarrels have sometimes added to delay.

Even though banks begin to "close ranks" once a rescheduling appears imminent, there is still a tendency for individual banks or groups of banks to pull in different directions. Thus it has been difficult at times to get agreement on coherent strategy. A 1976 bankers' attempt to obviate rescheduling by extending a balance-of-payments loan to Peru, for example, was undercut when some other banks simultaneously reduced their short-term credit lines to Peru. Divisions among banks during a time of crisis tend to be along national lines. The divergence may have any number of roots, including relative levels of exposure to a particular country, political pressures from home governments, or different accounting practices and/or capital requirements.

In most reschedulings the IMF plays a critical part in devising and imposing needed economic adjustment programs. As mentioned earlier, since 1966 the Paris Club has refused to proceed with reschedulings until the borrower has agreed to an IMF adjustment program. Banks, too, have sometimes made their rescheduling contingent on the borrower's acceptance of IMF conditions. In the case of Peru, banks discovered that they

alone did not have the sanctions to impose conditions for economic adjustment.

Poland's application to rejoin the IMF aroused expectations that such a move would facilitate the rescheduling of Poland's 1982 debt repayment.

The IMF can play a useful role as a catalyst exerting pressure on both sides to move towards a settlement. Indeed, in the Nicaragua rescheduling, where the IMF was not itself involved, other multilateral institutions such as the InterAmerican Development Bank, World Bank, and Central American Bank for Economic Integration played a somewhat analogous role.

Rescheduling Terms

With few exceptions, rescheduling whether by Paris Club or private creditors has consisted of a lengthening of maturities of principal repayments at market rates of interest. Banks have been particularly insistent on maintaining commercial terms and (except in the case of Nicaragua) have thus far upheld the principle that interest payments may not be rescheduled. Although borrowers have negotiated for lower spreads and fees, they have tended to accept lenders' determinations of grace periods and final maturities. For Paris Club debt the average maturity has lengthened only from 8 to 10 years since 1975. Bankers have rescheduled on similar terms with average terms of 7 to 10 years with up to 3 years grace at rates of LIBOR plus 1 1/4 to 2 per cent.

Creditors have so far emerged relatively undamaged from rescheduling. Paris Club creditors have undertaken no concessional debt restructurings since 1971. In a present value comparison of official loans before and after the debt rescheduling over the period 1956-1980, Chandra Hardy estimated the loss to creditors at only about \$2 billion or 0.5 percent of the total debt outstanding and noted that "since 1975, there has been no loss to the (Paris Club) creditors."⁸ Although it is not possible to duplicate these calculations for bank debt, estimates indicate that private creditors have probably not suffered a financial loss on a present value basis either. From the borrowers' perspective, however, the terms have been quite onerous, failing to reflect their likely cash flows and essential adjustment plans. Short maturities and creditors' insistence on rescheduling only one year's debt at a time have increased the likelihood of subsequent liquidity problems and the necessity for a subsequent rescheduling.

Conclusions

Most members of the study group believe that the present *ad hoc*

⁸ Chandra Hardy: "Rescheduling Developing-Country Debts, 1956-80: Lessons and Recommendations" Overseas Development Council Working Paper, No. 1.

mechanism may be insufficient that future reschedulings a complex, increasing the risk partly by creating intolerable collectively to be better organized effectively.

There also appears to be rescheduling terms are still opinions about optimum negotiators. In some cases reasonably satisfactory — cited. However, in some cases argued that the terms have term view by the banks on focusing solely on the criteria creditors may either have economic and political reasons sometimes has been to solve problems later — an event banks nor the borrower.

There are precedents for bank relationships with countries that the balance-of-payments from long-term structural reschedulings will be to reach medium-term interest of banks realistically are able to reschedule an ideal the study group is not achieving an optimum arrangement subject to different national position. "Equal" treatment for could mean unequal treatment interested parties should debt-servicing difficulties. To play the leading role in gaining in a stabilization program. It is a strong case for considering the banking industry to help lenders, discuss issues related expertise in this area that lenders (see chapter 7).

mechanism may be insufficient for the needs of the 1980s. They emphasize that future reschedulings are likely to be larger, more numerous and more complex, increasing the risks that the present system will prove inadequate, partly by creating intolerable delays. Most, then, see a need for banks collectively to be better organized to handle their role in rescheduling more effectively.

There also appears to be a need for re-thinking the principles on which rescheduling terms are struck. It is nearly always true, of course, that opinions about optimum terms for debt repayment will differ among negotiators. In some cases, the outcome appears thus far to have been reasonably satisfactory — the experience of Turkey and Jamaica may be cited. However, in some cases of sovereign debt reschedulings it has been argued that the terms have been based on an excessively narrow or short term view by the banks on their own best interest. On this argument, by focusing solely on the criterion of reaching an agreement on market terms, creditors may either have failed to recognize or turned a blind eye to economic and political realities confronting the borrowers. The result sometimes has been to set in place conditions likely to result in more problems later — an eventuality that is in the best interest of neither the banks nor the borrower.

There are precedents for less rigid approaches to debt restructuring in bank relationships with corporate borrowers. Given increasing recognition that the balance-of-payments problems of many borrowing countries stem from long-term structural development needs, the challenge for future reschedulings will be to reach terms that strike a better balance between the medium-term interest of banks and the timescale over which borrowers realistically are able to resume full debt service. While putting this forward as an ideal the study group is nevertheless aware of the practical difficulties of achieving an optimum arrangement. Banks in international syndicates are subject to different national taxes and national regulatory laws and supervision. "Equal" treatment for a borrower in an international rescheduling could mean unequal treatment for lenders. The essential point is that all interested parties should get together at an early stage in a country's debt-servicing difficulties. The study group feels that the IMF should usually play the leading role in gaining acceptance by all parties to the key elements in a stabilization program. However, in the group's judgment, there is also a strong case for considering the establishment of a representative body for the banking industry to help improve the flow of information available to lenders, discuss issues related to debt servicing difficulties and develop expertise in this area that would be of assistance to both borrowers and lenders (see chapter 7).

3. INTERNATIONAL INTERBANK MARKET

The international interbank market links banks to one another much as domestic money markets link banks within national markets. The market owes its existence to the need of banks to be able to bid for funds of a particular maturity to fund a loan of a similar maturity and their need to lay off unwanted deposits with other banks. Funds are thus shifted within the international banking system — and between the international market and domestic markets — as banks take deposits from and/or place deposits with one another. The market serves an important intermediary function between savers and borrowers on a global basis. By reallocating funds in the same currency among banks, it also permits participants to generate and/or manage liquidity.

Initially limited to transactions among major multinational banks, the market has grown from a few hundred banks in the mid-1970s to well about 1,000 banks from more than 50 countries by 1981.

According to BIS estimates, the size of the market grew from about \$182 billion in 1975 to \$522 billion in June, 1981. The world's largest banks play a predominant role in the international interbank market. The banks to which they lend typically relend a certain proportion as well. Most banks participate actively on both sides of the market. Reliance on interbank funding tends to be higher for smaller banks and newcomers in the international market, banks without a U.S. dollar base, and consortium banks. The market constitutes an indispensable source of funds for many banks' international activity; a recent study suggests that interbank deposits account for between two thirds and three-quarters of total external and Eurocurrency deposits.*

Two features deserve special mention — the practice of redepositing and the classification of banks according to perceived riskiness ("tiering"). It is not uncommon for funds from nonbank depositors to pass through a chain of interbank transactions before finding an ultimate borrower outside the banking system. Active trading on both sides of the market may accomplish one or more of the following purposes: (1) keeping the bank's name in the market; (2) enhancing the size of bank by increasing total footings; (3) establishing reciprocal relationships that will assure access to liquidity, or access at a reasonable price, in event of a squeeze (banks that only take funds are said to fare especially poorly when markets are tight); (4) gathering current market intelligence about both changing conditions of supply and demand in the market and the market's sense of the needs and

* J.G. Ellis, "Eurobanks and the Interbank Market" *Bank of England Quarterly Bulletin*, September 1981.

conditions of individual participants. Banks re-deposit more than 40 per cent of the funds (the largest banks) of interbank deposits.

The perceived risks of placing funds in the market have been reflected in pricing tiers and/or differences in rate between them, reflecting uncertainty. The Herstatt collapse in 1976, leading to a crisis in the foreign exchange market, was an instance of pricing tiers; some banks were able to obtain funds at lower rates. However, the pattern of interbank transactions has changed in the months.

In current practice, differentiation of funds may be more significant than the study group's survey confirms, and overall limits for the funds the banks can place. These are usually not disclosed, but are set by credit officers as parameters.

Risks and Concerns

There are two levels of risk — risk to individual banks based on their participation and risk for the system as a whole. On the one side of the market, they are concerned about their own risk. Second, and more importantly, they are concerned about the interbank linkages even should a problem caused elsewhere in the system. In the case of the UK fringe banking crisis, the system suffered.

The above-mentioned survey found that a majority of banks feel that interbank transactions are becoming more important because of a change in the composition of interbank borrowing (more banks). And bankers rated "unavailability of funds" as a potential threat to individual banks, and a major country debtor.

The concerns that have been expressed can be summarized as follows:

- How have banks and bank deposits changed in the market?
- Has risk in international banking increased in the interbank market? Do the interbank linkages contribute to its instability or stability?

MARKET

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conditions of individual participants. The bank survey shows that most banks re-deposit more than 40 per cent (nearly 60 per cent in the case of the largest banks) of interbank deposits.

The perceived risks of placing deposits with particular banks have been reflected in pricing tiers and/or credit limits. The number of tiers and differences in rate between them tend to increase in times of market uncertainty. The Herstatt collapse of 1974, though originating in overtrading in the foreign exchange market, appears to have provoked an extreme instance of pricing tiers; some banks paid as much as 2% above LIBOR. However, the pattern of interbank rates returned to normal within a few months.

In current practice, differentiation among banks in terms of credit lines may be more significant than the minimal tiering in deposit rates. As the study group's survey confirms, banks in the market typically establish daily and overall limits for the funds they will place with (loan to) other banks. These are usually not disclosed, committed lines but are internally imposed limits set by credit officers as parameters for bank traders.

Risks and Concerns

There are two levels of risk associated with the market — risk for individual banks based on their particular characteristics and market activity and risk for the system as a whole. First, since banks participate on both sides of the market, they are confronted with both credit and funding risks. Second, and more importantly, there is an underlying concern that because of the interbank linkages even sound banks might not be immune from a problem caused elsewhere in the system because of the knock-on effect. In the case of the UK fringe banking crisis of 1974, even perfectly sound banks suffered.

The above-mentioned survey by the Group of Thirty showed that a majority of banks feel that interbank activity may be becoming more risky because of a change in the composition of the market (an increasing proportion of interbank borrowing being done by second and third tier banks). And bankers rated "unavailability of interbank funds" as great a potential threat to individual banks, though not to the system, as "default by a major country debtor."

The concerns that have been articulated in the press and elsewhere can be summarized as follows:

- How have banks and bank supervisors responded to the funding risks in the market?
- Has risk in international banking increased because of growth in the interbank market? Do the inherent characteristics of the market contribute to its instability or stability?

Banking Practices

In the past, banks were "often prepared to lend on an interbank basis with relatively little financial analysis or personal knowledge of the borrowing bank . . . on the implicit assumption that a participant in the market possessed sufficient capital resources, support from stockholders (or parent bank) or a potential call on central bank assistance to be able to meet its obligations."¹⁰ In the aftermath of the international banking crisis of 1974, banks began to review this assumption, tightening and improving their credit analysis practices, utilizing stricter limits and controls, and developing more direct personal contacts.

Many banks now treat deposit placement lines in the same way as credit lines, basing overall limits and individual transaction limits on assessments of creditworthiness, including consideration of country risk (99 per cent of respondents to the G-30 survey said that country risk played a significant role in determining interbank placement and credits).

Four factors may influence decisions. First, *financial statements* may be analyzed. Some banks do a careful analysis of even the largest banks, supplemented by visits by bank staff. Banks without the resources to collect and compile financial information themselves can purchase balance sheet and income statement data along with some standard ratios from several outside sources.

There are problems, however, in interpreting annual reports because accounting conventions and disclosure practices vary widely. For this and other reasons, banks themselves as well as some of the new credit information services, place a great deal of emphasis on a second set of factors. These are the *ownership* of a bank (and the nature of its relationship to its parent institution, if there is one) and the bank's *national support systems* — the quality and degree of bank supervision and consideration of lender of last resort facilities; 69 per cent of respondents to the G-30 questionnaire said that they evaluated the willingness of the other bank's government or central bank to come to its aid in adversity. Third, banks watch for *unprofessional* money market dealings and evidence of overtrading. (This, too has its limits since skillful liability management can hide problems, although for only a short time). Finally, banks, to varying degrees, strive for a *qualitative assessment of management*.

However, not all banks exercise the same degree of care. Some banks omit or do only a cursory analysis of the very largest banks; some apply general rules of thumb, e.g., considering the largest banks in the world or in any country to be unquestionably creditworthy; and others appear to rely heavily on the judgment of their correspondents. The G-30 survey provides

¹⁰ Steven I. Davis, *The Euro-Bank* (John Wiley & Sons, 1980), p. 76.

some evidence to support the view that all the banks with which they are backed up by their central banks.

Although many banks charge commitment fees for these services, they are assured, and may indeed draw on them. Many banks therefore take great care in their overall relationships with other banks. Banks employ various methods to gauge as well as possible the creditworthiness and in different currencies a bank may be developed to reciprocate the deliberately cultivated as well as the

Supervisory Practices

As with banking practices, the supervision of banks with respect to their international activities. Beyond qualitative supervision, many banks have liquidity requirements or guidelines for placing outside bounds on their liabilities. (See Appendix D). The G-30 survey reported that their bank's international interbank market

Support Mechanisms and

The market as a whole has experienced shocks, as was demonstrated by the 1974 freeze. This may be partly due to the international interbank market tend to respond to a shock, because of the system. As a result, there is an adjusted rate differentials) and a tendency.

However, it is always in the case of serious mistrust. In the case of serious mistrust, it rests critically on a rapid response to a shock, because of the system. As a result, there is an adjusted rate differentials) and a tendency.

some evidence to support the contention that some banks act on the faith that all the banks with which they place deposits are well regulated and will be backed up by their central banks, even outside the Group of Ten countries.

Although many banks assure the availability of standby lines (paying commitment fees for these when necessary), interbank lines are not always assured, and may indeed dry up for any individual bank when most needed. Many banks therefore take great care to maintain and test lines and cultivate overall relationships with other banks. Diversification of sources is clearly important. Banks employ various techniques to monitor their lines and try to gauge as well as possible how much they can tap from different sources and in different currencies and maturities. Additional business relationships may be developed to reciprocate for lines, and personal contacts may be deliberately cultivated as well.

Supervisory Practices

As with banking practices, it is difficult to make generalizations about supervision of banks with respect to their activity in the interbank market. Beyond qualitative supervision of bank practices, the capital adequacy and liquidity requirements or guidelines of bank supervisors would play a role in placing outside bounds on the aggregate level of a bank's interbank liabilities. (See Appendix D). About one third of banks responding to our survey reported that their home supervisory authority does not monitor their bank's international interbank lending and deposit placement activity.

Support Mechanisms and System Stability

The market as a whole has so far been resilient in the face of external shocks, as was demonstrated by the moderate reaction to the Iranian asset freeze. This may be partly because the breadth and depth of the international interbank market tend to limit the damage when funds are switched in response to a shock, because that causes no net loss of liquidity to the system. As a result, there is a greater chance for a reflow of funds (with adjusted rate differentials) as long as there is no generalized loss of confidence.

However, it is always important to prevent the spread of contagious mistrust. In the case of serious shock, smooth functioning of the market rests critically on a rapid restoration of confidence and may therefore, depend also on the assurance of adequate support mechanisms. The market's ultimate dependence on official support mechanisms is heightened by the nature of market relationships. Since deposit lines are discretionary, some degree of credit rationing appears likely in a general crisis. To the extent that this occurs, banks faced with a sudden unavailabil-

ity of funds and unable to obtain new funds by raising rates would be at least temporarily reliant on official support.

There are various forms official support may take — including lender of last resort and other, *ad hoc* arrangements. For the interbank market, the somewhat paradoxical role of these mechanisms in their dormant state, i.e., short of actually being called into action, is to maintain a degree of ambiguity as to when and under what circumstances an individual bank will be given support while at the same time sustaining confidence that shocks to the system will be controlled and neutralized. The ambiguity serves on the one hand to induce discipline on the part of market participants while at the same time fostering confidence sufficient to ensure that shocks will not trigger panic. Hundreds of new participants have entered the interbank market in recent years, many of them relatively small. The quality of supervision of a number of such banks from outside the major countries and uncertainty about access they might have to lender of last resort facilities in time of crisis leaves cause for concern.

Conclusions

The interbank market has functioned remarkably well; its considerable breadth, liquidity, and efficiency enable the international banking system to accomplish its enormous recycling task smoothly. The major change in the market is the proliferation in participants that has introduced second- and third-tier banks and banks from a number of non-G10 countries to the system. This bears on both the risks facing individual banks and the system risk and is the main reason why banks themselves feel that the riskiness of the market has increased.

It appears from the survey results that banking practices have changed in response, although the extent to which this is true is difficult to gauge. The treatment of bank deposit facilities as credit lines is a positive development; it is just as important for banks to perform careful credit analysis when lending to other banks as when lending to non-bank borrowers. Similarly, effective monitoring and management of funding risks are highly desirable.

For large, well known banks, taking interbank deposits may not present funding risks significantly different from other types of interest-sensitive, short-term liquid liabilities. However, smaller banks, newcomers, and banks without an established funding base are more vulnerable than the major multinational banks to increased tiering of rates or unavailability of funds in the event of a loss of confidence. The possibility of a re-emergence of steeper tiering or withdrawal of standby lines under adverse market conditions, which would naturally have a particularly marked effect on banks that are large 'net takers' of interbank funds, should add an element of self-discipline for all participants. Because of such consid-

erations, and the lack of ascertaining the ultimate inter-bank market bank pressure less than it appears to be.

It would seem appropriate for the market to exercise special care to approach to interbank funding increase in activity in Europe overall deposit-taking and funding obtained through relationships which many banks have.

It is worth emphasizing that risk is not the only type of risk that supervisory authorities should be concerned with. The continued stability of such deposits, or place deposits with, is of the quality of management concerned, the economic conditions and a judgment of willingness and ability to support in an emergency.

4. MATURITY TI

While the practice of maturity mismatching at one maturity and lending at another, perceived changes in the market have prompted renewed concern about the borrowers' market has at the liability side, typical of the market has been reinforced by rising interest rates for other depositors as well to the market.

Competition in loan lengthening of lending market has been putting pressure for extra funds. At the same time, a shift in the management of monetary policy accompanied by great volatility.

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erations, and the lack of 'transparency' of the market — the difficulty in ascertaining the ultimate sources and uses of funds — reliance on the inter-bank market bank placements as a source of effective liquidity may be less than it appears to be.

It would seem appropriate for smaller banks and new entrants to the market to exercise special care and take a relatively more cautious approach to interbank funding, but it is not clear that all of them do so. The increase in activity in Euro-market brokers may reflect a relative increase in overall deposit-taking and placing by less well established banks, and funding obtained through brokers may be less reliable in times of difficulty because it does not carry with it the backing of business and personal relationships which many banks have cultivated.

It is worth emphasising that a bank is not necessarily a better or worse risk than any other type of borrower even though it is increasingly the case that supervisory authorities in each country pay special attention to the continued stability of such institutions. Decisions to extend credit facilities to, or place deposits with, a bank must therefore be made on an assessment of the quality of management and fundamental strength of the bank concerned, the economic and political condition of the country in which it resides and a judgment of the quality of supervision in that country. The willingness and ability to its central bank to provide "lender-of last resort" support in an emergency should not be taken for granted.

4. MATURITY TRANSFORMATION

While the practice of maturity transformation, namely receiving deposits at one maturity and lending at another, is an integral part of financial inter mediation, perceived changes in Euromarket conditions and practices have prompted renewed attention to the subject. On the asset side, a borrowers' market has at times produced a lengthening of maturities. On the liability side, typical OPEC preferences for short-term deposits have been reinforced by rising short-term interest rates which have induced other depositors as well to seek shorter terms.

Competition in loan markets has at times resulted not only in a lengthening of lending maturities, but also a shrinkage of loan margins, putting pressure for extra income on other bank activities. At about the same time, a shift in the U.S. approach to monetary policy, emphasizing management of monetary aggregates vs. short-term interest rates, was accompanied by great volatility of U.S. rates and hence Euromarket rates,

making portfolio management more difficult. In 1980 and early 1981, substantial losses on mismatched positions were reported by a number of major multinational banks. Others, however, profited from the new volatility of interest rates. This greater volatility increases both the risks and possible rewards of mismatching.

It is important to try to distinguish the two components of risk in maturity mismatching — interest rate risk and funding (liquidity) risk — and to understand how Euromarket practices affect each. The interest rate risk component is to a great extent alleviated (but not eliminated) by floating rates and the rollover technique which pass interest rate risk on to the borrower. The effect in a period of rising interest rates is to increase credit risk. The extent to which a bank covers itself against interest rate risk depends for the most part on how closely it matches liability maturities to the rollover maturities in its assets. If a loan that is repriced every six months is funded with 30-day money, the bank's exposure to potentially adverse changes in market rates of interest is not fully covered. In addition, smaller, less well-known banks would continue to be vulnerable to increased tiering of rates even if liabilities were completely matched to asset rollover dates.

The rollover mechanism does not, however, neutralize funding risk — that is, the possibility that a bank may be unable to tap resources to meet its continuing obligations. For the market as a whole, supply and demand are kept in balance by interest rates; however, the market response for particular banks in different circumstances can vary considerably. Banks with established names can reasonably expect to tap even a large amount of funds, when needed, and at relatively advantageous rates. For smaller, less well known banks, particularly relative newcomers or ones without a connection to the U.S. dollar market, the funding risk may be a real one.

Bank Practices

In the 1970's many banks began to re-examine procedures for asset and liability management with an eye to greater global coordination. Most banks monitor their liquidity positions with some care. As in the case of foreign exchange positions, top management sets general policy for maturity mismatches and puts limits on discretionary decisions by lower managers, based on assumptions about movements in rates. The range of practical approaches to fund management runs from centralized global control to decentralized, local (profit center) control. Neither way is clearly superior; there are advantages and disadvantages to both. Banks' actual practices vary. About 40 per cent of banks participating in the G-30 survey indicated that they had reduced limits in reaction to greater risks posed by the current volatility of interest rates.

Supervisory Practices

Bank supervisors must be aware of the problems that may arise from a comparison of the approach to maturity mismatching by the variety of wide institutional differences in participating in the survey of their mismatched positions.

Because of the increasing importance of Banking Supervision and Mr. Peter Cooke has been working on a uniform reporting system for maturity mismatching, particularly in the U.S.

A number of supervisory banks to fund a portfolio with long-term foreign currency business, banks who is itself the issuer of the currency.

Conclusions

Available maturity mismatches and conclusions about whether or not by bank supervisors to improve their position thus a positive development is important that the coverage of worldwide business.

Yet even if no worse place most bankers and volatility has tended to increase. This increased risk requires, of course, losses themselves greater discipline in bank supervision responsible for their own maturity mismatches concerned to ensure that

5. DISTRESSED

The growth of the international potential range of problems

Supervisory Practices

Bank supervisors are aware of special problems in liquidity management that may arise from banks' international operations. But direct comparison of the approaches adopted by different supervisors is rendered very difficult by the variety of techniques used to measure "transformation" and wide institutional differences. It may be noted, that about one third of banks participating in the survey said that supervisors' performance in monitoring their mismatched positions was "poor" or "fair".

Because of the inadequacy of existing statistics, the Committee on Banking Supervision and Regulatory Practices under the chairmanship of Mr. Peter Cooke has been working to try to encourage and develop a uniform reporting system to be used by the BIS to collect data on banks' maturity mismatching, particularly with regard to their international business.

A number of supervisors (e.g., France, Japan) have increasingly urged their banks to fund a proportion of their long-term foreign currency assets with long-term foreign currency liabilities, partly at least because in foreign currency business, banks have no automatic lender of last resort to turn to who is itself the issuer of the currency in question.

Conclusions

Available maturity structure data make it impossible to reach any conclusions about whether the degree of mismatch has worsened. Efforts by bank supervisors to improve the collection of statistics of this kind are thus a positive development and for these statistics to be fully meaningful it is important that the coverage of data should embrace international banks' worldwide business.

Yet even if no worsening of trends on a consolidated basis has taken place most bankers and study group members believe that interest-rate volatility has tended to increase riskiness of traditional mismatch practices. This increased risk requires banks to be more cautious. Furthermore, of course, losses themselves will tend to have the healthy effect of inducing greater discipline in bank practices. Whilst banks' managements are responsible for their own mismatching practices, supervisors must also be concerned to ensure that these are prudently established and operated.

5. DISTRESSED BANKS

The growth of the international banking system has increased the potential range of problems created by bank failure. The problems of a

single bank, unless contained, could have an impact through the international interbank market; banks and banking systems are always vulnerable to confidence crises. Moreover, the transnational structure of the international banking system and the potential global spread of contagion have enormously complicated the management and resolution of bank failures and distressed bank situations.

Three different cases of bank failures in the last decade illustrate some of the international ramifications such occurrences may have, not only the unfolding distress of the bank itself, but also the nature, extent, and timing of crisis resolution by national banking authorities.

- In June 1974, the Bankhaus I.D. Herstatt, which had incurred large foreign exchange losses, was abruptly closed by the German Federal Supervisory Authority for Credit Matters. The collapse of the bank shocked the markets, which had not previously demanded risk premia for interbank transactions. After the Herstatt crisis, rate tiering appeared, and many sound banks had difficulty getting access to funds simply on the ground of being small.

In addition, by closing Herstatt at the end of the banking day in Cologne but just after the beginning of the banking day in New York where scores of Herstatt's foreign exchange contracts were in the midst of settlement, the German authorities inadvertently interrupted the international payments mechanism. Herstatt's principal New York clearing bank, Chase Manhattan, froze the account. Debit orders were not honored; credits coming in were not returned. A race for Herstatt's New York assets by its creditors from around the world ensued.

- At about the same time as Herstatt's problems were becoming more visible in the spring of 1974, U.S. banking authorities were in the midst of a protracted attempt to prevent the collapse of Franklin National Bank, then the 20th largest bank in the United States. A decision by the Federal Reserve Bank of New York to provide emergency liquidity assistance in substantial amounts had as one of its two main objectives prevention of "the severe deterioration of confidence, at home and abroad, that would have resulted from an early failure of the bank." (Federal Reserve Bank of New York, Annual Report, 1974.)

The same concern for international market stability, which was shared by other central banks as well, also prompted the Federal Reserve to acquire Franklin's foreign exchange book when the market, fearing the bank would fail to perform on contracts, began to refuse to sell foreign exchange to Franklin.

Because Franklin had a large London branch, management of the problem required the Bank of England's cooperation at two junctures. First, during the months of liquidity assistance, the steadily increasing need for collateral for Franklin's borrowings from the Federal Reserve required the use of assets at the London branch. Second, the ultimate solution, a purchase and assumption transaction, required that the Bank of England help to secure the necessary approvals under English law for transfer of Franklin's London assets to the FDIC which acted as receiver prior to the sale to European-American Bank.

- In the spring of 1980, Argentina's Central Bank ordered the liquidation of Banco Intercambio Regional (BIR), the country's second largest private bank. The exposure of foreign banks was about \$80 million. Foreign

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currency deposits were not covered by Argentina's deposit insurance plan. Moreover, Argentinian authorities, claiming lack of authority, refused to accept responsibility for claims on BIR's New York branch. The New York State Banking Department took possession of the branch, hoping to be able to pay off depositors and creditors by selling branch assets.

The liquidation of BIR triggered a run on deposits at other Argentinian banks. The Argentine Central Bank was forced to inject an estimated \$2 billion to avoid a collapse of the private banking system. In the meantime, the country's \$10 billion accumulation of foreign exchange reserves had begun to drain away, leading some concerned observers to worry about the adequacy of Argentina's resources to meet a potentially prolonged banking crisis.

Concerns

Concerns about distressed banks and their impact on the stability of international financial markets spring from perceptions of the large degree of interdependence among banks from all over the world and market doubts about the ability of existing lender-of-last-resort facilities to manage and contain future crises of potentially global proportions.

A majority of bankers participating in the G-30 survey expressed their agreement with the proposition that "the international banking system would be vulnerable to a chain collapse in the event of a crisis affecting a significant bank or group of banks", although supplementary comments suggested that they considered this eventuality to be improbable. More than two-thirds said, however, that there was "a need for clearer understanding of lender of last resort facilities."

Two distinct lines of questions are raised by such firm comments:

- Do individual national authorities have the capacity (powers, resources, judgment) and willingness to act to avert an international crisis?
- Given the complex transnational structure of the international banking system, is there sufficient clarity of responsibility, i.e., which central bank is responsible for which banking institution?

Crisis Management Mechanisms

The organization of nations' crisis management systems reflects different national legislation and policies. In the United States and a few other countries, rescue responsibilities are divided among the institutions that respond to illiquidity and those that deal with insolvency. The distinction, of course, is not easy to draw, and interaction of the two functions is sometimes required to meet emerging problems. In some countries, the central bank has responsibility for handling crises both of illiquidity and of insolvency, though this is by no means true of all. However, in some of the latter countries there are other institutions for dealing with insolvency.

Crisis management mechanisms may take a number of forms, includ-

ing lender of last resort facilities, deposit insurance and *ad hoc* arrangements. Regardless of the original source or nature of an individual bank's problems, what triggers a crisis of confidence for the whole banking system is a liquidity crisis. In order to stave off or contain such a crisis, authorities must be able to provide needed liquidity quickly to avoid a panic run on deposits. Hence debates about dealing with distressed banks in an international context have tended to concentrate on lender of last resort facilities.

In the classic view, a lender of last resort is an institution which has the responsibility to provide the residual liquidity needs of the financial system rather than to specific institutions. These may arise in day-to-day activity or in emergency situations. In the latter case, the lender of last resort may prevent and neutralize the impact of financial shocks by lending to institutions during periods of crisis and by acknowledging its duty to lend in the future. In fact, the presence of a lender of last resort alone may be sufficient to sustain public confidence.

At the same time, the efficacy of lender of last resort and other kinds of support arrangements requires that they should not be viewed as providing an unconditional guarantee. Such a guarantee would have the perverse effect of encouraging some banks to take undue risks in the belief that if they got into trouble rescue by national authorities was assured.

The development of lender of last resort facilities and other types of crisis management mechanisms is closely related to the degree of maturity of a country's banking system. Such facilities are usually not questioned for the G-10 and other industrialized countries. However, as already noted, the increasing participation in the international system of banks from developing countries has given rise to some unease, in large part because the quality and commitment of their national support arrangements are not clear.

The transnational structure of the international banking system poses additional questions of access to lender of last resort facilities for several types of banking institutions. These include foreign subsidiaries and participations and sometimes even foreign branches which, in a crisis, may be unable to obtain access to their parents' lender of last resort. Increasing numbers of multinational consortium banks add their own element of uncertainty.

The Response of Banks After Herstatt

Since 1974, the behavior of banks in the interbank market has reflected varying perceptions of the support that may be made available to a distressed bank. Some banks treat possible unwillingness or inability of a central bank to support its national banks as part of country risk and may extend or withdraw credit lines as their analysis of circumstances dictates

(See answer to Question 5) attempts to determine whether large and/or government banks are believed to be in distress rests on the belief that they will then continue to lend in order to avoid crisis while others may continue to extend credit in order to take advantage of relatively low interest rates from having proved the

The Response of Major Central Banks

With the events of 1974, the potential need for concerted action was considered at a meeting of the Group of Ten in 1974. The statement that public concerns should be taken into account was available but, in order to avoid confusion, no specific measures were specified. Specifically, the statement announced that, after consulting with the Euromarkets, "they recognized the need to advance detailed rules on the use of lender of last resort facilities." But they were "not yet decided" and will be used if and when necessary.

Conclusions

The study group believes that the main feature of a lender of last resort is the conditions under which it operates and the discipline. At the same time, the need for clearer understanding of the role of the lender of last resort is emphasized.

6. COMPETITION FOR CAPITAL

In explaining the narrow margin of safety given the greatest weight to supply and demand by lenders seeking to enter the market.

(See answer to Question 50 in bank survey). Such analysis may include attempts to determine whether rescue efforts might be forthcoming only for large and/or government-owned banks. Once a bank is actually known or believed to be in distress, continued extension of credit from other banks rests on the belief that the authorities will provide support. Some banks will then continue to lend in an effort to maintain confidence in the system and avoid crisis while others withdraw deposits or lines; some banks that continue to extend credit may be additionally motivated by the opportunity to take advantage of relatively high rates and the hope of benefiting, over time, from having proved themselves "friends in need".

The Response of Major Central Banks

With the events of 1973 and 1974 as a catalyst, recognition of the potential need for concerted action in the event of international problems was considered at a meeting of the world's major central banks in Basle in 1974. The statement they issued reflected the classical model, that is, public concerns should be put to rest with assurance that support is available but, in order to keep the markets disciplined, the exact circumstances under which support would be forthcoming should not be formally specified. Specifically, the Governors of the G-10 and Swiss central banks announced that, after considering the problem of lender of last resort in the Euromarkets, "they recognized that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity." But they were "satisfied that means are available for that purpose and will be used if and when necessary."

Conclusions

The study group believes that some degree of ambiguity is a necessary feature of a lender of last resort facility. Any move to spell out specific terms and conditions under which assistance would be made available to banks in distress would have the detrimental effect of undermining market discipline. At the same time, the strong views of commercial banks that there is a need for clearer understanding of lender-of-last-resort facilities were noted.

6. COMPETITION, PROFITABILITY AND CAPITAL

In explaining the narrow spreads on international loans bankers give greatest weight to supply and demand conditions and to aggressive pricing by lenders seeking to enter new markets or expand market share. The entry

of new banks into the Euromarket and expansion of international activities by previously established institutions have obviously maintained intensely competitive conditions. For example, data on syndicated loans collected by the World Bank suggest that there may be as many as 10 times the number of lending institutions in the syndicated loan market today as there were in 1972. Of those that the World Bank identified by name (institutions in the first nine or ten manager positions), one-third of 1980's syndicated loan managers are headquartered outside Europe or North America, compared to only one-eighth in 1973: See Appendix C.

Concerns

Perceptions of increasing risk in international lending are frequently accompanied by concern that, with spreads on loans squeezed by intense competition, returns are not commensurate with risk. Moreover, there is concern that the narrow margins lead to lower profits, thus impairing banks' ability to maintain adequate capital ratios.

The remainder of this section will explore the following questions:

- What is the relationship between quoted spreads and bank profitability?
- How have banks responded to narrower margins?
- Does competitive pressure come particularly from some banks with competitive advantages?
- What has the supervisory response been?

The Effect of Spreads on Profitability

Quoted spreads are a guide to establishing borrower costs, not measuring profit margins, if only because banks' average costs of funds are usually below LIBOR, front-end fees on loan agreements provide further compensation and there is the unquantifiable benefit of other business kept or gained.

In general, large banks enjoy wider gross lending margins because of their lower average cost of bought-in funds. They and banks that take lead roles are more likely to gain more also from fees and related business. Participants that do not have such advantages — or have them to a lesser extent — have some offsetting benefit, however, since they do not incur as much indirect (non-funding) costs as the lead banks.

The question of what level of spreads is "acceptable," i.e., likely to generate an adequate net return, is a very difficult question for any individual bank. Analysis of the profitability of international lending, and international operations generally, poses problems which include allocating indirect costs. It has been reported that many bankers have been dissatisfied with their own internal data and profit-center analyses. The difficulty of accounting for the true economic cost of rescheduled loans, discussed earlier, further complicates the issues.

Follow-up interviews: "guesstimates" on profits true gross return at about estimated their breakeven elements of front-end fee

The record shows the erosion of loan spreads. maintain market presence the line at a given "accept" of its loan portfolio.

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Follow-up interviews to a previous Group of Thirty survey yielded some "guesstimates" on profitability from non-U.S. banks. Most estimated their true gross return at about 0.25 per cent above quoted spreads. Also, most estimated their breakeven point at about ¾ per cent over LIBOR plus some elements of front-end fees.¹¹

The record shows that individual lenders are not able to stop the erosion of loan spreads. Since banks feel in many cases compelled to maintain market presence, the principal results of a bank's attempt to hold the line at a given "acceptable" spread may be a deterioration in the quality of its loan portfolio.

Sources of Pressure on Margins

Some banks have competitive advantages that arise from the regulatory regime within which they operate. Highly leveraged banks can lend at relatively low margins and still earn a reasonable return on equity. Also, because there is less emphasis on profitability, some government-owned banks or savings banks may have a similar pricing advantage. Finally differences in reserve requirements and other regulatory measures can also have an impact on competitive abilities of banks, especially if they were to be manipulated to promote or discourage international activities.

However, not all competitive pressure comes from banks with regulatory advantages. For example, sluggish domestic loan demand may lead to more aggressive pricing by banks from different countries at different times. Also, more recent entrants may at any given time be competing more aggressively to gain market share or carve out a special niche. Finally, even the more established institutions may adopt a competitive strategy of cutting price to increase market share. Waves of intense competition from various groups of banks tend to maintain the pressure on margins.

Such competitive pressures in the market are expected to continue. The bank survey identified varying capital requirements as the main factor distorting competition, in the view of bankers. Differences in regulation were thought by a majority to be "somewhat" important factors affecting competition.

Supervisory Capital Requirements

The continuing decline in spreads, since 1976, in spite of some recent recovery, and perceptions of increased risks in the market, has prompted special attention to capital adequacy on the part of banking supervisors from the major industrialized countries. Germany and Switzerland, for

¹¹ "The Outlook for International Bank Lending", G-30, August 1981. It should be noted that these guesstimates were highly qualified since many respondents indicated they are not able to monitor efficiently their marginal cost of dollars, and most admitted that inability to allocate overheads, etc., made costing unreliable.

example, have recently widened the scope of their capital requirements in order to encourage their banks to increase provision for the risks they incur in their international activities. A brief outline of capital adequacy requirements is given in Appendix D.

To the extent that capital requirements are effective, they should ultimately constrain expansion of lending when returns are inadequate. Reportedly, some Swiss and German banks have reduced their international lending activity in reaction to new or proposed requirements, and some banks in London claim to have been constrained by Bank of England capital adequacy guidelines, although it is not clear whether this has had any direct impact on their international business. A previous Group of Thirty survey revealed that respondents' banks believe capital adequacy will be one of the more important constraints on future international lending, although not necessarily a very significant one.

The BIS, in its April 1980 communique, listed capital adequacy as one of the three elements of international banking soundness to which the central bank governors attach "cardinal importance", and endorsed the efforts of the Cooke Committee in this area. It seems likely pressure by national authorities to sustain adequate levels of capital will continue, and will be beneficial for the protection of the earning capacity of the international banking system as a whole. This may be accompanied by some move towards convergence of different countries' capital adequacy standards, although this is likely to be a fairly long-term prospect.

Conclusions

It is the opinion of the study group that supervisors should not attempt any direct action to increase loan margins. There may in any event be practical limits to the efforts of individual supervisors, because of possible disadvantages to their banks from prudential requirements that are significantly more stringent than their competitors'. For that reason, cooperative efforts among supervisory authorities are a very positive development. The bank survey revealed support for the view that requirements should be harmonized — with a preference (perhaps not surprisingly) for achieving this by reducing rather than raising regulatory requirements.

7. FURTHER SUGGESTIONS FOR REDUCING RISKS IN BANKING

The purpose of this concluding section is to explore two suggestions for reducing risk — through a requirement for banks to make provision for

rescheduled loans and dealing with rescheduled indebtedness. These preceding sections

Provision For Rescheduled Loans

A recently topic should be obliged to be ruled. The question is the making of some time of rescheduling indicates the existence of presumably resolved doubt that the lender not been borne out of provision for opposite opinion of the study common, it would be against rescheduled some general provisions exceptional, supervisory

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rescheduled loans and, secondly, by way of improving the arrangements for dealing with rescheduling and the flow of information on international indebtedness. These are in addition to the recommendations made in the preceding sections of this report.

Provision For Rescheduled Loans

A recently topical subject has been the question of whether banks should be obliged to make provisions against loans that are to be rescheduled. The question is whether regulators ought to move towards requiring the making of some provision against a portion of rescheduled loans at the time of rescheduling. To put it another way, rescheduling — *de facto* — indicates the existence of a loan quality problem. Even if this problem is presumably resolved through an agreed rescheduling, there is no reason to doubt that the lending institutions' judgment at time of loan origination had not been borne out. Consequently, provision against possible loss or a provision for opportunity-loss seems prudent and reasonable. It is the opinion of the study group that, as reschedulings may become more common, it would be in the interest of banks to make some provision against rescheduled debts either specifically or through the existence of some general provision of adequate size and, unless circumstances are exceptional, supervisors should encourage action on these lines.

Those who argue against this point of view note the following:

1. There is little international uniformity in the treatment of non-performing and rescheduled loans. Obviously, the inequity posed by differing rules and differing standards can be used as an argument to frustrate the basic concept of provisions for rescheduled sovereign loans. However, individual regulators could proceed along lines they deem to be best for the safety and soundness of their banking system even if other regulators are more lenient.
2. A second argument is that the requirement for rescheduling can be solved by bank refinancing. Rescheduling might be avoided by increasing loans to cover interest and/or principal payments. This technique is obviously nothing more than putting off the day of reckoning; it amounts to the same thing as a rescheduling and lacks conviction.
3. A third argument in opposition to provisioning has been that it weakens creditors' negotiating position and might tempt debtor nations not to fulfill their obligations, although there is little evidence to suggest that this has been a feature in rescheduling activities to date.

On the positive side, the argument for provisioning is that:

1. The rescheduling is, in and of itself, an indication of loan-quality problems. Such quality problems should be recognized and some portion of the rescheduled loan should be reserved both as an indication of the reality of the loan quality problem and also because of the costs involved in rescheduling, not the least of which is the opportunity cost.
2. Provisioning reinstalls into sovereign lending one element of discipline

which may have diminished substantially over the past decade as losses in international lending have been contained due to rescheduling activities.

Clearly, the problems concerning provisions for losses and rescheduling activities are substantial. On the other hand, a more rigorous approach could help improve discipline within the international banking system. In addition, it would discipline the sovereign borrowers and strengthen forces making for better balance of payment adjustments. In sum, the study group believes that it is appropriate for all supervisory and regulatory authorities to encourage banks to take action in this area, although it is recognized that it is unlikely that this will be possible at least initially in any uniform way.

Inadequacies of Existing Arrangements

The study group feels that the existing arrangements among banks to deal with country debt reschedulings are unsatisfactory, being almost entirely of an ad hoc nature. In particular, the period leading up to renegotiation has been extended, to the detriment of all parties, by the need for lending banks to be persuaded to join together, pool information and appoint negotiators (recent experience has shown that it can take a long time before the major banks even know what other banks are involved). Also, the study group notes that the assembly process in respect of gathering information on cross-border claims of commercial banks is incomplete and needs to be improved.

A good example was that of Turkey where the first estimates of lending proved to be far lower than the total which emerged when banks and other creditors revealed their individual lending figures. The same happened in the case of Poland. The study group feels that it would be in the best interests of both debtor countries and creditor banks if it were possible to have a central unit in which statistics on international lending were kept complete, up-to-date and confidential. This might be undertaken by the BIS, building on their existing work, or conceivably by a new organization established by the banks themselves.

Clearly, the combination of a prolonged recession, falling commodity prices and historically high levels of real interest rates in most major countries and especially in the United States could lead to further strains appearing in the banking system, especially if a number of reschedulings were to take place either simultaneously or within a short space of time. It might well be that the banks would react to an increase in perceived risk by cutting back international lending. If the same phenomenon applied to the inter-bank market, an individual bank could find it difficult to renew deposits in the inter-bank market, thus setting off a contraction in liquidity. While these risks exist whether arrangements for rescheduling of country debts

are efficient or inefficient unnecessarily increased activated mechanism for lems. By contrast, it would creditors, once a council convened and the government in unison to a common purpose.

The same point applies to the International Monetary Fund (even informal) system as a group and officers regularly to discuss mutually that the IMF and the World Bank initiate discussions with being accused by members is felt strongly that this establish means of better to establish a method of lending, namely the commercial and government credit each other and with borrowers to react quickly in case

A Consultative Group for

The study group felt dealing with a debt rescheduling country could resolve its to a precipitous withdrawal severe domestic economic such prompt action consideration to initiative international financial cooperation.

One area in which obviously in this report, is in the on the liabilities of countries.

Data on international Bank and the Bank for which could supplement additional information from increasing the transparency information on the exposures sovereign borrowers, let

are efficient or inefficient, the study group feels that the level of risk is unnecessarily increased because there is no generally accepted and readily activated mechanism for dealing with a potential escalation of such problems. By contrast, it was noted that in the case of official government creditors, once a country finds itself in difficulty, the Paris Club can be convened and the government creditors are able to react quickly and in unison to a common problem.

The same point applies to relationships between commercial banks and the International Monetary Fund and the World Bank. No formal (or even informal) system exists whereby representatives of commercial banks as a group and officers of the International Monetary Fund can meet regularly to discuss mutual problems. Naturally, the study group recognizes that the IMF and the World Bank would find it difficult, if not impossible, to initiate discussions with commercial banks on country problems for fear of being accused by member countries of favoring such creditors. However, it is felt strongly that this legitimate concern does not obviate the need to establish means of better communication. The overriding consideration is to establish a method or forum whereby the major actors in international lending, namely the commercial banks, the multilateral official institutions, and government creditors could find a way of working more closely with each other and with borrowers both to improve the flow of information and to react quickly in case of need.

A Consultative Group for International Banking?

The study group felt that the more rapid the action of the main actors in dealing with a debt rescheduling need, the more likely would it be that a country could resolve its problems in a timely manner without being subject to a precipitous withdrawal of credit and hence possibly unnecessarily severe domestic economic adjustments. Among various ways in which such prompt action could be encouraged the study group gave close consideration to initiatives that might be taken by the private sector of the international financial community.

One area in which further improvement is required, as noted previously in this report, is in the collection and timely dissemination of statistics on the liabilities of countries to the banking system and capital markets.

Data on international bank lending is already gathered by the World Bank and the Bank for International Settlements, but a banking bureau which could supplement information from such sources by obtaining additional information from borrowers or lenders could play a useful role in increasing the 'transparency' of the market (for example, by gathering information on the exposure of banks from different countries to particular sovereign borrowers, lending by banks outside the Group of Ten and

Switzerland, the positions of official and other non-bank creditors, and movements in short-term credit flows).

Beyond such initiatives to improve information could come the establishment of some forum (an "International Banking Consultative Group"?) in which leading international bankers would be able to discuss issues of mutual concern. It might also be able to liaise on behalf of bankers with official international and government agencies, providing these bodies with an additional forum for discussing problems concerning international capital flows and market regulation. Equally important, it would be available as an additional channel through which borrowers would be able to convey their views more effectively to the international banking community at large.

This role as a "channel of communication" might over time be found particularly useful in connection with international debt servicing problems. The body could not itself represent banks in rescheduling negotiations, but could in certain circumstances occupy a liaison role between bankers and borrowers, and between different banking interests in a problem loan situation. The possibility of conflicts of interest must be acknowledged, given that the group would be composed of bankers who are themselves active in the international field, but the group would be in a good position to look beyond such interests and focus on factors of longer-run importance.

Past experience has shown that debtors as well as creditors have much to gain from improvements in the machinery for dealing with debt problems. It would be for the "consultative group" to demonstrate through its actions that its role is a constructive one, and not narrowly sectoral in outlook. It could provide the means for bringing involved banks together quickly once a rescheduling request had been received, and in due course could be expected to develop expertise that would be of great assistance to negotiators of both parties. A "consultative group" could not, of course, have legal powers to enforce decisions, but would derive its authority from the standing of its members, the expertise of its secretariat, and from the moral support given to its work by the international banking industry. It would certainly be important to discuss the objectives of the new body as widely as possible, to demonstrate the positive role it is intended to play, and to take full account of the views of sovereign borrowers.

New patterns of international financial flows will be called for in carrying through the volume of international lending needed in the 1980's. These may include expanded use of co-financing, parallel lending and similar techniques. Progress in these directions, which has so far been disappointing, might well be facilitated if there was in existence an authoritative body amongst commercial bankers with which the international agencies could co-ordinate their thinking and establish acceptable ground rules for co-operation and joint development.

The study group fully difficulties in setting up such members should be form banking communities or se consideration. On the one markets have developed or of interest along national li best to avoid members bein (There is also the possibility this should not be exaggera would provide a more for perhaps strengthen its mo

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The study group fully recognized that there are likely to be many difficulties in setting up such a group. For example, the question of whether members should be formally representative of their respective national banking communities or selected in another manner would require careful consideration. On the one hand, in view of the fact the Euro-currency markets have developed on a transnational basis and that sectionalization of interest along national lines could be counter-productive, it may well be best to avoid members being nominated by national banking communities. (There is also the possibility of anti-trust conflict to be considered, though this should not be exaggerated). On the other hand, national representation would provide a more formal element of structure to the Council and perhaps strengthen its moral authority.

More generally, these areas of difficulty might be found less of a problem if in the first instance an experimental body were to be established on an informal basis. It would then grow when experience was gained, thus helping to avoid the problem of unrealistic expectations, and by this means enjoy greater freedom to set a style for future operations. Private discussions indicate that a wide measure of support exists, both inside the banking industry and among interested outside parties, for the concept of a representative international body of the kind discussed in this paper.

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APPENDIX B

The Rescheduling of Country Debt: Is a More Formalized Process Necessary?*Richard Huff***Introduction**

With the growing importance of commercial bank lending in international financial flows in the 1970s, it was inevitable that country debt service crises would take on a new flavor. The debt reschedulings that resulted from such crises were not new or unprecedented, of course. Reschedulings of official debt had become fairly commonplace ever since Argentina had asked its government creditors to reschedule in 1956; ten countries engaged in 31 separate reschedulings over the two decades 1956—75. Such multilateral exercises had, in fact, become fairly routine through the procedures of the Paris Club, an informal group of major Western creditor governments chaired by the French Treasury.¹ And, while the rescheduling of debt owed to private creditors was less frequent, it was by no means unheard of; several countries — including Argentina, Brazil, and Chile — had rescheduled their private debt in the 1960s and early 1970s.

What distinguished the reschedulings of the later 1970s, then, was not so much their novelty as their scope. Instead of the relative handful of banks, often from a single country that once had been involved in negotiations, there were now 100, 200, or more. (Poland is currently attempting to reschedule debts owed to some 500 separate institutions.) And where a few million dollars were once at issue, the stake had grown to the hundreds of millions, or, in some cases, billions of dollars.

This increase in the scale of the reschedulings suggests a corresponding increase in their complexity — a complexity manifested both in the substance of the talks as well as the mechanics of a process involving so many participants. And it calls into question whether the ad hoc approach that has previously been taken toward the organization of these negotia-

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tions will continue to be effective in the reschedulings of the '80s. That approach, to be sure, has thus far been adequate to the demands placed upon it. No rescheduling talks have failed simply because of organizational difficulties in starting a new rescheduling process from scratch each time that banks and debtor governments decide to enter into negotiations. And the flexibility afforded by the absence of a more formalized process has perhaps aided in the resolution of difficult substantive issues. But "ad-hocery" has had its costs — notably the confusion and delay in resolving difficult organizational and procedural questions before substantive discussions can begin. And if reschedulings become more numerous and frequent in the years ahead — as many observers predict — it is well worth considering whether the process for conducting them ought to be more formalized and institutionalized.

This paper will examine that question. We will begin with a review of the rescheduling experience of the past half-dozen years, focusing in particular on whatever recurring problems and difficulties have arisen. The paper will then consider the coordination of commercial debt rescheduling with the renegotiation of official debt and the appropriate role of the International Monetary Fund. It will conclude with a brief discussion of possible improvements in the present rescheduling process.

The Rescheduling Process

Getting to the table. A recent IMF staff study² examined the cases of six IMF members that rescheduled their obligations to commercial banks between 1976 and 1980. It noted that the rescheduling process was generally a long and difficult one, taking from two to five years from the time a debt service problem first emerged until an agreement was actually signed. Generally, negotiations did not begin until one or two years after such signals as the emergence of arrears or the reluctance of banks to roll over maturing credits might have suggested that a rescheduling would be necessary; once begun, the talks themselves took anywhere from 18 months to four years to complete.

One of the difficulties the parties to these negotiations faced surely was the lack of a well established means of resolving their differences. "While the modalities for the restructuring of official debt were fairly well established," comments the IMF study, "the restructuring of debt owed to commercial banks involved, to a large extent, the breaking of new ground." Previous commercial debt reschedulings had concentrated on the restructuring of short-term trade credits, but now the focus was on medium-term syndicated Eurocredits, which brought a host of complications. The hundreds of banks of many different nationalities involved in the various loan syndications had to be contacted. Basic data on how much was owed to

whom had to be collected. (One country, which had to send out a queue of requests.) And in four cases, negotiations had to be conducted with creditors who insisted that preconditions be met.

Ultimately, though, the six cases were successfully reached and signed agreements were adhered to the terms. The actual hard bargaining was done by a dozen or so lead banks, often assisted by other banks. Also playing key roles were active participants, such as the World Bank. The negotiations were chosen from the least likely to succeed, lent money to the countries, the largest individual exporters were chosen on the basis of each of the major countries.

Interbank tensions. When they faced the negotiating position, they had been one of the more difficult negotiations, yet interbank discord, because of competitive business, a creditor might simply ignore a debtor's financial problems, develops, creditor banks, debtor country. They loans or reschedule problems, but only as they are decided by that of someone else. the guiding principle expected to participate proportion to its exposure, however, is no easy covered, and often be

whom had to be collected, information that was not always readily available. (One country, which had not kept its records particularly well, had to resort to sending out a questionnaire to its creditors to find out exactly how much it owed.) And in four of the six cases covered in the IMF paper, the negotiations had to be coordinated with parallel discussions with official creditors, who insisted that private and official debt be rescheduled on "comparable terms."

Ultimately, though, despite such obstacles, the negotiations in each of the six cases were successful — at least in the sense of an agreement being reached and signed. (Whether the debtor countries will actually be able to adhere to the terms of these agreements is, of course, a separate question.) The actual hard bargaining was done by a steering committee of a half-dozen or so lead banks on the one side and representatives of the debtor nation (often assisted by investment bankers acting as advisers) on the other. Also playing key roles in the talks, generally as advisers rather than as active participants, were officials of the IMF, and, to a lesser extent, the World Bank. The members of the steering committee were generally chosen from the lead managers and agent banks of the syndicates that had lent money to the country; usually, these banks were the ones with the largest individual exposures. Additionally, steering committee members were chosen on the basis of country representation, so that a bank from each of the major creditor countries was present.

Interbank tension. After the steering committee members were chosen, they faced the sometimes-daunting challenge of forging a common negotiating position for all of the creditor banks. Interbank politics have been one of the more important factors influencing the course of rescheduling negotiations, yet one of the less well understood. One reason for interbank discord, beyond the normal commercial rivalries of this intensely competitive business, has been the fear that debt relief advanced by one creditor might simply be used to pay off someone else, thus leaving the debtor's financial position unchanged. Once a debt-servicing problem develops, creditor banks naturally want to reduce their exposure in the debtor country. They may be willing to go along with efforts to float new loans or reschedule old ones to allow the country more time to work out its problems, but only as part of a joint effort of all the country's creditors. And they are decidedly unwilling to increase their own exposures only to reduce that of someone else. Thus the doctrine of "fair treatment" has emerged as the guiding principle of debt-restructuring negotiations: each bank is expected to participate in debt relief (either new funding or rescheduling) in proportion to its existing exposure. The enforcement of that doctrine, however, is no easy matter. Short-term trade financing is generally not covered, and often banks have sought to reduce their exposure by allowing

such credits to expire, thus exacerbating the debtor's foreign exchange shortage and debt-servicing difficulties.

Also contributing to interbank tension have been differences of opinion over the terms that should be offered to the debtor country, with some banks favoring a hardline approach while others adopt a more generous posture, in the belief that the debtor should be given more room to maneuver. In some cases, such divisions follow national lines, with U.S. banks favoring one position and German or French banks another, for example. At other times, however, banks divide up on the basis of size, with large banks adopting one posture and small banks another. Negotiating postures are often influenced by expectations of future business with the debtor country, with banks that hope to do a lot of business taking a more conciliatory attitude than those that do not. Negotiating positions are also influenced by the size of each bank's exposure, reflecting the old adage that a large enough debt turns a creditor into a partner. Further, bank negotiating positions are sometimes determined by the personnel that each chooses to send to the bargaining table with country lending officers — whose basic orientation is toward selling future loans — tending to take a softer line than, say, credit review officers.

A final source of interbank tension is the danger that one or more banks will break rank and strike a separate deal or will attempt to have the debtor nation declared in default and its external assets attached. Because of the cross-default clauses included in most loan syndications, even one such default declaration could set off a chain reaction of defaults, leading to a massive legal tie-up that could take years to unravel. Still, the probability of such a disaster should not be overestimated. Declaring default would only make sense if the initiating bank held deposits from the debtor country sufficient to cover its outstanding loans, but the deposits and other foreign assets of countries in debt service difficulty are generally only a small fraction of their total obligations. In addition, such a bank would be considered a pariah by its peers and could find its access to other international business reduced.

Country advisers. When Indonesia's state-owned oil company Pertamina ran into financial difficulty in 1975, the Indonesian central bank called in three investment banks to assist the troubled company work out its debts with its foreign creditors. The three — Kuhn Loeb of New York, S.G. Warburg of London, and Lazard Freres of Paris — later formed a consortium to provide financial advisory services to other developing countries; their clients have included Zaire, Turkey, Gabon, and Sri Lanka. Similarly, Morgan Grenfell has advised Sudan and Oman.³

In past reschedulings, these firms have assisted their clients by pulling together the data on how much they owed and to whom, by advising them

on the terms they might have greased the wheels. The bankers' role has drawn them to the side of the table. When reorganizing and consolidating in some cases, were in debtors' more unrealistic interposing themselves will inhibit the development of such situations. In addition, will attempt to duplicate clients, with the result concerned with preconditions the investment banker countries have every right to top-flight legal advice.

Relationship to Official

In four of the six cases negotiated a multilateral the Paris Club. In these cases, the principle of "comparable treatment" was not want to grant debtors particularly when the "country" had extended credit previously. Nonetheless, a country's reschedulings reveals a more generous. This primary interest charges at market below-market. However, schedule interest in arrears been signed. The bank conditions for lending, were not as usual" until the debt

Role of the IMF

In each of these six cases, provided technical support with information on the prospects; this was done in meetings between bank

on the terms they might reasonably expect from the banks and, in some cases, by actually negotiating on their behalf. But though such services have greased the wheels of the rescheduling process, the investment bankers' role has drawn a good deal of fire from the commercial bankers' side of the table. While applauding the investment firms' assistance in reorganizing and consolidating their clients' debt service accounts (which, in some cases, were in shocking states of disarray) and in toning down the debtors' more unrealistic demands, some commercial bankers fear that, by interposing themselves between debtor and creditor, the investment advisers will inhibit the development of the confidence and trust necessary in such situations. In addition, these bankers believe that the investment firms will attempt to duplicate the terms won for one country for all of their other clients, with the result that rescheduling will become less flexible, more concerned with precedent, more legalistic and more adversarial. Naturally, the investment bankers dispute these contentions, arguing that the debtor countries have every right to expert financial counsel, just as they have to top-flight legal advice.

Relationship to Official Rescheduling

In four of the six cases covered in the IMF study, the debtor nation also negotiated a multilateral rescheduling of official debt under the auspices of the Paris Club. In these cases, creditor governments insisted on the principle of "comparable treatment" of other creditors. Like the banks, they did not want to grant debt relief only to see it used to bail out someone else — particularly when the "someone else" was a private commercial bank that had extended credit presumably in full awareness of the risks of nonpayment. Nonetheless, a comparison of the terms of the private and official reschedulings reveals that the official creditors were somewhat more generous. This primarily reflects the fact that private loans carry variable interest charges at market levels, while rates on official loans are fixed and below-market. However, official creditors were also more willing to reschedule interest in arrears and resume lending once the agreement had been signed. The banks, by contrast, reflecting their quite different motivations for lending, were understandably more reluctant to return to "business as usual" until the debtor's creditworthiness markedly improved.

Role of the IMF

In each of these six cases, the staff of the International Monetary Fund provided technical support to the negotiations. The IMF provided the banks with information on the debtor nations' economic outlook and payment prospects; this was done in an informal manner, either by telephone or in meetings between bank officials and Fund personnel. The IMF also aided

the countries involved in preparing for their negotiations with the banks, particularly in those cases where the lack of reliable statistical data was an important problem. In four of the cases, IMF staff members sat in on discussions between the banks and the countries, and on one occasion, when talks were at an impasse, the IMF played a more active role by trying to mediate the dispute.

In each instance, the banks suggested that the debtor country negotiate an upper credit tranche program with the IMF. Such programs were important to the banks not so much for the hard currency provided but as signs that the countries had embarked on the road to recovery. In five out of the six cases, such a program was in place at the time the rescheduling agreement was signed, with the disbursement of new funds or the consolidation of existing obligations being made contingent upon the country's compliance with the terms of its IMF arrangement.

The flow of information between the IMF and the banks has not been strictly one-way, however, since the IMF needs to know the magnitude of expected private capital flows, including debt relief, in devising a realistic adjustment program for countries with payments problems. In some cases, the IMF has even offered its suggestions to the banks on what would be an appropriate amount of debt relief, in one case playing an "active role" (the words are from the IMF staff study) in assuring that the banks in fact provided the targeted level of assistance.

The reschedulings of Peru's and Nicaragua's debts illustrate both the importance and limits of the IMF's role. In 1976, before Peru had begun talks with the IMF, the banks agreed to a \$400 million balance of payments support loan conditional upon the government's compliance with its announced stabilization program. That program had been drawn up at the request of the banks and strongly resembled standard IMF orthodoxy, although the IMF was not involved in either its design or its execution. The banks soon found, however, that they were unable to monitor the program in the manner of the IMF; they had neither the expertise nor the standing to do so. Peru's performance quickly diverged from that promised by the program, and the banks were forced to cancel the second \$200 million installment of the loan. At that point, the IMF was called in.

The lack of IMF participation in the Nicaragua talks reflected the unusual political circumstances surrounding those negotiations, which help, in part, to explain the unusually favorable terms that resulted. The IMF had begun talks with the Somoza government on a stabilization program in 1978; the two sides reached agreement, in fact, only a few weeks before that regime fell in 1979. After their accession to power, the Sandinistas renounced the agreement and would have nothing further to do with the Fund, despite the devastated state of the Nicaraguan economy and its need

for foreign exchange. Nicaragua, however, only because of the deposits it received from other sources, the World Bank and Inter-American Development Bank, needed its foreign exchange coffers to meet its need for an IMF agreement with the banks. The moral and political pressure coupled with pressure to react in a "good offices" role normally played by sister institutions.

The absence of the IMF from the process need for a process flexible enough to meet the needs of its members. Unfortunately, the IMF and Nicaragua were unable to do so, and the mediaries have yet appeared.

Alternatives to the Present Process

Those who are concerned with the lack thereof often express the need for a institutionalized process, perhaps the most logical institutional mechanism for the pivotal role in balance of payments adjustment. Commercial bank rescheduling mechanisms, under an umbrella, several important obstacles. At least of these are the somewhat limited role of parties to rescheduling negotiations. As a collection agent for the commercial banks, their part, believe that the Fund is biased in favor of governments and is thus biased. In such an event, private creditors will probably have legal claims to a supranational institution.

Another possible institution that is suggested is the International Bank for Reconstruction and Development (pp. 33 through 35).

Whatever procedures for rescheduling simply evolve, it may be useful to have them originally extended by incorporating documentation. Such language would advance the conditions under which the talks should be conducted and how the talks should be conducted, usually associated with getting the

for foreign exchange. Nicaragua was able to succeed in shutting out the IMF, however, only because of the donations, soft loans, and central bank deposits it received from other governments and multilateral institutions — the World Bank and Inter-American Development Bank in particular. With its foreign exchange coffers replenished, Nicaragua was able to avoid the need for an IMF agreement and was in a stronger bargaining position with the banks. The moral and financial support it received, however, was coupled with pressure to reach a rescheduling agreement. In this way, the "good offices" role normally performed by the IMF was filled instead by its sister institutions.

The absence of the IMF from the Polish rescheduling underscores the need for a process flexible enough to handle situations involving non-IMF members. Unfortunately, the institutions that stepped into the breach in Nicaragua were unable to do the same in Poland, and no other intermediaries have yet appeared.

Alternatives to the Present Process

Those who are concerned over the adequacy of the present system (or lack thereof) often express their preference for a more formalized, institutionalized process, perhaps under IMF auspices. The Fund is probably the most logical institutional home for such a mechanism, in light of its pivotal role in balance of payment adjustment cases. However, if a commercial bank rescheduling mechanism were to be set up under the IMF umbrella, several important obstacles would have to be overcome. Not the least of these are the somewhat skeptical attitudes toward the IMF of both parties to rescheduling negotiations. Debtor countries may view the Fund as a collection agent for the commercial banks, while many bankers, for their part, believe that the Fund is ultimately answerable to its member governments and is thus biased toward the interests of the debtor. In any event, private creditors will probably be wary of surrendering any of their legal claims to a supranational arbitration body, however (and wherever) institutionalized.

Another possible institution that could aid in rescheduling negotiations is the suggested International Banking Consultative Group (described on pp. 33 through 35).

Whatever procedures for rescheduling are ultimately decided upon, or simply evolve, it may be useful to anticipate them at the time loans are originally extended by incorporating the appropriate clauses in the loan documentation. Such language would have the advantage of specifying in advance the conditions under which rescheduling would be appropriate and how the talks should be conducted, thereby reducing the costly delays usually associated with getting the negotiations underway. The other side of

such specificity, however, is the loss of the flexibility of the current process. In addition, such clauses would of course not be binding upon the parties to other loan syndications not including them; they might, therefore, be rendered inoperative if these other creditors did not agree to them.

Conclusion

Procedural reforms will not, of course, avert the difficult financial problems which lead to reschedulings. But the prospect of such problems underscores the importance of procedures intended to avoid their less desirable effects. The likelihood of continued large payments deficits and the possibility of debt service problems in major debtor countries suggest that rescheduling will be a recurring feature of the international financial system of the 1980s. If so, participants in that system may wish to alter the process of rescheduling so as to improve its probability of success, either by the proposals offered here or by some other, as yet unsuggested, reforms. Reforms of the rescheduling process should thus be a matter for active consideration.

¹ Occasionally, these governments met in the Hague or London; sometimes they styled themselves as OECD or IBRD consortia. Despite the variance in place and name, however, their basic structure and function was analogous to that of the Paris Club.

² Bahram Nowzad, Richard C. Williams, et al., "External Indebtedness of Developing Countries," Occasional Paper No. 3, International Monetary Fund, Washington, D.C., May 1981. This note draws heavily on information contained in the IMF study and two other recent papers (A Porzecanski, "The Assessment of Country Risk: Lessons from the Latin American Experience," in Garcia-Zamor and Sutin, eds., *Financing Development in Latin America* (NY: Praeger, 1980); and L. Brainard and T. Trebat, "The Role of Commercial Banks in Balance of Payment Crisis — The Cases of Peru and Poland," presented to the International Conference on Multinational Corporations in Latin America and Eastern Europe, March, 1981) as well as the case studies of Nicaragua and Turkey presented to the Study Group and recent material from the press and trade journals.

³ See Anthony Sampson, *The Money Lenders* (New York: Viking Press, 1982), pp. 218–220.

Trends in

The burgeoning publicized volume of publicized Eurocurrency individual institution dedicated Euroloan world's top Euroloan participants in considered the cha Bank data, Office examine these nor publicized Eurocurrency

Analysis of the average of 66 independent into the Eurocurrency 1980, nearly 400 independent. In the earlier years American banks and American, Middle East greater numbers. Few well-documented Eurocurrency lender institutions, Middle East market from less than total in 1980. However

Diane Page and Walter D. Office of the Comptroller Weiss made valuable contributions necessary computer program not necessarily represent

FORTUNE**BANKING/DAVID B. TINNIN**

THE WAR AMONG BRAZIL'S BANKERS

□ A quiet, unseen revolt has been roiling the American banking community. Regional banks, enraged over the treatment they've received in the Brazilian debt crisis, have refused to go along with a crucial part of the country's refinancing. The insurrection, largely unreported until now, has transformed relations between regional banks and their big money-center counterparts. It also helped scuttle the original Brazilian bailout.

Now the big banks and Brazil, with the help of the Federal Reserve and the International Monetary Fund, are scrambling to put together a new rescue plan. The stakes in the crisis are tremendous. The outcome will determine the financial fate of both Brazil and some of the largest and most influential U.S. banks. The conflict may also determine whether the present international lending system will continue to function.

Brazil, now the focal point of the global debt problem, for years was a darling of international investors; it grew and prospered on a carnival of credit until it became the world's largest borrower, with around \$90 billion in foreign debts. The borrowing was supportable so long as Brazil's economy continued to thrive. But the worldwide recession and falling commodity

RESEARCH ASSOCIATE *Sarah Bartlett*

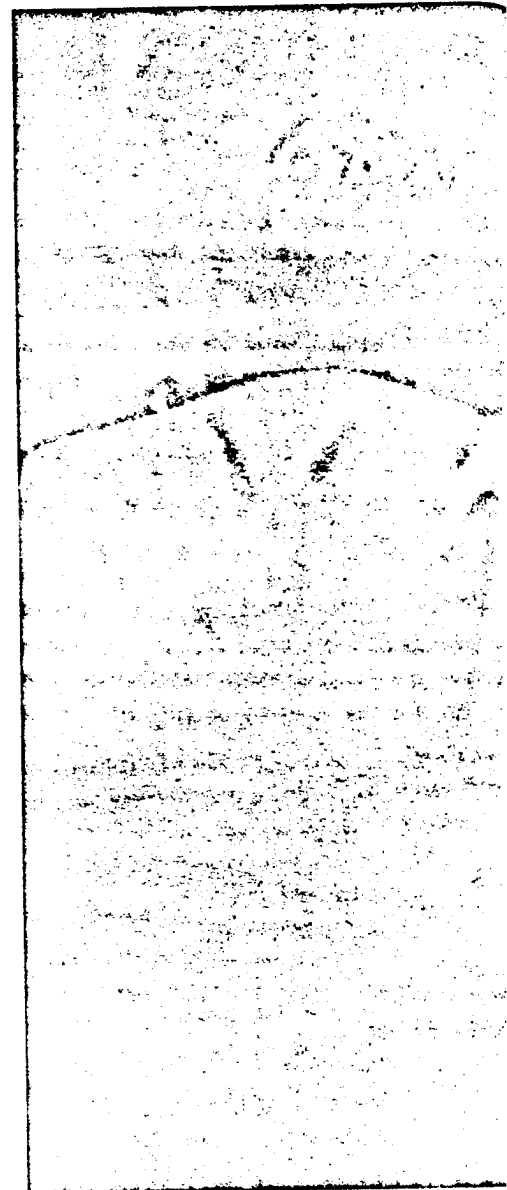
prices clobbered its export earnings just as interest rates were climbing to all-time highs. Debt-service payments rose to such proportions that they consumed the country's entire export revenues last year, leaving nothing with which to buy imports. Brazil became dependent on infusions of new loans just to keep its economy running.

When international lenders began cutting back on loans to Latin America in the wake of the Mexican crisis last summer, Brazil was caught in an unbearable squeeze. It turned in desperation to the big American banks and the IMF last fall. The IMF agreed to make emergency loans on the condition that Brazil adopt a tough austerity program, and the big banks arranged a complicated package of new loans and stretch-outs of existing ones.

The bank package began coming apart almost at once as regional banks

and many foreign banks refused to put up their assigned shares of the new money. The big U.S. banks were compelled belatedly to admit that sorry fact in June after the IMF ruled that Brazil wasn't complying with some provisions of the austerity program and refused to advance any more funds. The IMF is negotiating a new austerity program with Brazil, while the big banks face the equally knotty problem of cajoling the newly militant regionals back into line.

THE BIG BANKS on one side of the battle over Brazil are nine of the largest in the U.S. Six are New Yorkers: Citibank, Chase Manhattan, Chemical Bank, Bankers Trust, Morgan Guaranty, and Manufacturers Hanover. Two are Chicagoans—First Chicago and Continental Illinois—and the



ninth is Bank of America in San Francisco. The rebels in this Wall Street vs. Main Street affair include several hundred smaller banks generally classed as regionals. Many of the principal regionals, however, are notable names in their own right—Wells Fargo, Bank of New York, National Bank of Detroit, Philadelphia National Bank.

U.S. banks have never marched in lockstep, and deregulation and the growth of interstate banking have greatly intensified competition between the big banks and the regionals.

a high degree of shared interest and cooperation has persisted, especially in foreign lending. Lacking large staffs abroad, the regionals relied heavily on the advice of their big brothers. As petrodollars flooded into the money markets in the 1970s, the big banks became leaders in organizing syndicated loans to for-

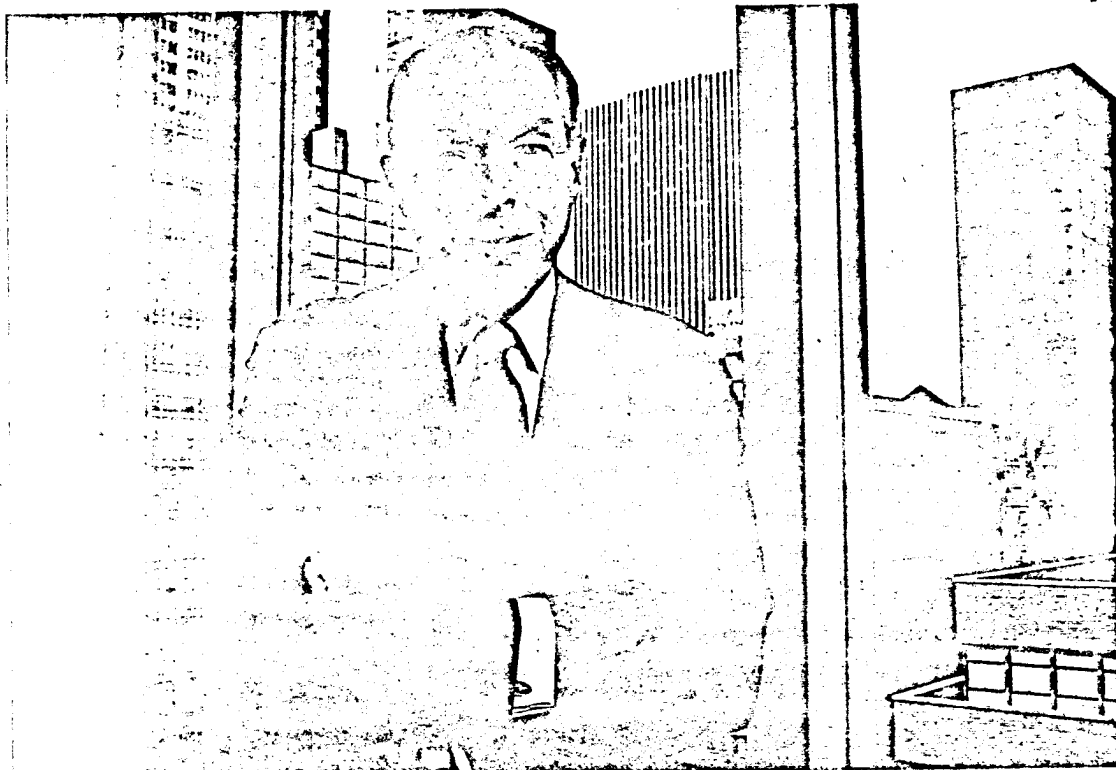
ments and corporations. Since lending overseas was far more profitable than at home, the regionals strove to be on good terms with the big banks so they would be invited to buy portions of the lucrative loan packages.

But as foreign loans have turned riskier and less rewarding, the two sets of banks have been driven apart by divergent interests. One important source of friction is investment strategy. The money-center giants have done most of their foreign lending to "sovereign borrowers," bankers' jargon for governments and public sector enterprises. Typically most of a money-center bank's Brazilian portfolio is invested in relatively long-term loans—eight years or so—that are backed by the government. Regional banks, on the other hand, usually make most of their loans to the private sec-

financing and short-term loans that are more liquid and less risky than long-term commitments.

Yet the most profound difference between the money-center banks and the regionals is the size of their loans. The money-center banks' loans to Brazil are so mind-bogglingly large that those banks simply can't opt out; they have to keep on lending. Keefe Bruyette & Woods, a securities firm that specializes in bank stocks, calculates that the nine big banks have loaned more than \$16.6 billion to Brazil, a sum that collectively represents about 57% of their entire capital base. Some bankers try to play down the importance of capital as a measure of a bank's strength. But if a bank suffered widespread loan defaults, its ability to weather the storm would depend chiefly on how comfortably its capital

After a showdown meeting in New York, Morgan Guaranty's Antonio Gebauer (center) fields questions from regional bankers still chafing over his handling of the Brazilian bailout.



Citibank's Walter Wriston frequently reminds people who worry about Third-World borrowers that his bank has lost far less on loans abroad than it has lending to deadbeats at home.

exceeded the losses. Chase Manhattan has \$2.7 billion loaned to Brazil, a sum that represents 73% of its capital base; Manufacturers Hanover's \$2-billion of loans equal 68% of its capital.

All exposures pale in comparison to that of America's largest bank. Citibank has built up a portfolio that now amounts to \$4.6 billion loaned from the U.S. corporation, plus another \$1 billion from Brazilian branches. The \$4.6 billion from the U.S. equals 83% of Citibank's capital. Brazil is not only Citibank's largest operation outside the U.S., but also has been its most profitable by far. Last year Brazil accounted for \$287 million of Citibank's pretax earnings, or 22% of the bank's total profit.

In a worst-case scenario—if Brazil repudiated its external debts and nationalized foreign assets in the country—Citibank's global capital would be almost entirely wiped out. That, however, is an extremely unlikely occurrence. The Fed and other central banks undoubtedly would undertake a rescue operation long before the bank's survival was threatened.

The greater risk is that Brazil might be forced into a temporary default—an event that would leave Citibank and other big lenders alive but severely crippled. A moratorium on interest payments, for instance, could wipe out about half Citibank's pretax income. If it had to set up a special loss reserve

of, say, 10% of its Brazilian loans, the sum—over \$400 million—would take out most of the remaining earnings.

The regional banks are not nearly so deeply into Brazil. Few of these banks have more than 20% of their capital base invested in Brazilian loans. Exhortations from Citibank Chairman Walter Wriston and others to keep on lending strike many regional bankers as self-serving. Says a senior vice president at one large regional, "My question to the big banks is: You've bailed them out, but why should we bail you out?"

In some cases, however, the regionals are blaming the big banks for their own imprudence. In the go-go days of the Seventies, many of the regionals rushed into high-profit international loan syndications with nary a thought about the risks. "We were greedy little pigs," says Michael Rossi, a senior vice president at Wells Fargo. "Now we're going to slaughter."

Brazil dispatched a scouting team to New York last October to sound out bankers on how to save itself. The team was led by Carlos Geraldo Langoni, 38, an economist who did postgraduate work at the University of Chicago and who has been president of Brazil's central bank since 1980. Langoni turned for advice to Citibank and Morgan Guaranty. The message from both banks was the same: Brazil must slow its pace of new borrowing, make

convincing progress toward reducing inflation and government spending, and above all seek the help of the IMF in establishing a program of economic discipline.

Just before Christmas, Langoni returned to New York with an IMF-approved plan in hand. In a meeting with bankers in Manhattan's Plaza hotel, he spelled out the details of a four-part package. Project One, as the bankers and Brazilians call it, involved a new \$4.4-billion eight-year loan. The Brazilians tapped Morgan Guaranty to lead that financing. Project Two called for the rescheduling of \$4 billion in loans that would otherwise come due this year. Citibank was asked to manage the rescheduling.

PROJECT THREE was intended to preserve sufficient lines of trade financing for Brazilian exports. This was essential under the IMF plan, which set an extremely ambitious target of a \$6-billion trade surplus this year vs. a surplus of only \$800 million in 1982. Chase Manhattan, the second most active bank in Brazil, was given the task of rounding up \$9 billion in standby trade credits.

Project Four entailed strengthening the access of Brazilian banks to the so-called interbank market. That is the market outside the U.S. in which banks deposit excess dollars in other banks that temporarily need extra liquidity. Interbank deposits—actually overnight and short-term loans from one bank to another—are vital to the smooth functioning of the world financial system.

Interbank loans were especially vital to Brazil. In structuring the rescue package, it insisted on holding the "jumbo" loan of new money—Project One—below the \$5 billion that Mexico had required. But Brazil needed at least that much or even more. Without announcing their intentions, the Brazilians were counting on interbank loans to make up the difference between the \$4.4 billion in Project One and the amount really needed to keep the economy going. Bankers Trust, the clearing agent for Brazil's largest commercial bank, Banco do Brasil, was assigned the mission of arranging \$10 billion of interbank credit lines for Brazilian banks with hundreds of European, Arab, Japanese, and U.S. banks.

Brazil chose Citibank and Morgan

aranty as co-chairmen of the overall rescue operation. But from the start Citibank sought an uncharacteristically low profile, entirely out of keeping with its usually aggressive stance. Behind a well-kept wall of corporate silence, Citibank was engaged in a paralyzing struggle over who called the shots on Brazil. Gerard Finneran, who was tapped as Citibank's representative in dealings with Brazil, is a senior vice president in the merchant banking operation. His single-minded emphasis on making the rescue work collided with the caution of James Farley, Citibank's executive vice president for Latin America. Farley has the responsibility for holding new commitments to any single country in his area within closely defined lending limits. He was supported by Senior Vice President Jack Guenther, who advises top management on country risks.

In the vacuum left by Citibank's inaction, Morgan's man shot into overnight prominence and controversy within the lending group. He is Annio Gebauer, 43, the senior vice president for Latin America. The son of German immigrants who settled in Venezuela, Gebauer came to the U.S. in the late 1950s, got his bachelor's and MBA degrees at Columbia, and then joined Morgan. He built his career in part by developing close connections with the powers that be in Brazil. He was married to a Brazilian for a time, and still entertains Brazilian officials and executives at his spacious East Hampton estate, named Samambaia (Portuguese for fern). To a casual

acquaintance, Gebauer exudes charm and wit. But rivals within the banking fraternity charge that he is imperious and willful, and say a resemblance to Napoleon is more than physical.

The rescue went extremely well at first. Morgan and Citibank completed Projects One and Two in only two months. One reason the deals went so smoothly is that only big lenders were asked to put up new money or roll over existing loans. "We thought that the little boys would stay in the game for short-term money," says Gebauer. "That's where we made our mistake."

THE LITTLE BOYS gladly stayed in Project Three, which was quickly oversubscribed by \$1 billion. But the regionals refused to follow the lead of the big banks in Project Four, the interbank credits. "We were voting with our feet," says one regional banker. How the voting went is charted below. The regional banks, especially National Bank of Detroit and Bank of New York, have slashed their interbank credit lines far below the "fair shares" assigned by Brazil and the U.S. money-center banks.

Although the regionals accounted for no more than about 20% of the interbank credit available to Brazil in mid-1982, it turned out that they represented a crucial margin. As the regionals and foreign banks cut back on their interbank lending, money-center banks tried to fill the void by contributing more than their assigned shares. But the total fell \$1.5 billion short of

what Brazil needed, even though the target level for interbank credit was scaled back from \$10 billion to only \$7.5 billion. Interbank loans to Brazilian banks dropped from \$9 billion in mid-1982 to only \$6 billion or slightly less throughout most of this year.

Nearly all of those retreats from the interbank market had occurred by last December, when the money-center banks and the Brazilians began to put the rescue package together. Yet, incredibly, neither the Brazilian officials nor the money-center banks were aware of the extent of the outflow, even though the interbank loans played such a pivotal role in the re-financing plans.

Once they realized what had happened, getting the regional banks to replace the funds they had withdrawn quickly became Brazil's and the big banks' first priority. The method selected was peer pressure, a tactic that managed only to offend the regional banks and badly damage the tradition of bank confidentiality. In January, in an effort to shame offenders into paying up, Bankers Trust sent out a massive—but outdated and incomplete—list of the positions of the banks in the interbank market. Copies of the computer printout went by courier to all the 700-odd participating banks in the U.S. and overseas. U.S. bankers could hardly believe their eyes. Says one banker, "The first thing I did was look at my nearest competitor's position, but since the figures were wrong about me, I couldn't be sure they were right about him."

The Little Do Less

U.S. regional banks refused to maintain their short-term loans to Brazilian banks at the "fair shares" demanded of them in the rescue plan. In an effort to salvage the salvage operation, big U.S. banks pumped in more money. The banks whose loans are charted are the four largest U.S. interbank lenders to Brazil and four of the least accommodating among the large regionals. Regional banks dispute the actual loan figures, which were calculated by Bankers Trust, as well as the "fair shares."

continued

BIG BANKS

Interbank loans
to Brazil
in millions

\$200

\$150

\$100

\$ 50

Manufacturers
Hanover
Trust

Citibank

Morgan
Guaranty

Bankers
Trust

Actual loans as of May 17

SMALLER BANKS

"Fair shares"

Bank of
New York

National
Bank of

Wells
Fargo

First
Interstate
Bancorp

Every week until mid-May Bankers Trust sent out an update of the list showing every bank's compliance or noncompliance with the "fair shares." Langoni and the big banks, meanwhile, sent imperious telexes telling banks when and where to deposit loans they "owed" to Brazil under other parts of the bailout package.

Gebauer struggled manfully to save the foundering Project Four, but his efforts weren't always appreciated. Some of his fellow big bankers criticized him for ignoring their advice about how to handle the problem. "Tony can be very abrasive," says one. To the regionals Gebauer came to represent the archetypal New York banker—aloof, domineering, and all-knowing. Gebauer says he privately sympathized with the regionals, but felt that everyone had to do his part to hold the package together.

The incessant dunning served only to galvanize resistance among the re-

gionals. They had plenty of good reasons to hold firm. For one thing, their directors had become increasingly alarmed about foreign loans. Called before their boards for the first time in years, foreign-lending officers scored what few points they could by reducing their interbank lines. "How do I justify going back to a position that I had explained was an overexposure six months ago?" asks one Georgia banker. "How could I explain to my board that we were giving up everything that we had gained by being clever and foresightful?"

THE REGIONALS also feared that the Brazilians might refuse to repay the interbank loans, forcibly transmuting the regionals' short-term money into long-term loans. Says one East Coast regional banker: "I simply will not tolerate some whippersnapper of an assistant V.P. at a money-center

bank determining what our portfolio is going to look like."

Relations between the big banks and smaller ones frayed. When a money-center bank vice president telephoned the chief of the international division at a major Southeast regional in February to remind him he was under "fair share" on Project Four, the Southerner retorted that he felt the big banks "had done a piss-poor job" in putting together the Brazilian package and that they obviously had been taken. "I knew you were going to say that!" exploded the New York banker, who heatedly recounted all the problems the money-center banks had had to consider. The regional banker was unmoved. His rejoinder: "Down South here, we have a saying, 'A bit dog yelps,' and friend, I hear you yelping."

Poor communications simply added to the trouble. No regional banks were included in the advisory groups that counseled the lead banks, an omission

"BRAZIL WILL EMERGE A STRONGER COUNTRY"

Carlos Geraldo Langoni, president of Brazil's central bank, jetted into New York in mid-June for talks with major U.S. lenders. Between breakfast at Citibank and a meeting at Morgan Guaranty about the latest revisions in his country's rescue plan, Langoni took time out for an interview with FORTUNE's David Tinnin and Sarah Bartlett. Excerpts:

On the IMF's refusal to extend more credit to Brazil until certain economic goals are met: I'm sure Brazil will have the green light from the IMF very soon. The funny thing is, the most difficult target now looks more than feasible. I'm talking about the \$6-billion trade surplus [that Brazil is required to achieve] for 1983. The IMF is even saying it will be above \$6 billion. Anyway, you should not judge the Brazilian program just on the first quarter of the year. We didn't have time to put in place the instruments to reach certain targets. There have been deviations, especially in government spending and inflation. But we have just announced very important new measures: the elimination of subsidized credit for agriculture, further cuts in public expenditures, and new restrictions on bank lending to the public sector.

On the expansion of the number of banks in the committee monitoring and advising Brazil: We need a broader base and better geographic distribution. In addition to the large group of 43 banks, we will have a smaller group of 14 that will serve as an inner



Brazilian central banker Langoni

council. The smaller group will discuss strategy and the larger group will implement that strategy. This time there will be only one chairman, and it's natural to have Citibank, since it has the largest exposure in Brazil.

On Brazilian awareness of the importance of the American regional banks: We realize that the regionals were not getting direct access to information about the situation in our country. We have been trying these last three months to visit them. I've been to the West Coast and Chicago, and soon I will be going to the Midwest and Dallas. We have to give them the feeling of participation.

On plans to combat inflation and dismantle Brazil's pervasive system of indexation: There's a consensus in the country now that we need to break down that automatic relationship between past and future inflation. There is also a very interesting discussion taking place on how to reduce indexation. We know we cannot live with 120% inflation. With

a substantial cut in public spending and a political decision on wage law, we may have important changes in inflationary expectations.

On the prospects for lessened reliance on foreign borrowing: Brazil will emerge a stronger country coming out of this financial crisis. If you look ahead at which developing country will be less dependent on foreign borrowing, I think Brazil has a much better chance of succeeding than others.

at Gebauer now admits was a major error. Word of decisions made in New York went out so slowly that regional-bank officers often learned about them in the press. "The New York bankers keep saying that it takes time to get to us," declares James Nelson, the president of Washington National Bank in Washington, D.C. "But we remember that they could get to us quickly enough when they had a deal they wanted us to participate in."

AS THEIR FRUSTRATION level rose, many regional bankers began pressing for a showdown with the big boys. It finally came in early June at the Grand Hyatt Hotel in New York City. The proceedings were far more cordial than any of the participants expected, but the regional bankers didn't get what they wanted from Gebauer and Finneran of Citibank. "They were still playing hardball and trying to load all the guilt on us for the failure of a misconceived project," remarks one regional banker.

Meanwhile, unbeknownst to the regional bankers, other events were in train that in effect handed them their victory. On May 31 Fed Chairman Paul Volcker met at the Federal Reserve Bank of New York with the chairmen of five money-center banks and the chief of Chase Manhattan's international division. Volcker told them that the Fed and the Bank of England were worried that the problems with Brazil threatened the entire interbank market. The Brazilians were running out of cash, and there was talk that they might freeze the interbank funds in their possession—an act that could shake faith the world over in the safety of interbank deposits. Volcker asked the money-center bankers to solve the Brazilian problem, quick.

Wriston and Lewis Preston, the chairman of Morgan Guaranty, got together to hammer out a new plan. According to one insider, Preston urged Wriston to have Citibank take over as sole chairman of a newly constituted committee of banks to monitor and advise Brazil. Wriston agreed. He also quickly resolved the internal struggle at Citibank by benching all the players and naming a new captain—William Rhodes, 47, a senior vice president who earned wide respect for his handling of the Mexican rescue last year.

On June 10 a tele: Approved For Release 2008/01/23 : CIA-RDP97R00694R000200870001-3



clattered into the major money-center banks announcing the Wriston-Preston plan for a new advisory committee, though without credit to the authors. Now that Rhodes is chairman of the bank group, Gebauer has stepped down to become one of two deputy chairmen, along with Guy Huntrods of Britain's Lloyds Bank. The number of banks on the coordinating committee has been expanded from 18 to 43, including the first two regionals, Wells Fargo and Crocker National. In addition to the committee of 43 there will be a smaller advisory committee made up of 14 banks. Republic Bank of Dallas was asked to join the smaller committee as the regional-bank representative. It refused, saying it couldn't spare an executive to attend all the upcoming meetings.

Rhodes plans to set up yet another committee, under the leadership of Manufacturers Hanover, to keep the regionals informed. He used a similar committee for liaison with the regionals during the Mexican bailout. "We need a better flow of information both ways," he says.

The obvious danger in the new setup is that the committees are so large they'll be unable to come to any decisions, much less take prompt and unified action. But at least one obstacle is gone: Project Four has been consigned to the scrap heap. Instead of trying to

the new committee will try to lure the regionals into either establishing direct lines of credit or participating in syndicated one- or two-year term loans to Brazil's central bank.

Brazil has by no means solved its financial problems. The IMF has yet to reinstate its loan to the country, and the banks dare not commit new funds until it does, for fear of undercutting the IMF's authority. Meanwhile Brazil has fallen about \$1 billion in arrears on trade obligations and interest payments, and slips further behind each day. The country will need another \$3.5 billion this year and yet another jumbo loan of \$4 billion or so next year. Persuading the regional banks to take a piece of the action will be tough. One regional banker, echoing many others, says of the new plan: "That's no jumbo, that's a dumbbo."

■ The Brazilian episode has taught some hard lessons to the big money-center banks—the principal one being that they can't rely on their regional partners to follow blithely into the abyss when a borrower comes on hard times. A syndicated loan is much like a joint venture in any business. As the revolt of the regionals illustrates, partners will always—and quite rightly—put their own interests first. As the big banks have found, partners who overlook that fact do so at their

The top banker in Wells Fargo's international division, Lewis Coleman (left), and Michael Rossi, head of Latin American lending, blame Brazil and the big banks for the failure of the first refinancing plan. They complain of strong-arm tactics used against smaller banks and poor communications.

While the bankers are worrying about repayments on their Latin American loans, the fact is that a surprising amount of all of the billions of dollars they have lent was wisely invested.

South American debt— now look at the assets

FROM THE POSH boutiques of Buenos Aires to the earsplitting traffic jams of Caracas and the crowded beaches of Rio de Janeiro, the question is always the same: How will the foreign bank debt be dealt with?

Practically every Latin economy lies in ruins in the wake of a great tidal wave of foreign capital, far larger in constant dollars than the fabled Marshall Plan. Foreign banks, chiefly American, urged dollars upon the South American continent, raising its external debt from \$27 billion at the beginning of the Seventies to \$300 billion by 1982. Over two-thirds of that \$300 billion came from commercial banks, bulging with a sudden flood of petrodollars pouring into an already enormous Eurodollar overhang. Where to lend it? South America was the obvious answer. It had relatively advanced economies and a thirst for capital.

The South Americans could scarcely believe it: "For years we had been begging for money," says a South American newspaper editor, "and for years you had been promising it to us. But it never came in the amounts we needed. Not under the Point Four Program, not under the Alliance for Progress, not under AID. And then, suddenly, there it was... cheap—all the money we'd been asking for. We might not have known what to do with it all. But we sure took it. It was a chance that might never come again."

The damage done by that sudden infusion of billions and billions of dollars has shaken the world's financial system. First, last autumn came the news that Mexico could not meet the interest payments on its \$80 billion debt. It did not take long to see that the rest of the Latin American "exposure" was in the same boat. For the nine largest U.S. banks, loans amounting to well over 100% of their equity had turned bad.

Too late the bankers realized they had made two critical mistakes: First, they had offered

By Geoffrey Smith

term loans than they were used to. Second, they had priced those loans at low but variable rates. The variable feature was there to protect the banks, but it proved a trap for the Latin Americans once the U.S. decided in earnest to fight inflation. By 1979 a worsening global recession triggered by anti-inflationary monetary policies had driven interest rates up and commodity prices down. The interest cost of existing debt tripled, and, because of the unprecedented rise in oil prices, the revenue from hard-currency-earning exports was cut in half. It was bankruptcy, but neither the Latin Americans nor the banks could face it.

In prior years such foreign debt problems had often been solved by simply changing Ministers of Finance. As Paulo Rabello de Castro of the renowned Getulio Vargas Foundation in Rio put it, with more than a little irony: "When the foreign banks had no confidence in us, we changed the government, put in people who spoke good English and had earnest faces, and pretty soon everything was all right again." But this time that simple ploy won't be enough.

Today, neither Brazil nor Argentina is able to pay the interest on its huge debt, which is \$83 billion in Brazil and \$39 billion in Argentina. Both are faced with runaway inflation (well over 100% annually) and desperately struggling to reschedule their external debt. Even oil-rich Venezuela was forced recently to request a rescheduling of its \$12 billion foreign borrowings. The reason is obvious: "If our monetary reserves continue declining as rapidly as they have been recently," says Venezuelan economist Pedro Palma, "we'll deplete our reserves in just five months."

Why rich Venezuela? Explains Palma: "Actually, our main problem at the moment is that the percentage of short-term debt in our foreign borrowings is higher than that of the others in the big four debtor nations: Brazil, Mexico and Argentina." To appreciate how bad Venezuela's plight is, consider the fact that nearly one-third of



Oris de Roa of Argentina
"Perhaps 80% of
Brazil's borrowings are
in fixed investment.
But only 30% of

"For years we had been begging for money. And for years you had been promising it to us. But it never came in the amounts we needed. And then suddenly there it was . . . cheap. We might not have known what to do with it. But it was a chance that might never come again."

that it comes due this year. There is no way to pay it. The threat of outright repudiation of debt, given the upcoming national elections in Brazil, Argentina and Venezuela, is real. Topic number one at the Williamsburg, Va. economic summit conference of the U.S., Britain, Canada, France, Italy, West Germany and Japan last month was the international debt crisis, of which the Latin loans are the core.

Even politically cynical South American businessmen are deeply pessimistic. "I honestly think the situation is hopeless this time," an Argentine businessman says quietly. "This is the worst economic crisis I've ever witnessed in Brazil, and this time I don't see any way out," says I. Hersz Kahane, who came to Brazil from his native Poland 30 years ago and founded what is now Metalurgica Emesa, a \$50 million (sales) diversified trading company. Kahane, a trained economist, has a better perspective on the question than most. Says Kahane's young finance vice president, Emilio Figer: "It doesn't help too much to say today, 'You see, Brazil, you wasted \$10 billion on those nuclear plants or I don't know what.' Okay, we wasted it. Let's try not to waste it again."

Wasted it? That's the quick answer. It might not be right. Given patience, given optimism, the story may yet turn out to be far from hopeless. Was the \$16 billion Itaipu dam, the largest in the world, a waste just because Brazil will not immediately need all the nearly 13 million kilowatts it will generate in five years' time? When they are needed, those kilowatts will cost less than most Brazilian power. "Suppose 20% to 25% of our investments were completely crazy, megalomaniacal," says Brazilian economist Paulo Rabello de Castro. "The other 75% to 80% were good enough. Some of our seemingly megalomaniacal investments may be eaten up very fast, given a good global economic recovery—faster than one might imagine." North Americans would do well to remember how many of their now priceless railroad assets were once bankrupt and redundant.

Many Argentines sing the same refrain: "I don't think we spent funds in a bad way here," says Federico Carles of Carles y Cia, a medium-size, old-line financial institution in Buenos Aires. "Of the \$39 billion in foreign debt that we now carry, some \$22 billion was spent by the public sector on things like highways and dams. Aerolineas Argentinas bought new jumbo jets. Our railroads spent a substantial amount renewing

equipment. Our port authorities bought new equipment to handle crops that have increased dramatically in size in recent years." He adds, with less conviction: "And something on the order of \$5 billion was poured into the re-equipping of our armed forces."

There is no question that, unlike in Brazil, a substantial portion of Argentina's sharply increased foreign borrowings were consumed, not invested, including that questionable spending on the military. "I would say that, whereas perhaps 80% of Brazil's foreign borrowings remains in the country as fixed investment, only about 30% of Argentina's does," says Carlos Oris de Roa, the Argentine head of Continental Grain's \$400 million (sales) South American operations. What happened to the rest? Some was consumed by the Argentine middle class, taking advantage of their overvalued pesos to snap up appliances and Sony Walkmans across the border in Brazil. Much more was used as working capital by Argentine companies under severe pressure from cheap imports and harassed by the government's austerity program. But even in Argentina there was investment, and there might have been more but for constant government efforts to manipulate the economy.

An Argentine garmentmaker sits tanned and trim beside his backyard pool in the elegant San Isidro suburb of Buenos Aires. "When Martinez de Hoz took over as Minister of the Economy in 1977, he told us we were going to mount a huge export drive," he says with a sneer. "So I invested heavily in the latest knitting machinery in order to be able to export to the U.S. Then what does Martinez de Hoz do? This former industrialist? He overvalues the peso in order to reduce inflation in our once closed economy through competition from cheap imports. How can I export with an overvalued peso?" the garmentmaker asks. "I closed my factory. I put the new machines in mothballs. And I imported from Hong Kong and resold to the U.S." Yet today the peso is so cheap relative to the dollar that the garment producer's new knitting machines are running practically around the clock, producing for the U.S. market.

Waste? Venezuelan economist Pedro Palma can tell you where most of his country's money was spent: "When the oil industry was nationalized in Venezuela in 1976, we realized we would have to invest a lot of money in exploration, offshore and in the tar sands of the Orinoco Faja belt. We have

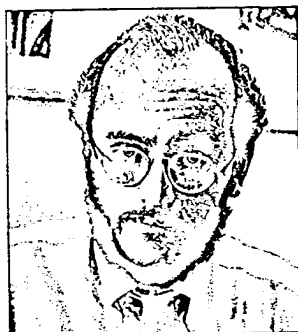


Kahane of Brazil
"This is the worst economic crisis I've ever witnessed in Brazil, and this time I don't see a way out."

"Suppose 20% to 25% of our investments were crazy, megalomaniacal. The other 75% to 80% were good enough. Some of our seemingly megalomaniacal investments may be eaten up very fast, given economic recovery—faster than one might imagine!"



Gouvea de Bulhões of Brazil
"Now the bankers are worried! The time for them to have worried was when they were handing out loans in the first place."



Duran of Brazil
"From 1974 to 1979 Brazil followed a dangerous strategy: to make the economy grow at a very high rate by using foreign debt."

spent the money correctly, and our explorations have been successful—particularly with offshore gas. But all this is very expensive. At the same time we tried to do too much too fast in other areas of the economy. During the oil boom years we decided to quintuple the capacity of our steel industry and the same in petrochemicals, but we didn't have the infrastructure to support that. If you went to the port of La Guaira in those days, you could see maybe 50 or 60 ships at anchor just waiting to be loaded." Such bottlenecks inevitably raised the cost of capital expansion and helped prove its undoing.

The bottlenecks were chiefly caused by time pressures. Here the banks are partly to blame. They acted like Santa Claus. And who can resist the old fellow? Brazilian economist Tulio Arvelo Duran of FUNCEX, a think tank in Rio that specializes in the study of export trade, explains, "From 1974 to 1979 Brazil followed a dangerous strategy: to make the economy grow at a very high rate by using foreign debt. So while everyone else was going crazy with the oil crisis, Brazil achieved a real growth rate of 7% a year."

It would have been a shrewd strategy, had it not been for Paul Volcker at the Federal Reserve Bank. Who dreamed the U.S. would push an anti-inflation policy so hard? The Brazilian strategy was based on interest rates that were essentially negative, but under Volcker the rates turned highly positive. "When the interest rate went from 7% to 20%, the cost of our debt service went from \$3 billion to \$9 billion because we had borrowed on escalating rates like everyone else," says Brazil's Duran.

Argentina made somewhat worse mistakes, springing in part from its Peronist heritage. Federico Carles explains: "In Argentina today, state participation in the economy is nearly 50%, according to our best estimates. We are a socialist country without even knowing it. In such a system you cannot be strict on the private sector, which you can control through monetary policy, and then not also be strict with the state-owned sector—allowing state-run companies to run huge deficits, borrowing money in the open market, competing with the private sector and thus driving up the interest rates." Once an economy becomes highly politicized—state-owned—it becomes increasingly less responsive to market forces.

But there were other mistakes that resulted from mismanagement and corruption

and too easy money. Carles: "We went through a period when the Banco Central didn't investigate too deeply the morals or abilities of people who were trying to get into the financial market. So, more new banks were authorized from 1977 on than probably was wise. This resulted in a lot of bankruptcies and very nearly caused a serious financial panic because these people were not bankers. They were lending the funds mostly to their own companies, or using the funds of the public to create new businesses, all of which forced Banco Central to intervene and liquidate some of them."

All this is ancient history to the bankers. It's the repayment of loans that worries them. The bankers get little sympathy from men like Octavio Gouvea de Bulhões, acknowledged father of the erstwhile "Brazilian miracle" and still president of Rio's Getulio Vargas Foundation. "Now they're worried," he says contemptuously. "The time for them to have been worried was when they were handing out those loans in the first place."

But postmortems are not enough. Today the question is: What is to be done now? How can Brazil possibly cope with its \$83 billion external debt when half of its export earnings are eaten up by its oil bill and inflation is running over 100% a year? "If inflation continues at 100%, I am sure we will have a crisis," Bulhões replies. "But if we eliminate inflation, and if the world economy improves, then I am sure that there will be no crisis at all, and that in two or three years' time we will have an economy that will vindicate all those who invested in Brazil."

Bulhões recommends an immediate end to Brazil's elaborate system of government subsidies, which now account for perhaps 40% of the government budget. But most doubt that this is politically feasible. Like the leaders of many other developing nations, they are pinning their hopes on a major export drive.

What worries U.S. bankers every bit as much are things like the upcoming Argentine elections, scheduled for Oct. 30. Seasoned Buenos Aires newspaper editors predict "an emotional period" of six years or so, under either the front-running Peronist party or the Radical party. Might this not mean repudiation, not just by Argentina but by a cartel of debtor nations?

Hardly, says the Argentine right wing: "We either abide by what is expected of us by the creditors, or we have to repudiate the

"The one thing you might criticize in Brazilian strategy was that we were trying to do too many things at the same time without realizing that liquidity could change in the financial markets as it did."

debt, jump the fence and go to somebody else," says Carles coolly. Here the "somebody else" is code for Soviet Russia. "If we repudiate the debt, all our lines of credit would be cut off, and our imports along with them. Somebody else? They don't have the economic power to provide what Argentina needs today. So it would be ridiculous. Besides, there is no political party in Argentina that is communist-oriented. The worst I can imagine is a Mitterrand situation: poor handling of the economy, a messy situation of trying to give everyone what everyone asks for.

"You know," Carles continues, with a sly smile, "I would be afraid if we did not have all that external debt. Because then there would be a margin for making mistakes without the threat of incurring immediate consequences that would be felt by large sectors of the country. What the International Monetary Fund has required of Argentina is not too strict. It is much more lenient than it was 20 years ago. It knows the country cannot bear a very severe recession and, therefore, it is likely to be flexible if we cannot meet the objectives." In this context Argentina's foreign debt can be seen as a needed brake on any excesses that "emotional" populist regimes might otherwise attempt.

"If Argentina had proper monetary and fiscal policies, everything else would be easy to solve," says newspaper editor Roberto Alemann, the widely admired minister of the economy under the military Galtieri regime just prior to the Falklands War. "Of course, you have to have a president who is prepared to endure all the screaming by vested interests. My approach was to reduce the deficit in the budget, control foreign exchange reserves and control money creation by the Central Bank. Only when you have control of the three sources of money creation can you think of building a stable economy. I brought inflation, as measured by the consumer price index, down from 12% a month in January to 3% a month in May. People learn very quickly to live with it. Of course, many debtors were furious with me. They wanted money from me, in the form of trade credits and subsidies, every hour of the day. The labor unions were against my program; so were the businessmen and the politicians. I knew that. I just didn't listen to them. I just said, 'No, my deficit is this, and I'm not going to change it.' If I had been allowed to stay in office without a war, I would have made it. Just by not giving in to the demands for fresh money. That's all. You should do the same thing in the U.S."

Easier said than done, of course, but say this for the debt crisis: It leaves little choice. Today's money markets have a way of vetoing unwise political policies. Ask Francois Mitterrand.

What now, South America? Somewhere between the unthinkable Scylla of repudiation and the Charybdis of redlining by the big international banks is the most likely outcome. That still leaves the big question of the restraints on South American governments' policies that all that foreign debt will inevitably impose—a question now being studied by a blue ribbon panel of U.S. business and government leaders sponsored by the Americas Society. Call it muddling through, but what's wrong with muddling through? Consider the alternatives.

What lessons were learned from the great petrodollar credit binge in South America? Brazil's minister of the economy, Emrane Galveas, puts it this way: "I think the one thing you might criticize in Brazilian strategy was that we were trying to do too many things at the same time without realizing that liquidity could change in the financial markets as it did. The capitalistic world is subject to these ups and downs, and you never know at what part of the cycle you find yourself. So if you invest too much at one point, you might find that you have to pay it back just when you are not prepared to do it, just when the market is not offering the same conditions for your exports."

Argentina's Federico Carles, perhaps out of wishful thinking, sees the crisis as a final negation of Peronist tenets: "What we have learned is that we cannot ignore the rest of the world, that we have to be integrated with countries that are able to give us advanced technology; that it is not possible to substitute for imports entirely; that if you want growth, then you have to import, and that importing means lines of credit, which means reasonable relations with foreign banks."

But leave the last word to I. Hersz Kahane of Rio's Emesa, because it still reflects the current beliefs of many South Americans: "With all the problems that Brazil has, if there is in this world a place where you can still come, settle, and if you bring a willingness to work... very few places have as much to offer as Brazil. When I first came here 30 years ago, I started out in the north of Brazil just picking up cashew nuts that were lying on the street and sold them in the marketplace. There are still a lot of cashew nuts, figuratively speaking, available in Brazil."

In the last resort, those figurative cashew nuts may prove the bankers' best collateral.



Carles of Argentina
"In Argentina state participation in the economy is nearly 50%, according to our best estimates. We are a socialist country without knowing it."

Some free advice

And what suggestions would these same South Americans have to give the Reagan Administration, based on their own painful experience over the past decade?

"If I could speak to President Reagan, I'd say to him that he should make more effort to reduce expenditures on welfare," says Brazil's Gouvea de Bulhões. "I would also urge more incentives through income tax, as he is inclined to do, but relating these incentives specifically to investment in corporations."

"I think the main cause of inflation in the U.S. is the expenditures on the welfare economy. That, too, is a massive transfer of income from the production sector of the economy to the consumption sector. And that is the reason productivity is declining in the U.S. But it is not easy to cut back the welfare economy. It could bring some political reaction, so you must be careful. It takes time."

"In terms of corporate incentives for investment, the problem in the U.S. is that, if you buy shares in a company, you face double taxation: first on profits and again on dividends. I would say that the dividends you receive from buying a corporation's new shares—not the old ones—ought to be exempt from corporate tax. Taxes on those dividends should only be paid by indi-



Alemann of Argentina

viduals. This permits the corporation to increase the dividends on its new shares and so attract new equity. After some investment is made by the corporation, the exemption might be extended to the old shares, too. If your President did that, I'm sure he'd recuperate the private sector of your economy in short order."

Argentina's Roberto Alemann would be equally stern on U.S. fiscal policy. "If I were your Secretary of the Treasury, I would reduce the deficit," he says. "I see in the U.S. a very substantial money-supply expansion through fiscal deficits. I don't see any correction of it. What Mr. Reagan really did was reduce income and increase expendi-

tures. And therefore the deficit has never been as high as it is now in the U.S. And it's the Fed that's financing it. You'll have to adopt indexation if you keep it up. Cut back fiscal deficits, and you might have a small reduction in the standard of living for a while, but then there would be a significant increase. The dollar would be the strongest currency in the world. You'd have long-term money to invest. But instead you will go down the other road. You pump money into the economy. You get higher prices. Then you index, and you think you have corrected. But you have not."—G.S.



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SYNDICATED CREDITS

THE LOAN DROUGHT HITS AFRICA

Even the good African risks may reschedule as bankers hold off.

By Charles Grant

As they talked in Nairobi in the second week of May, African bankers and finance ministers attending the African Development Bank meeting faced a major problem: the drying up of Euromarket lending to Africa. For many African countries, Eurocurrency loans had become an important means of funding current account deficits.

The source is dwindling. Syndicated loans to African borrowers totalled \$5 billion in 1982, a drop of \$2 billion from the year before. Euromarket borrowing declined more drastically in the first quarter of 1983, with the signing of only 17 loans worth \$609 million.

At a time when the syndicated loan market has been contracting worldwide, Eurobankers have needed little prompting to close their doors on African borrowers, many of which rank among the world's least solvent countries. Eleven of them have recently rescheduled foreign debt or are in the process of doing so: Central African Republic, Liberia, Madagascar, Malawi, Sierra Leone, Senegal, Sudan, Togo, Uganda, Zaïre and Zambia.

Three of Africa's biggest borrowers are possible candidates for rescheduling this year: Nigeria, Morocco and Ivory Coast, which together owe \$35 billion. Other candidates include Kenya, Tanzania, Mozambique and Ghana. (For analysis of the Nigerian economy, see "Nigeria on the brink", *Euromoney*, April 1983.)

Bankers polled by *Euromoney* believe that only six African countries can still borrow by a traditional syndicated balance of payments loan: Algeria, Cameroon, Tunisia, Botswana, Gabon and Libya. And three of these favoured countries, Botswana, Gabon and Libya, are unlikely to borrow in 1983.

However, several other African countries can still tap the Euromarket for project finance on a club basis, as long as the circumstances are favourable for foreign banks. If part of the loan is export credit guaranteed, or if the project contractor is an important customer of the lending bank, foreign banks are more likely to join a project loan.

No African country's creditworthiness has fallen more spectacularly in the last year than that of Ivory Coast. Up till last August, it borrowed regularly and easily on the syndicated loan market. On August 16 Bankers Trust won a mandate to raise \$150 million. Two days later, Mexico announced that it would reschedule, and all sovereign lending received a shock. The Ivory Coast

deal was no exception and in the end only \$123 million was raised.

Bankers were also alarmed by the debt service ratio of 34%, and the news that oil reserves were less than expected. But the market's reluctance was not justified by any sudden turnabout in the Ivorian economy, which remained under the aegis of an IMF programme.

According to the 1983 Ivorian budget, the country will seek commercial bank loans of \$183 million this year. A few banks are still prepared to lend on an export-related project basis. They point to the efficiently managed and diversified cash crop sector, and to the likelihood of oil exports starting later this year.

"France wouldn't let Ivory Coast reschedule, it's the jewel of French West Africa," said an optimistic banker. "It can continue to borrow from the French Treasury, via the Banque Centrale des Etats de l'Afrique de l'Ouest."

But other bankers are less confident that French indulgence is unlimited. Some banks will not lend any more to Ivory Coast. Inflows of new Eurocurrency funds have fallen to a trickle this year. If more banks hold back new lending, a rescheduling could be precipitated.

Morocco is another country which some bankers have tipped for rescheduling in 1983. Morgan Guaranty predicts that 65% of this year's export earnings will be used to service Morocco's \$10.3 billion of foreign debt. Conservative Arab countries are expected to chip in over \$1 billion of aid, but that may not suffice to cover the current account deficit.

Morocco will continue to seek Euromarket funds for the development of its phosphates industry. It has 75% of the world's known phosphate reserves. Some leading French banks told *Euromoney* that they had struck Morocco off the list of countries they were prepared to lend to, but other French banks believed the kingdom could still raise project-linked funds, provided Arab banks supported the loan.

"Despite the grim economic situation," said a French banker, "the European and American banks which are already heavily committed will provide the credits Morocco needs, because of its immense strategic importance; it has offered bases to the US Rapid Deployment Force."

Only a couple of years ago Kenya and Zimbabwe ranked among the brightest credit risks in Africa. Now the ratings of both have entered a steep slide, in part because of political instability. Zimbabwe is becoming a one-party state, while in Kenya political opposition has been crushed following last August's attempted coup.

"Kenya's gone downhill since Kenyatta died; mismanagement and corruption have flourished," said a British banker who

covers East Africa. "It's fifty-fifty whether or not they reschedule this year."

Zimbabwe should still be able to borrow for projects, at the short end of the medium-term market. It is not expected to seek many commercial loans: most of this year's current account deficit, which is not likely to be less than last year's \$500 million, should be covered by an IMF loan of \$384 million agreed in March, together with western aid.

Among the handful of countries which could borrow balance of payments loans without difficulty, Gabon and Botswana are unlikely to do so because of their extremely conservative economic management, while Libya is unlikely to do so because of its radical politics. Libya does not want to become enmeshed in the capitalist system, so is unlikely to repeat its Euromarket sortie of December 1981, unless oil output drops drastically.

Only Tunisia, Algeria and Cameroon have sought or look likely to seek balance of payments credits this year. Fresh from the success of its \$125 million loan signed in February, which achieved an astonishing 50% sell-down below lead manager level, Tunisia is expected to borrow again. Falling oil output has widened the current account deficit, not all of which can be financed by Arab aid. Tunisia should be able to hold the very fine spread of ½% which it paid in February, thanks to the scarcity value of its paper. Much in Tunisia appeals to bankers: political stability, up-to-date statistics, and diversified sources of foreign exchange, including tourism, and exports of olives and citrus fruit, as well as oil.

Algeria, like Tunisia, has been spurred to borrow by falling demand for oil. The \$500 million eight-year credit launched in April met a warm reception in the market. American, Japanese and French banks joined the five Arab coordinating banks at lead manager level and the amount was increased to \$600 million.

> The loan's success was despite a split spread of only ½ to ¾%, Algeria's alarming debt service ratio of 35%, and its total foreign debt of \$16 billion. The explanation? Algeria has abstained from balance of payments borrowing for four years, its foreign debt has fallen, and it has started to diversify its exports away from crude oil towards LNG and refined petroleum products.

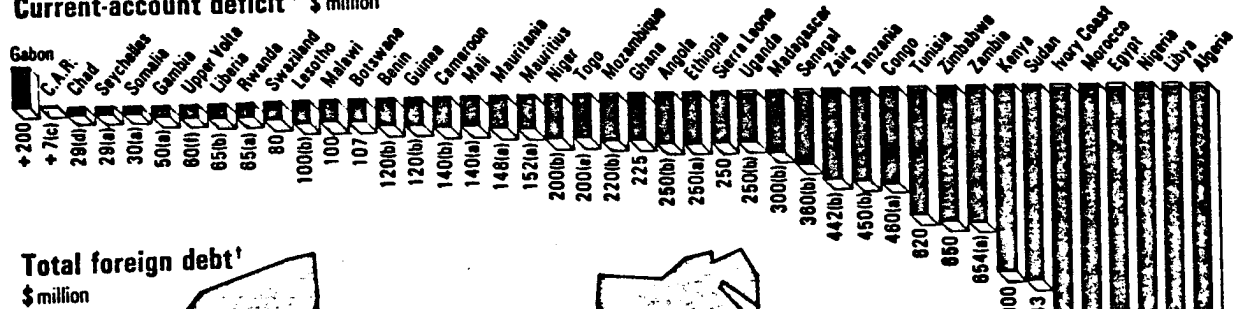
Cameroon, like Algeria, has borrowed little since 1979. But this March it returned to the market, with a \$350 million loan, led by Bankers Trust and Crédit Lyonnais, for the development of the Lokele oilfield. Cameroon's enormous gas reserves of 100 billion cubic metres are still undeveloped, but if President Paul Biya decides to launch an LNG industry, considerable external finance will be required.

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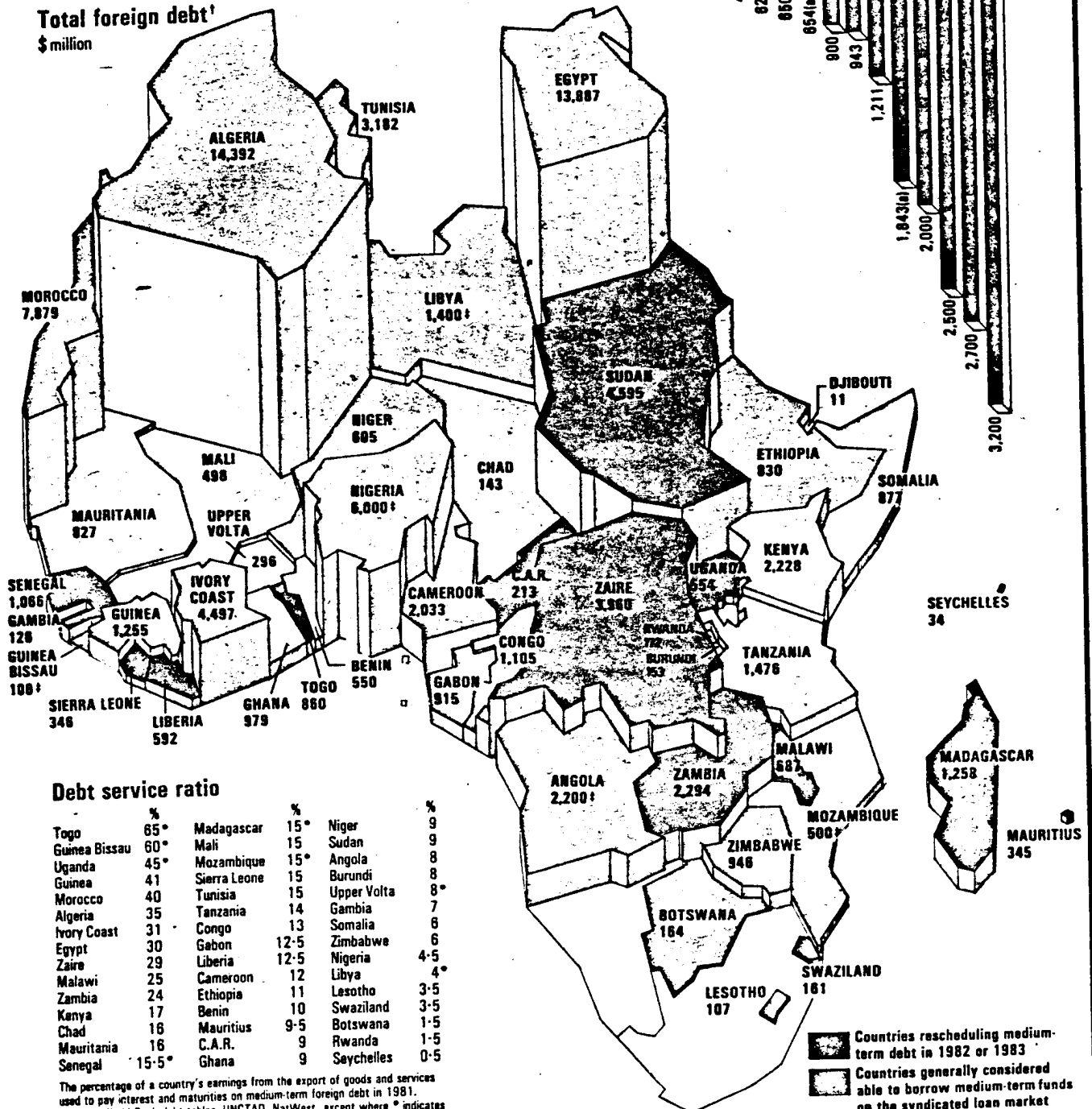
HOW THE DEBT STACKS UP

Current-account deficit* \$ million

Figures for Burundi, Djibouti and Guinea Bissau are not available



Total foreign debt[†]
\$ million



Debt service ratio

Togo	85*	Madagascar	15*	Niger	9
Guinea Bissau	60*	Mali	15*	Sudan	9
Uganda	45*	Mozambique	15*	Angola	8
Guinea	41	Sierra Leone	15	Burundi	8
Morocco	40	Tunisia	15	Upper Volta	8*
Algeria	35	Tanzania	14	Gambia	7
Ivory Coast	31	Congo	13	Somalia	6
Egypt	30	Gabon	12.5	Zimbabwe	6
Zaire	29	Liberia	12.5	Nigeria	4.5
Malawi	25	Cameroon	12	Libya	4*
Zambia	24	Ethiopia	11	Lesotho	3.5
Kenya	17	Benin	10	Swaziland	3.5
Chad	16	Mauritius	9.5	Botswana	1.5
Mauritania	16	C.A.R.	9	Rwanda	1.5
Senegal	15.5*	Ghana	9	Seychelles	0.5

The percentage of a country's earnings from the export of goods and services used to pay interest and maturities on medium-term foreign debt in 1981.
Sources: World Bank debt tables, UNCTAD, NatWest, except where * indicates a Euromoney estimate

* Estimate for 1982, except where (a) indicates IMF figures for 1981, or where (b) indicates estimate for 1981 or (c) IMF figure for 1980 or (d) IMF figure for 1977 or (e) IMF figure for 1979 or (f) IMF figure for 1978

† All medium term disbursed debt, owed to official and private creditors, at December 31, 1981. Figures based on World Bank debt tables except where * is indicated, which denotes a Euromoney estimate.

Countries rescheduling medium-term debt in 1982 or 1983
Countries generally considered able to borrow medium-term funds on the syndicated loan market

Eurocredit

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APPENDIX C

Trends in Eurocurrency Credit Participation
1972-1980*Diane Page and Walter D. Rogers*

The burgeoning Eurocurrency credit market exceeded \$70 billion in publicized volume in 1980, compared to \$9 billion in 1972. Today, the bulk of publicized Eurocurrency lending is done by bank syndicates rather than individual institutions. Although the financial press annually allocates syndicated Euroloan volume among managing institutions, identifying the world's top Eurolenders, no one has documented the steady influx of new loan participants into the Eurocurrency credit market or comprehensively considered the changing nationality of participants over time. Using World Bank data, Office of the Comptroller of the Currency staff were able to examine these non-volume indicators of the increasing breadth of the publicized Eurocurrency credit market.¹

Analysis of the World Bank data shows that a relatively constant average of 66 independent financial institutions became first-time entrants into the Eurocurrency credit market each year between 1973 and 1980. By 1980, nearly 400 independent financial institutions were active in the market. In the earlier years, the new entrants were largely European and North American banks and international consortium banks. More recently, Latin American, Middle Eastern and Asian institutions have entered the market in greater numbers. Further findings from the World Bank data reinforce the well-documented expansion of Middle Eastern financial institutions into Eurocurrency lending. For example, in terms of number of participating institutions, Middle Eastern institutions have increased their presence in the market from less than one percent in 1972 to an eight percent share of the total in 1980. However, in every year, European and U.S. institutions ac-

Diane Page and Walter D. Rogers are Financial Analysts of the Strategic Analysis Division of the Office of the Comptroller of the Currency. C. Stewart Goddin, Judith A. Walter and Steven J. Weiss made valuable comments on earlier drafts of this paper. Vivian L. Oyola did the necessary computer programming. The views expressed in this paper are the authors' and do not necessarily represent the views of the Office of the Comptroller of the Currency.

count for the bulk of total participating institutions as well as total loan participations.

Introduction

Analysis in this paper is restricted to publicized Eurocurrency credits. It examines financial institutions which were Eurocurrency loan participants between 1972 and 1980, considering their nationality, entry into the Eurocurrency market, and number of yearly loan participations.

Eurocurrency credits are loans and credit lines denominated in a currency other than that of the country in which the lending institution is located. Eurocurrency credits first appeared in the 1960s. At that time, they were almost exclusively fixed-rate loans to corporate borrowers underwritten by specialized investment banks, notably the British merchant banks, which later sold participations to other banks. The Eurocurrency credit market began to take on its present characteristics in the early 1970s. Loans became floating rate instruments. Nations began to finance balance of trade deficits through Eurocurrency borrowings. And the world's large international commercial banks began managing large Eurocurrency credits through syndications. Syndication of credits reduced risk for the underwriters and brought together the large resources necessary to finance sovereign debt. With successive oil price increases in 1973 and 1974, the oil-producing nations developed trade surpluses while non-oil-producing less-developed countries faced growing deficits. The Eurocurrency credit market began to serve a vital function as a recycling mechanism, moving surplus capital from the oil-producers to the non oil-producing nations. Publicized Eurocurrency credits reached a volume of \$70.4 billion in 1980, according to World Bank data. Publicized credits, which are medium- to long-term and usually syndicated, represent only a portion of international borrowing. It has been estimated that one-half of Eurocurrency bank lending is short term, unpublicized lending used for private trade and international business financing.² International and foreign bond issues are another vehicle for international borrowing, and accounted for \$41.8 billion in 1980.³

Description of the Data

Data collected by the World Bank cover publicized borrowing in international capital markets in the form of Eurocurrency credits between 1972 and 1981.⁴ Notice of Eurocurrency credits appears in a published announcement known as a tombstone. The tombstone generally contains the name of the borrower, the amount of the credit, and the names of the financial institutions which participate in the loan. Often, but not always, Eurocurrency credits are led by a single large institution. Smaller volume

credits are less likely to be more co-lead managed by a prospective borrower group.

The lead manager makes a commitment. On the tombstone the participation they

Year	Loan Volume (\$ billions)
1972	8.8
1973	20.8
1974	28.5
1975	20.6
1976	28.7
1977	34.2
1978	73.7
1979	70.2
1980	70.4

Source: World Bank data.
* A small percentage of participation is by more than one institution.

first, followed by managers successively smaller in alphabetical order, then an equal participation order within manager

Computerized data participants per institution on the tombstone. If participants are identified, there is no way to be participated in all loans in a number of named and and likewise to deter

credits are less likely to have a lead manager, while some loans have two or more co-lead managers. The lead manager receives a mandate from the prospective borrower to raise funds and seeks to put together a managing group.

The lead manager typically underwrites the entire amount of the credit, making a commitment to provide the funds before arranging the syndication. On the tombstone, institutions are usually listed in order of the size of the participation they take in the loan. As a rule, the lead manager is listed

Table I
Eurocurrency Credit Aggregates
1972-1980

Year	Loan Volume (\$ billions)	Total # Loans	Total # Participations	% Loans with Unnamed Participants	% Participations By Unnamed Participants
1972	8.8	258	415	1	1
1973	20.8	402	725	1	1
1974	28.5	474	1027	1	1
1975	20.6	418	1482	5	6
1976	28.7	430	1827	8	9
1977	34.2	489	2360	10	10
1978	73.7	786	3781	15	20
1979	70.2	813	4329	16	22
1980	70.4	797	4913	18	24

Source: World Bank data.

* A small percentage of participants are listed as "syndicates" and thus actually represent more than one institution.

first, followed by managers, co-managers, and participants, which take successively smaller portions of the loan. When institutions are listed in alphabetical order, this generally indicates that each participant has taken an equal participation. Sometimes institutions are listed in alphabetical order within manager, co-manager and participant sub-groups.

Computerized World Bank data identify by name a maximum of ten participants per individual Eurocurrency credit in order of their appearance on the tombstone. When a loan has more than ten participants, nine participants are identified by name and the number of additional, unnamed participants is indicated. Since these additional participants are not identified, there is no way to ascertain how many individual institutions participated in all loans in each year. However, it is possible to aggregate the total number of named and unnamed *participations* for all loans in each year, and likewise to determine how many loans had unnamed (more than ten)

participants. As shown in Table I, an increasingly significant proportion of total loan participations, 24 percent by 1980, have been taken over time by participants not identified by name in the World Bank data. The number of loans with unnamed participants increases to 18 percent of total loans by 1980. The reader should bear in mind that, in most of the following discussions of participant nationality, new entry and loan participations, only named participants, those who took the first nine or ten listed positions on each loan, are considered. It was not possible to identify the unnamed participants or to draw any conclusions about their entry trends or nationality patterns.

In the following analysis, information has been provided on those institutions appearing as first listed participant for each loan in the World Bank data, i.e., institutions listed first on the loan tombstones. Although this information provides some indication of the nationality distribution of lead managers, it should be interpreted with caution. As explained above, lead managers usually appear first on the publicized loan notices. However, since some credits have no lead manager, some credits have a number of co-lead managers, and some tombstones list all participants alphabetically, first participant position in the World Bank data is not a perfect proxy for lead manager. (World Bank staff estimate that about 20 percent of the Eurocurrency credit tombstones list participants alphabetically.)

Nationality of the named participants is not included in World Bank data and was determined using a variety of almanacs, yearbooks and other reference sources. Institutions were grouped by nationality of ownership rather than country of charter; Euroloan activity of branch offices or subsidiary companies has been credited to the head office or parent institution. For example, Deutsche Bank AG, Deutsche Bank AG (London), and Deutsche Bank Cie. Fin. Luxembourg were all considered part of a single German financial institution when determining the number of German Euroloan participants, German entry into the market, and the number of German loan participations.

Results

Between 1972 and 1980, the number of publicized Eurocurrency credits tripled from 258 to 797 and their combined volume increased from \$8.8 to \$70.4 billion, according to World Bank data (see Table I).⁵ The following analysis is based on a direct comparison between Eurocurrency credit activity in 1972 and 1980, since changes between 1972 and 1980 reflect trends which characterize the intervening years. However, the figures are also affected by specific factors such as the slowdown in U.S. Eurolending dating from 1979 and government restrictions on foreign lending of Japanese banks in 1980. (See Appendix tables.)

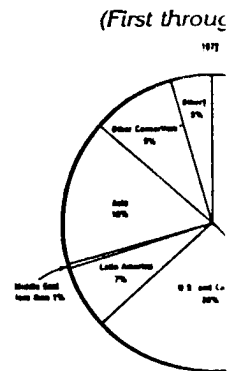
Number of lenders

The number of named institutions, nearly tripled shows a geographic break (Consortium banks were in categories when their own European or all Middle Eastern geographic categories in over time. The predominance of the total in both years Middle Eastern institution total share in 1972 and 8 institutions, on the other hand share of Asian institution

New entry

Between 1973 and 1980, participated in any previous Eurocurrency credit market constant, averaging 66 percent

Nationality of Parent Institutions



Source: World Bank data

* Consortium banks which did not participate in Eurocurrency credit activity by European and Middle Eastern banks.
† Africa, Oceania and a very small number of other countries not be identified by nationality.

Number of lenders

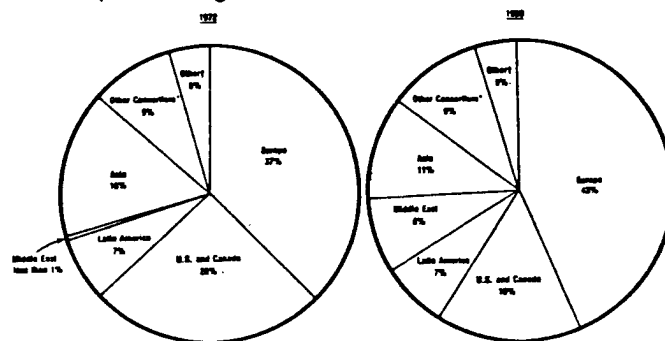
The number of named loan *participants*, consolidated into parent institutions, nearly tripled from 133 to 386 between 1972 and 1980. Figure I shows a geographic breakdown of these institutions in 1972 and 1980.* (Consortium banks were placed in the Asian, European and Middle Eastern categories when their owning institutions were identified as all Asian, all European or all Middle Eastern.) The absolute number of managers in all geographic categories increased, but relative shares of the total changed over time. The predominance of European institutions, well over one third of the total in both years, is evident, as is the growing importance of the Middle Eastern institutions, which represented less than one percent of the total share in 1972 and 8 percent in 1980. The share of U.S. and Canadian institutions, on the other hand, dropped by ten percent of the total, while the share of Asian institutions dropped by five percent of the total.

New entry

Between 1973 and 1980, 526 parent institutions which had not participated in any previous year for which data are available entered the Eurocurrency credit market. The number of new entrants is relatively constant, averaging 66 per year (Figure II).

Figure I

Nationality of Parent Financial Institutions Participating in the Publicized Eurocurrency Credit Market 1972 & 1980 (First through Tenth Listed Participants Only)



Source: World Bank data

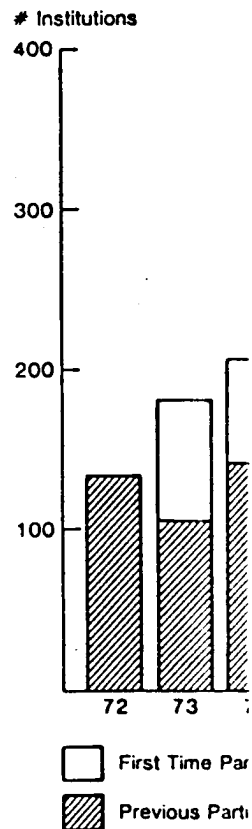
* Consortium banks which did not fit in any regional category, such as UBAF, which is owned by European and Middle Eastern institutions.

† Africa, Oceania and a very small percentage (less than 1 percent) of institutions which could not be identified by nationality.

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**Financial Institutions
Participating in the Euroloan Market
1972-1980**
(First through Tenth Listed Participants Only)

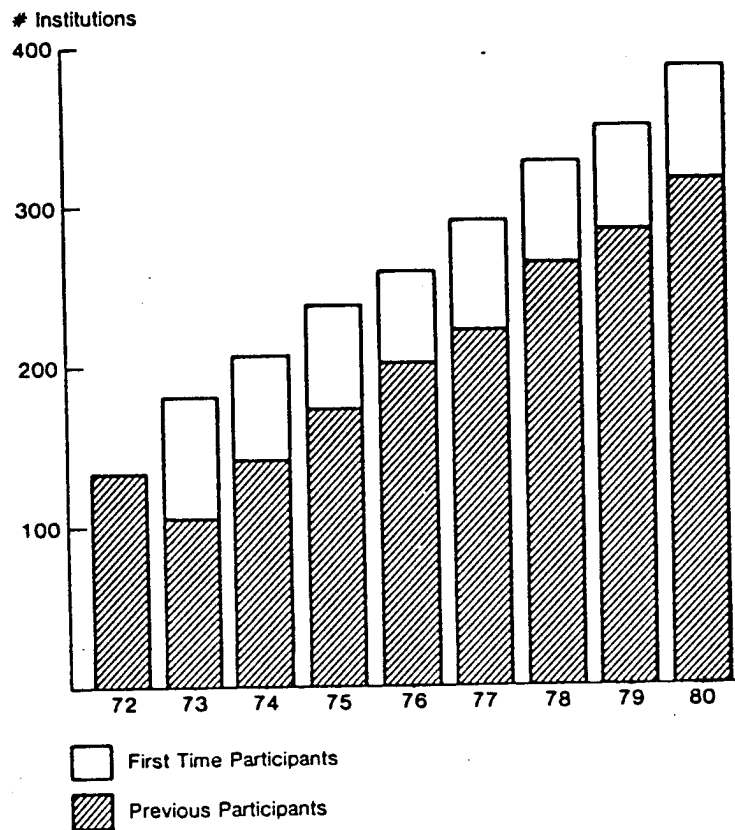
	72	73	74	75	76	77	78	79	80
Austria	0	0	4	4	4	11	5	7	14
Belgium	4	3	3	5	4	3	3	4	4
Luxembourg	3	3	3	4	5	7	11	7	7
Fed. Rep. of Germany	5	7	10	13	13	17	17	22	21
France	9	15	14	16	15	17	17	22	19
Italy	3	5	6	5	8	9	18	12	15
Netherlands	0	1	3	4	5	5	5	6	5
Spain/Portugal	2	5	9	13	14	13	11	19	22
Switzerland	2	2	4	4	9	9	8	9	11
United Kingdom	18	24	20	18	19	18	18	19	18
Other, W. Europe	1	9	9	18	12	14	14	16	17
E. Europe	1	2	3	3	2	1	1	2	5
Total	48	76	88	107	110	124	128	145	158
Canada	3	4	7	9	7	9	9	10	9
USA	31	40	41	46	46	43	49	50	54
Total	34	44	48	55	53	52	58	60	63
Mexico/Central/S. Amer.	6	3	5	6	5	8	8	12	23
Caribbean	3	2	5	3	4	3	2	4	3
Middle East	1	2	3	6	11	17	25	23	25
Africa	1	0	1	1	1	2	1	2	3
Japan	17	21	17	7	13	18	24	24	24
Other Asia	5	2	4	5	4	9	11	16	19
Total	22	23	21	12	17	27	35	40	43
Oceania	2	0	1	2	1	1	3	5	8
Consortia	12	22	30	36	48	49	60	51	51
of which European	1	4	4	5	6	7	7	8	9
Arab	0	0	1	2	3	5	9	6	6
Asian	0	1	1	1	1	0	0	1	0
Other	11	17	24	28	38	37	44	36	36
Unidentified	4	6	5	7	6	5	7	5	9
GRAND TOTAL	133	178	207	235	256	288	327	347	386

First-Time and
Eu

* Refers to first-time entry si

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Figure II
First-Time and Previous Participants in the Publicized
Eurocurrency Credit Market*
1972-1980



* Refers to first-time entry since 1972; data not available for previous years.

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**Financial Institutions Entering the Euroloan
Market for the First Time***
1973-1980
(First through Tenth Listed Participants Only)

	73	74	75	76	77	78	79	80
Austria	0	4	1	1	5	1	0	5
Belgium	0	0	1	1	0	0	1	0
Luxembourg	0	0	2	3	3	3	0	2
Fed. Rep. of Germany	2	5	4	1	4	1	4	2
France	7	2	4	2	3	0	6	1
Italy	2	1	1	2	5	5	2	1
Netherlands	1	2	1	2	2	1	0	0
Spain/Portugal	3	4	5	2	1	1	6	7
Switzerland	1	2	0	5	3	1	3	2
United Kingdom	9	2	1	1	0	1	0	1
Other, W. Europe	8	3	9	3	1	0	0	1
E. Europe	1	1	1	0	0	0	0	3
Total	34	26	30	23	27	14	22	25
Canada	1	3	3	1	1	0	1	0
USA	13	9	10	7	5	7	6	10
Total	14	12	13	8	6	7	7	10
Mexico/Central/S. Amer.	2	2	0	0	3	3	3	10
Caribbean	0	2	0	0	2	0	3	1
Middle East	2	3	2	6	9	11	7	3
Africa	0	0	0	1	1	0	2	1
Japan	4	1	0	1	2	4	1	1
Other Asia	2	1	2	1	6	4	5	10
Total	6	2	2	2	8	8	6	11
Oceania	0	0	1	0	0	1	4	2
Consortia	13	14	13	14	7	15	6	5
of which European	3	0	1	2	1	0	1	0
Arab	0	1	2	1	1	4	0	1
Asian	1	1	1	0	0	0	0	0
Other	9	12	9	11	5	11	5	4
Unidentified	4	4	3	2	3	4	4	5
GRAND TOTAL	75	65	64	56	66	63	64	73

* Refers to first-time entry since 1972; data for previous years not available.

Nationality of Paren
Eurocurren

Year	Eur.	N. Am
1973	37	14
1974	26	12
1975	31	13
1976	25	8
1977	28	6
1978	14	7
1979	23	7
1980	25	10
TOTAL	229	77

Source: World Bank data
* Refers to first-time entry since

Table I shows the American and Other C owners did not fit nearly rate of new entry. This is the most international entered the Eurocurren established early as a m and Middle Eastern ins time. Asian ins would Japanese government Japanese entry and pa fluctuate. Other Asian tion. While European in in terms of sheer numb regions indicates the gr

Number of loan partic

Total yearly loan pa
Eurocurren credit ma
number of participation
from 45 to 4313 betwe
tion of varied particip
period are categorized i

64

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Table II
Nationality of Parent Financial Institutions Entering the Publicized
Eurocurrency Credit Market for the First Time*
1973-1980

Year	Nationality					Other	
	Eur.	N. Amer.	Latin Amer.	Asian	M. East	Consortium	Other
1973	37	14	2	2	7	9	4
1974	26	12	4	4	3	12	4
1975	31	13	0	4	3	9	4
1976	25	8	0	7	2	11	3
1977	28	6	5	10	8	5	4
1978	14	7	3	15	8	11	5
1979	23	7	6	7	6	5	10
1980	25	10	11	4	11	4	8
TOTAL	209	77	31	53	48	66	42

Source: World Bank data

* Refers to first-time entry since 1972; data not available for previous years.

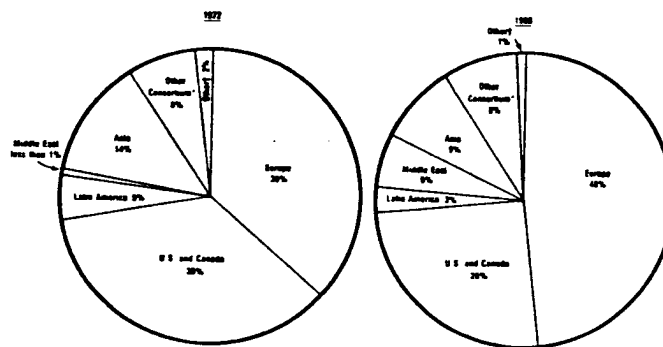
Table II shows the nationalities of the new entrants. European, North American and Other Consortium institutions (consortium banks whose owners did not fit neatly into a regional category) demonstrate a declining rate of new entry. This is not surprising since institutions from countries with the most internationally active and highly developed banking systems entered the Eurocurrency credit market first. Also, consortium banks were established early as a means of access to the market. Latin American, Asian and Middle Eastern institutions exhibit increasing rates of new entry over time. (Asian rates would be more pronounced if not for the effect of periodic Japanese government restrictions on foreign lending, which caused Japanese entry and participation in the syndicated Euroloan market to fluctuate. Other Asian nations demonstrate steadily increasing participation.) While European institutions continue to dominate the new entry table in terms of sheer numbers, the increasing entry of institutions from other regions indicates the growing breadth of the Eurocurrency credit market.

Number of Loan participations

Total yearly loan participations by all institutions provide a measure of Eurocurrency credit market size distinct from dollar volume measures. The number of participations by both named and unnamed participants grew from 415 to 4,913 between 1972 and 1980, a twelvefold increase. Participations by named participants, which grew from 412 to 3,723 in that time period, are categorized by nationality in Figure III. In terms of loan participa-

tions, European institutions increased their share from just over one third to almost half the yearly total. Again Middle Eastern growth is notable, from a less than one percent to a six percent share. Both the North American and Asian shares declined, by ten percent and five percent of the total respectively.

Figure III
Publicized Eurocurrency Credit Market Participations
by Nationality of Participant
1972 & 1980
(First through Tenth Listed Participations Only)



Source: World Bank data

* Consortium banks which did not fit in any regional category, such as UBAF, which is owned by European and Middle Eastern institutions.

† Africa, Oceania and a very small percentage (less than 1 percent) of institutions which could not be identified by nationality.

First listed participants

World Bank's first listed participants can be used as a proxy, albeit an imperfect one, for Eurocurrency credit lead managers. It is evident that changes in national shares of total first listed participants are consistent with other share changes described in previous sections. Figure IV illustrates that European institutions account for almost half of total first participants positions in 1972 and 1980. North American institutions moved from holding first participant position in almost a third of all Eurocurrency credits to a 22 percent share in the same time period. Asian institutions maintained a stable first participant share of approximately ten percent, while Middle Eastern institutions, which appeared in no first participant positions in 1972, had a seven percent share in 1980.

Eurolo

(Fir

Austria
Belgium
Luxembourg
Fed. Rep. of German
France
Italy
Netherlands
Spain/Portugal
Switzerland
United Kingdom
Other, W. Europe
E. Europe

Canada
USA

Mexico/Central/S. Ame
Caribbean
Middle East
Africa

Japan
Other Asia

Oceania
Consortia
of which European
Arab
Asian
Other

Unidentified
GRAND TOTAL

249

**Euroloan Participations by Nationality of Participant
1972-1980**
(First through Tenth Listed Participants Only)

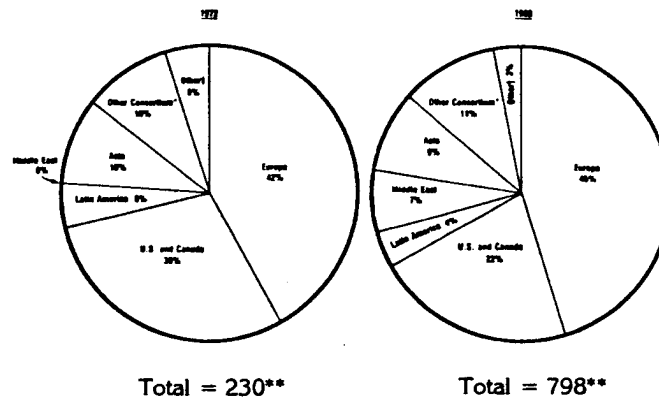
	72	73	74	75	76	77	78	79	80
Austria	0	0	5	16	7	42	15	31	41
Belgium	12	6	17	28	12	35	49	106	110
Luxembourg	8	9	15	11	27	31	51	70	45
Fed. Rep. of Germany	11	15	59	115	108	219	254	300	254
France	27	67	125	100	92	103	162	223	395
Italy	9	25	22	7	11	15	39	55	98
Netherlands	0	2	8	27	28	45	81	78	67
Spain/Portugal	5	7	29	32	36	41	38	77	100
Switzerland	2	4	9	20	32	47	63	74	76
United Kingdom	65	106	113	127	156	207	280	357	416
Other, W. Europe	2	15	16	35	48	47	46	71	81
E. Europe	3	4	7	11	6	1	2	6	17
Total	144	260	425	529	563	833	1080	1448	1700
Canada	10	24	44	117	121	153	261	284	301
USA	136	239	346	503	653	658	749	613	657
Total	146	263	390	620	774	811	1010	897	958
Mexico/Central/S. Amer.	10	3	8	29	19	22	29	60	95
Caribbean	9	10	12	3	5	3	2	4	9
Middle East	1	5	4	19	19	48	106	80	113
Africa	1	0	1	1	3	2	2	2	5
Japan	51	99	37	14	32	97	355	466	258
Other Asia	6	4	7	14	11	24	36	42	80
Total	57	103	44	28	43	121	391	508	338
Oceania	2	0	2	3	1	1	5	5	25
Consortia	36	70	128	161	233	284	373	386	467
of which European	4	9	25	14	19	37	45	55	72
Arab	0	0	1	4	8	12	50	54	92
Asian	0	1	1	1	1	0	0	2	0
Other	32	60	101	142	205	235	278	275	303
Unidentified	6	6	9	15	9	6	9	9	13
GRAND TOTAL	412	720	1023	1408	1669	2131	3007	3399	3723

67

16-632 0 - 83 - 17

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Figure IV
Total Publicized Eurocurrency Credits by Nationality
of First-Listed Participants
1972 & 1980



Source: World Bank data

* Consortium banks which did not fit in any regional category, such as UBAF, which is owned by European and Middle Eastern institutions.

† Africa, Oceania and a very small percentage (less than 1 percent) of institutions which could not be identified by nationality.

** Totals do not match loan totals in Table I due to omissions in World Bank data.

Number of Euroloans

Austria
Belgium
Luxembourg
Fed. Rep. of Germany
France
Italy
Netherlands
Spain
Switzerland
United Kingdom
Other, W. Europe
E. Europe

Total

Canada
USA

Total

Mexico/Central/S. Amer.
Caribbean
Middle East
Africa

Japan
Other Asia

Total

Oceania
Consortia
of which European
Arab
Asian
Other

Unidentified

GRAND TOTAL²¹ First-listed participant in World Bank data.² Totals do not equal Eurocurrency credits in World Bank data.

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**Number of Euroloans by Nationality of First-Listed Participant¹
1972-1980**

	72	73	74	75	76	77	78	79	80
Austria	0	0	3	3	1	3	3	2	6
Belgium	6	2	3	7	1	7	7	13	19
Luxembourg	4	4	3	3	7	10	7	14	8
Fed. Rep. of Germany	4	7	20	19	23	39	67	55	40
France	19	34	58	32	23	19	35	45	70
Italy	2	7	7	1	2	4	15	8	9
Netherlands	0	1	2	6	8	6	17	8	12
Spain	1	1	2	5	6	10	8	21	27
Switzerland	1	1	4	4	2	1	10	21	22
United Kingdom	45	83	73	50	46	50	73	100	90
Other, W. Europe	0	2	3	7	11	18	18	19	19
E. Europe	3	0	0	3	0	0	0	0	0
Total	85	142	178	140	130	167	260	306	322
Canada	6	12	7	14	10	14	35	55	45
USA	87	145	179	181	190	194	286	242	231
Total	93	157	186	195	200	208	321	297	276
Mexico/Central/S. Amer.	1	0	3	6	4	2	12	11	15
Caribbean	7	10	6	1	2	2	1	1	1
Middle East	0	3	3	1	2	6	34	17	28
Africa	0	0	0	0	0	0	1	0	0
Japan	11	33	12	2	5	12	45	66	24
Other Asia	1	2	3	8	5	4	4	2	11
Total	12	35	15	10	10	16	49	68	35
Oceania	1	0	1	1	0	0	2	2	5
Consortia	26	31	59	51	79	84	96	105	114
of which European	1	1	3	3	8	11	11	15	21
Arab	0	0	1	2	4	1	16	10	14
Asian	0	0	0	1	1	0	0	0	0
Other	25	30	55	45	66	72	69	80	79
Unidentified	5	1	4	5	0	4	0	3	2
GRAND TOTAL²	230	379	455	410	427	489	776	810	798

¹ First-listed participant in World Bank data usually refers to the lead manager.

² Totals do not equal Eurocurrency loan totals found in Table I in the text due to omissions in World Bank data.

Conclusion

World Bank data, although identifying only ten participants per Euroloan, can be used to provide some information on the pace of new entry into the Eurocurrency credit market and patterns of changing nationality among lending institutions. Conclusions drawn from the data become less certain in later years, because of the significant increase in the number of unidentified participants listed beyond position ten in individual loans.

The picture resulting from a study of the data is one of a growing and broadening syndicated Eurocurrency credit market between 1972 and 1980. The growth in number and volume of loans has been accompanied by a growth in the number of institutions participating in those loans. Growth in total number of loan participations has outstripped the growth rate in number of loans; this is another indicator of increased market breadth. A steady average of 66 new institutions has entered the market yearly.

Institutions headquartered in Europe and North America, active in the Euroloan market in earlier years by virtue of their well developed international banking presence, still accounted for the bulk of yearly participations, lending institutions and first listed participants (a proxy for lead manager) in 1980. However, new lender institutions from these countries are entering the publicized Eurocurrency credit market at a declining rate. In recent years, increasing numbers of new entrants are from Latin America, Asia and the Middle East. Institutions from the Middle East as a whole have increased their share of yearly loan participations, loan leadership and representation among lending institutions notably, from less than one percent of the total in 1972 to six to eight percent in 1980. This increased share has been balanced in part by the declining share of North American institutions.

Endnotes

¹ World Bank data are limited, identifying a maximum of ten participant institutions per individual loan. This limitation becomes more important over time. See Table I for the number of loans with unidentified (greater than ten) participants on a yearly basis.

² Laurie Goodman, "The Pricing of Syndicated Eurocurrency Credits," Federal Reserve Bank of New York *Quarterly Bulletin*, Summer 1980, p 40.

³ Morgan Guaranty Trust Company, *World Financial Markets*.

⁴ The World Bank stopped collecting this type of data as of the second quarter of 1981, since it is now available from several other sources such as Caploan and the Euromoney syndication service.

⁵ Volume of publicized Eurocurrency credits is available from many other sources including Morgan Guaranty Trust Company, the OECD and Caploan. Reported numbers differ due to differences in timing, coverage, etc. Compare, for example, the World Bank figures with those found in Morgan Guaranty's *World Financial Markets*: \$6.9 billion in 1972 and \$76.8 billion in 1980.

⁶ Tables from which these charts are derived may be found in the following these notes.

Overview

National authorities bank safety and soundness system as a whole. The into preventive regulatory schemes which offer protection and support provided by liquidity difficulties

Preventive Regulation

Among measures banks are those concerning safety, permissible business activities of loans and currency

In virtually all national entry stage. Before the requirements which typically minimum amount of capital formalized, varying from US\$10m (United Kingdom) branches of foreign banks endowment capital, although requirement while Canada form. Several countries market entry may be reviewed to curbing excess

In addition to a number

Richard Dale is currently a senior advisor at the Brookings Institution

FROM BRAZIL? JUST A MINUTE, SIR

The interbank deposit markets are the Euromarket's most sensitive barometer. Here's how the climate's changed.

By Tim Anderson

"We realize we have had to prove our credibility," said George Gunson, general manager of Euro-Latinamerican Bank. "To reassure the market, we never ask to roll over an interbank deposit. That way the bank can prove it has the funds to repay them."

In National Westminster Bank's Threadneedle Street offices, interbank deposit dealers do not take calls from Brazilian banks. If one of the direct lines lights up on a dealer's desk, he politely refers the caller to the Latin American division. There is no automatic trading, as there used to be.

Neither would have happened a year ago. These changes are the everyday realities of the reshaping of the Eurodollar interbank market, which took place after the shocks which hit banking last year, and has continued with Brazil's attempts to maintain its interbank lines.

The flight to quality, most vividly seen during the autumn of 1982 in the Euro-dollar certificate of deposit market (*Euromoney* October 1982), when the yield on CDs rose to 300 basis points over T-bills, had an impact on the interbank market which many believe is permanent.

US banks are offered more deposits than ever — so many that they may even be turning them down, thereby reducing the pool of funds available to other banks. For non-US banks, the market is now fragmented. Greater caution, higher spreads, stricter bank and country limits, have reduced liquidity. The interbank market remains the main source of short-term funds for most international banks and its size depends, more than ever before, on the funds funnelled through the big US banks. Calm has returned to the Eurodollar CD market, and it remains an important source of funds for a select club of eight US banks.

Euro-Latinamerican and other banks connected with Latin America have suffered the brunt of the changes because the shocks from the region have been the most severe. But no bank is unaffected. The shocks which undermined confidence in banks were worldwide; from Banco Ambrosiano in Luxembourg and Italy to Penn Square and Lombard-Wall in the US. And there is hardly a bank in the world without exposure to Mexico, Brazil or Argentina.

As the lubricant of the international banking system, the interbank market is



Carl Malmaeus of Toronto-Dominion Bank: "Interbank has to be risk-free."

essential. Now there is grit in it. In 1973 the size of the market was just \$150 billion. By the end of 1982 it had reached \$1,000 billion, 12 times larger than the syndicated loan market. But in the last quarter of 1982 it grew by only \$20 billion, as compared with the \$63.5 billion increase in the same quarter in 1981.

While the interbank market was expanding dramatically every year, it gained a confidence which pushed aside the memory of the Herstatt crisis in 1974. Now banks are more selective over which banks they deal with. Limits are tighter and more strictly imposed.

Gunson of Euro-Latinamerican said: "There is a general decrease in liquidity. As a result there are very few banks which quote prices continually. We have learned who our friends are." Euro-Latinamerican has had to ask its shareholder banks to increase their interbank lines to it, to compensate for the cuts made by other banks.

It is important for a bank's market credibility to be seen as a provider as well as a taker. Consortium banks generally use their lines from their shareholders, which they obtain at the finest rates, to lend in the market. They fund their books from what they can raise on the interbank market.

Part of the decrease in liquidity comes from the fall in the Opec surplus. Last year Opec members were large net takers of funds, withdrawing \$18.3 billion in deposits, whereas in the past they were enormous net contributors. The switch has hit liquidity and confidence.

But what hits liquidity more is the increased selectivity in the market. While

the biggest US banks are offered more dollar deposits than ever, other banks, including consortia, have to scratch around the market for funds.

Carl Malmaeus, general manager of Toronto-Dominion Bank, said: "In practice banks deal with those banks with which they do other business. Interbank has to be risk-free because the return is so low."

As there is now a risk, banks want a good return, and they are insisting on the profitability of all interbank lending. Combined with strictly imposed balance sheet restraints, this has further reduced liquidity.

In the 1970s, spreads of 25 basis points were justified by the low risk and the high volume. With a new view of risk, volume does not appear so attractive.

Mike Rice, head of Citibank's international money markets division, said: "Profit, not growth, is the emphasis now. It is not attractive to turn money round at small spreads as before."

This pattern of higher profits, from deals with more cautiously selected banks, restricts the flow of funds.

For the big US banks, "the problem is not funding", according to Rice. He added: "People are so risk-averse that banks like Citibank are offered more deposits than ever. But we do not like taking money at a quarter under Libor to lend at Libor."

The US banks, which supplied so much of the market liquidity in the 1970s, are now constrained by return on total assets ratios.

Some US banks deny that these ratios have caused them to refuse deposits. In the secretive interbank market it is difficult to discern what is happening. But, according to the head of one US bank's treasury ▶

THE INTERBANK MARKET

section, the ratios are biting. "Increasingly you see banks trying to raise their fee income from bond, CD, and forex trading. If they can increase the income side of the ratio, they can then take on more assets. It is one of the giveaway signs." Last year US banks supplied 45% of the net increase in funds — \$38.3 billion out of \$85 billion, according to the Bank of International Settlements. In 1981 they supplied only 29% of the net increase, but the amount was greater — \$47.7 billion in 1981, or \$9.4 billion more than in 1982. Direct deposits have become more important, as US corporations have recognized the higher yields available in the Euromarket. US banks have also encouraged rich individuals to deposit with their London subsidiaries for the same reason. These are more stable sources of funds and are cheaper than the wholesale market.

On the wholesale Euromarket the cheapest funds available are Eurodollar CDs. It is a US-dominated market. Over 60% of the CDs outstanding in March this year were issued by US banks, according to Bank of England figures. Most of these were issued by eight US banks at as much as 75 basis points under interbank rates, the lowest available in the market. And the CDs of these banks make up 70 to 80% of those actively traded in the secondary market. The marketmakers are US investment banks and the buyers US investors — corporations, pension funds, money market funds, states and municipalities.

These CDs are issued by a select club called the run, which enables those on it to issue CDs at the lowest rates. Once a bank is a member of this informal and unregulated club, its CDs are always issued and traded at the best rate. The club's CDs carry the same risk and investors buy them on a no-names basis. The run used to include nine banks, but Continental Illinois removed itself in July 1982 after its involvement with Penn Square was made public.

For the banks on the run the liquidity of their issues is as important as the volume. This was undermined at the height of the debt crisis last year. Investors, who see CDs as one of the most liquid ways to invest money, began to fear for the acceptability of CDs. As these investors, and the traders of on-the-run CDs, are mainly from the US, the lack of confidence in some US banks was a reflection of the feeling inside the US. That confidence seems now to have been largely restored, and, with it, the liquidity of the market.

The largest US banks also virtually monopolize the next cheapest source of funds, deposits by US regional banks. Early afternoon, London time, when the regional US banks enter the market, is often the busiest part of the day.

This part of the interbank market is as secretive as the rest. But it is clear that regional banks are becoming more selective over where they place their deposits. Some

now prefer the large regional banks from their own areas to the money centre banks. One broker said: "The regionals are more careful, but the market is calm."

Outside the Euromarket, US banks and a select number of European banks, which have the best rating from Standard and Poors and Moodys, obtain their funds by issuing bankers' acceptances and commercial paper in New York. Both are, at least in theory, trade related. They are a cheap source of funds, but an insignificant slice of the market. The Securities and Exchange Commission sets a limit on the amount of commercial paper a bank is permitted to have outstanding. NatWest's limit, for example, is \$1.5 billion. The average life is 50 to 70 days, with a maximum of 270.

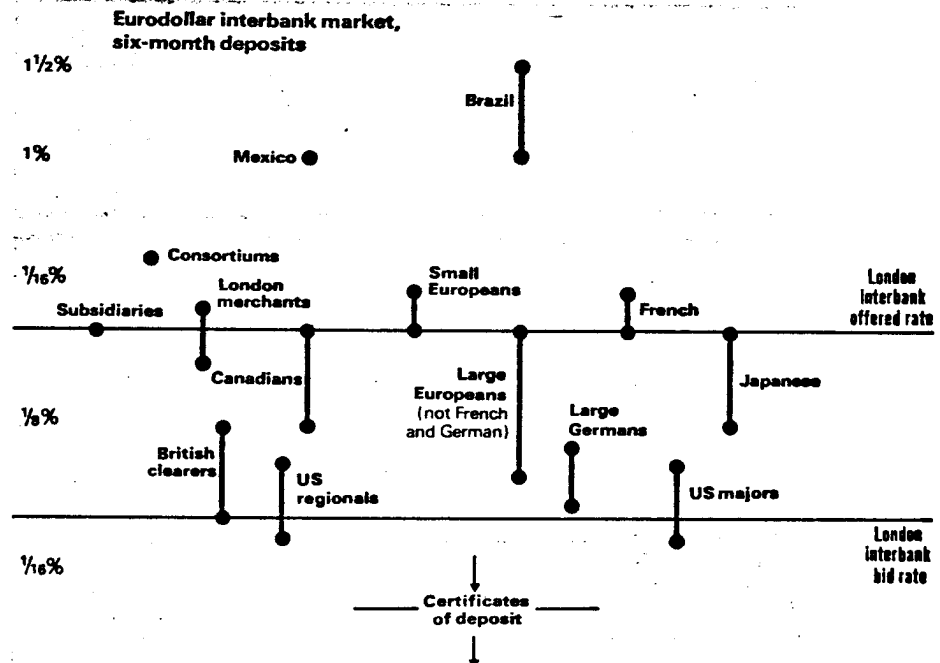
For most international banks the shape

of the Eurodollar interbank market is all-important. French banks make great use of floating rate notes and Japanese banks favour floating rate CDs, because of Ministry of Finance requirements. But it is the interbank market which provides both with immediate access to funds.

One US bank treasurer suggested that the full consequences of the changes in the market had not yet been seen. "If the pattern continues, the top US banks will break away from the rest of the market and automatically obtain rates well under interbank."

At the other end of the market, Brazil is already paying 1% to 1½% over interbank. Perhaps the change in the shape of the interbank market has only just begun.

The Rates Banks Bid for Funds



This diagram is a guide to the shape of the interbank market. When the market is illiquid, even US regional banks could be forced to pay the offered rate. When it is highly liquid, French banks obtain the bid side of the market. Each transaction is an individual agreement between the bank offering the funds and the one taking them. This diagram shows the underlying positions of the groups of banks in the market.

US majors. These are rarely takers in interbank. If they require wholesale funds they prefer issuing certificates of deposit because they are a cheaper source of funds.

Large Europeans. Of these, the big German banks command the best rates, often at the bid rate of the market.

French. These tend to move the market rate because of the size of their trades.

US regionals. These hardly ever bid for funds. If they do, it is through brokers and they get the best rates.

Japanese. The trust companies pay the highest rates. For big trades even the best names pay the top rates, near the offered rate.

Canadians. Much the same as the big Japanese banks. They pay near the offered rate for size.

Brazilian. These rarely raise funds through brokers. They have to rely on their direct relationships

Country Risk

You're the best judge of foreign risks

*A guide to the best techniques
for managing your
international exposure
without having to rely
on outside experts*

Pravin Banker

When the world returned from the almost unbelievable economic stability that characterized the 1950s and early 1960s to the more normal instability of the 1970s, many international companies and the managers who ran them were hit hard. They had grown their businesses in a hot-house environment and all of a sudden saw their well-cultivated gardens flattened with monsoon-like ferocity.

This turn of events brought into vogue the idea that executives should make risk management part of their international strategy. Despite the prominence of exposure management, many companies still lack sophisticated strategies for coping with the unpredictable environments they face in international markets. In this article, a financial expert gives readers the benefit of his years of international experience. His practical guide to exposure techniques shows where many that are considered sacred fall down and where more innovative methods might do a better job.

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Photographs courtesy of E.P. Jones and Ivan Massar.

In today's world, it is safe to say that nothing is sacrosanct. The France of d'Estaing, Pompidou, and de Gaulle can quickly become the France of Mitterrand. Even the once hallowed doctrine of sovereign risk, under which commercial banks lent to countries like Poland at rates equal to the prime plus one-half of 1% because it was considered unthinkable that a communist regime, with its inbuilt power of perpetual control, could ever default, is now in disrepute. As a consequence, nothing is more important to maintaining the profitability of international companies than the successful management of exposure to political, economic, and financial risk.

Taking risks is, of course, a part of any business. Because of the larger number of unknown factors, however, international business has always entailed greater risk than domestic enterprise. But many companies have only recently come to realize that the degree of risk to which they are exposed is growing just as fast as the complexity of doing daily business.

Despite years of experience, most have developed no precise guidelines for managing their exposure to this risk. Many companies simply rely on techniques they have always used. They don't factor in much of their own experience. Often they assume that outside organizations can provide secret formulas or cookbook solutions. Managers turn too often, for example, to standardized risk ratings for quick solutions to the problem of matching countries with investment or operating plans, but these ratings do not include the sophisticated detail necessary for success. All countries have some element of risk as well as some potential to produce profits. The difference is in the degree of risk.

Outside organizations and indices can at best provide basic information, but the manager must know how to use it in light of his or her own experience. Remember that the track record of con-

sulting and rating organizations is not good. The best illustration I have comes from my recent experience with the Mexican devaluation. At the beginning of 1982, I polled 11 experts for their opinions. Most of them believed the Portillo-Kolbeck assurances that the peso would be devalued by merely 18%. Only one correctly predicted the actual extent of the devaluation (50%, on February 17, 1982).

To determine the degree of risk a company can stand and yet sustain its profitability, a manager must understand the risk factors of the countries in which the company operates and develop techniques to handle each one. For its part, the company must create a focal point clearly charged with the responsibility of protecting its worldwide investment and profitability. The world is full of narrow windows of opportunity requiring quick entry; it does not suffer plodding bureaucracy. Responsibility must stay in-house. The involvement of senior line executives is critical, for without it, even the most brilliant plan can fail in execution.

The following discussion, drawn from my experience with international business, serves as a guide to the various techniques needed to successfully implement a strategy to soften political, economic, and financial risks.

Handling political & economic risks

Because they are not as precise, the techniques developed to deal with political and economic risks are more difficult to apply than those dealing with financial risks. Managers should use them sparingly and only after identifying the potential for misapplication.

Concession agreements. Prior to making new commitments or adding to existing ones, companies (particularly in extractive industries) often reach agreements with host governments either through written legislation or through verbal understanding. Such concession agreements define the rules under which multinationals can do business in local environments. Usually they include the concessions the government grants in the form of royalties, market share, tax incentives, tariff protection, and pricing flexibility. Historically, multinationals investing in less developed countries (LDCs) have favored such agreements. But history has also shown that the developed countries, with their tradition of orderly governmental change, are more likely to honor them. In LDCs, the risk of their emasculation or outright repudiation is high.

Insurance. Most industrialized countries offer political risk insurance for MNCs' investment in certain countries. The U.S. Overseas Private Insurance Corporation, for example, offers coverage against expropriation, war, revolution, insurrection, and blocked currency. This coverage is narrow, however, and useful only in extreme cases like the expropriation of assets by North Vietnam after the fall of Saigon.

A more sophisticated kind of insurance used in an LDC is the currency swap agreement. With a central bank (often through a commercial bank intermediary) a company signs a contract whereby, for a fee, the central bank guarantees the future convertibility of a foreign currency investment at a fixed exchange rate. Swap contracts usually apply to foreign loans. Instead of making direct capital investment, multinationals therefore often offer subsidiaries "parent company" loans denominated in foreign currencies, which are then covered by swaps.

Funneling the parent company loan through a commercial bank intermediary (via a participation agreement) enhances protection and flexibility. One note of caution: if the country issues too many swap agreements, it may not be possible for the central bank to honor them on maturity. This is the dilemma confronting Argentina, which has more than \$5 billion in such agreements maturing within six months.

Organization & structure. MNCs are complex organizations that may make machine parts in Brazil, assemble them as engines in Germany, install the engines in bodies in Italy, and ship completed cars to the United States for sale. The manufacture of a single finished product may depend on three manufacturing plants located in three countries, and sales may depend on a fourth.

Companies have fostered this strategy of "dependency" to neutralize the political risks of operating in one country. But economic risks grow with such dependency—a company agreeing to export a certain product volume in a concession agreement can get in trouble if demand in the country of sale falls and an alternative market is not available. The country in which a part is produced may be unreceptive to cutbacks due to falling demand. Instead, the multinational must often maintain full production and yet honor the country's export commitments.

A recent innovation, called an export enhancement program, attempts to address this problem. Host countries will allow the international companies to export less than the amount specified in their export contract if they will make up the shortfall by exporting other companies' products. MNCs have responded by exporting coffee from Honduras, crude oil and petroleum derivatives from Iran, machine tools from Brazil, and cacao from Ecuador.

A multinational does not have to scatter its product manufacture to neutralize risk.

A LIST OF CURRENCY TECHNIQUES

- 1
Hedging:
Make currency swap arrangements, and negotiate forward cover.
- 2
Remittances:
Use leads and lags.
- 3
Capital structure:
Remit surplus or convert to a parent company loan or a bank participation agreement.
- 4
Pricing:
Use anticipatory pricing at the retail level; charge a manufacturing transfer pricing premium.
- 5
Liabilities:
Minimize strong currencies and maximize weak ones by prepaying strong currency liabilities, converting them to weak currency loans, and demanding confirmed letters of credit for strong currency imports.
- 6
Assets:
Maximize strong currencies and minimize weak ones by floating external (strong currency) bonds and by making parallel market currency purchases and cross-currency, cross-company loans as well as local exchange-indexed intercompany loans, preferably with bank guarantees.
- 7
Accounts receivable:
Tighten collection procedures to transfer exchange risk to local finance companies by factoring local currency receivables.
- 8
Contracts:
Bill in strong currencies (most commonly dollars); use a price escalation clause to take care of large devaluations, an index clause for accounts receivable, and a force majeure clause for protection against large devaluations.
- 9
Blocked currencies:
Two methods. One, choose a blocked funds country as a site for an international convention or seminar and use local funds for expenses, including air tickets. Two, set up a barter arrangement whereby marketable goods are exported in lieu of a dividend, royalty, licensing fee, or other service; an offshore agent will handle the details and convert the goods to cash dollars for a fee.

Foreign risks

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Developing its worldwide marketing and distribution capability and control of transport facilities is just as effective. Because they cross borders, they are fairly safe from government action.

During the political turmoil between Zambia and the then white-minority-controlled Rhodesia, an uneasy economic alliance continued because Zambia depended on the Rhodesian railroad to transport its principal commodity (copper) to the sea and European markets. The sacrosanct railroad enjoyed long tranquility during the guerrilla wars.

Proprietary protection. Patent and trademark protection is the most common proprietary technique used in exposure management. Another method, commonly used by pharmaceutical companies, is to locate research and development facilities in the home country. Today many countries oppose both techniques. Mexico, for example, forces companies to use trademarks that are geared to its culture and sold to local interests. India has introduced price controls on drugs and mandated the dilution of equity in foreign subsidiaries through its restrictive Foreign Equity Regulation Act. Canada, Australia, Brazil, and Mexico all require companies to transfer technology if they wish to keep their access to these countries' markets.

In light of these trends, companies that are dependent on proprietary protection should consider developing other kinds of protection.

Phaseout. During the Allende years in Chile, the self-liquidation, or planned divestiture, of a potentially risky investment became popular. As an objective, however, it is very difficult to guarantee. Companies have chosen two ways to accomplish it. The preferred approach is to structure the investment with a minimum of capital and a maximum of loans. Loans should come first from local government sources (incentive loans), second from international bodies, third from banks (preferably local), and last from parent companies. The loans should be short-term rollovers to limit investment risks. True, the loans constitute leverage, but they transfer some of the risk to the shoulders of organizations that are influential enough to ensure companies' continued economic well-being.

Companies can extend this technique by tapping local marketing outlets for advances or loans that can eventually be converted to local equity ownership. I remember a scene during the anti-American riots in Istanbul more than a decade ago when troops were posted in front of the Istanbul Hilton, where management had hung out a large sign clearly stating "Turkish ownership." Conrad Hilton had always stressed local ownership and invested not one nickel in his hotels abroad. His profits came through lucrative management and service contracts.

Another phaseout approach is to sell a majority investment to local shareholders—for the

future. The uncertainty of price and local investor availability make this approach more difficult to take, MNCs discovered in Malaysia when they were forced to sell equity to "Bumiputra" (indigenous investors). A company takes a chance when it agrees to negotiate a price in advance; governments have been known to renege. Even the much-vaunted shah of Iran revoked a contract to supply oil to India at a fixed price when the price of oil skyrocketed.

Risk premium in profitability. As part of the evaluation of a potential investment in a country, managers often calculate how much more the investment must return on capital in comparison with a similar investment in its home country. The difference is called the risk premium.

Take, for example, an investment in a country with a low level of political risk at 1% (on a scale where Switzerland's risk is zero and Iran's or Zaire's 100%) but with an economic risk of a periodic (say, five-year) boom-and-bust cycle that translates into one exceptionally bad year out of five as well as a 40% risk of devaluation.

First, we calculate the return on invested capital (ROIC) that a top multinational normally requires: $ROIC = \text{interest} + \text{business risk} = 18\% + 12\% = 30\%$. Then we use this ROIC to see what the ROIC for that country is: $\text{country ROIC} = \text{company ROIC} + \text{political risk} \times \text{economic risk} \times \text{devaluation risk} = (30\% + 1\%) 1.2 \times 1.4 = 52\%$. To be equal to an opportunity for that multinational in its home country, the investment in this country would have to command a 52% ROIC before taxes.

This kind of premium is, of course, hefty and difficult to realize in a competitive environment. Moreover, its calculation is based on the most subjective of assessments. Sophisticated companies therefore often factor political and economic risks into the profitability of their operations and relegate the responsibility for devaluation or financial risk to a currency exposure management team. Their objective is to neutralize currency loss and maintain profitability in constant currency.

Can you be ready for everything?

Beyond these techniques, corporate strategy dictates that most companies be in business in host countries for the long run and live within the political and economic rules they set. During periods of prosperity, companies build up protected reserves. When adversity strikes, they reassess, reorient, restructure, and even retrench, but they don't immediately divest. It is possible to weather most storms.

Companies should of course be alert to the possibility that the adverse condition is permanent

and requires action. A simple illustration is Costa Rica. Stable for decades with the only democratic government in Central America, the economy of Costa Rica suddenly became turbulent in 1980. Its government unpegged the currency from its official mooring of 8.6 colones to the dollar in September 1980; the colon reached a level of 14 by year-end. Throughout 1981, the president and the legislature remained deadlocked on plans to redress the deteriorating economic situation.

Costa Rica's supreme court interceded in mid-1981 with a decision that the floating rate, which by that time was up to 40 colones to the dollar, was illegal. Ignoring the court decision, customs continued to impose duties calculated at the free rate, while the central bank offered dollars only at the free rate. The government reneged on its 1980 vow to settle dollar liabilities incurred prior to the colon float at the official rate. It offered government bonds to cover dividend remittances. High dollar interest rates and fear of Nicaraguan encroachment triggered flight of capital from the country—in short, economic conditions became chaotic.

The situation turned into a nightmare. Imports were payable at the free rate, but companies could collect dollar billings only at the official rate. Companies had to limit price increases because of contractual obligations or because customers simply would not pay. The outlook for government payables, receivables, and even tariffs was riddled with uncertainty. The only alternative to ceasing business entirely was surgery.

Many international companies would say that the speed with which events unraveled in Costa Rica prevented them from being forewarned and thus, forearmed. But I have found that an alert company can be ready for abrupt changes and have in hand a number of ways to deal with crisis. Because financial risk is the most common operational risk encountered, the company that arms itself with sophisticated techniques to counter financial risk can protect its long-term profitability.

The complexity of financial risk

It has become fashionable to play down the importance of finance to the success of international companies, but this attitude is as shortsighted as that which gave finance undue importance in the first place. Unlike political and economic risk, which hits companies haphazardly, financial risk presents almost daily difficulties.

In a financial market like the United States, the availability of capital is large, the flexibility of vehicles through which companies can find that capital is considerable, the costs competitive, and long-term stability almost ensured in the hands of a responsible institution. When a company leaves this country, however, the picture changes dramatically. While it is not possible within the context of this article to examine all the variations in each environment, you can learn a lot from looking at one typical problem and the techniques used to solve it.

The Peruvian headache

At the beginning of 1980, the environment in Peru changed—for the better, it seemed. A long period of socialist military rule gave way to an elected civilian government. Anxious to encourage foreign investment, implement the International Monetary Fund's recommendations, and secure the IMF payments credit facility, the government refinanced its external debt and modified the onerous provisions of Decision 24 of the Andean Common Market (ANCOM).

The trade balance had turned positive, and estimates of the potential surplus ran as high as \$1.4 billion—quite a remarkable change from the flirtation in 1978 with bankruptcy.

The total financing requirement of one U.S. multinational's Peruvian subsidiary was around \$12 million, about \$5 million of which was long term. The local financing environment the subsidiary faced had:

- ☐ Limited local currency available for primary customers. Five local banks could provide \$6 million at an interest rate of 4% per month, but it was available for a maximum term of six months with one six-month rollover guarantee. ANCOM's rules forbade multinationals to borrow long term.

- ☐ The prospect of a minidevaluation of 30% annually, bringing the effective costs of local loans to about 23% annually (interest at maturity).

- ☐ Local dollar loans with no limit but a maximum of 180 days and an interest rate of New York prime plus 4%.

- ☐ Offshore loans at the London interbank rate (LIBOR) plus 1/2% but with a 25% mandatory deposit required without interest. The central bank granted exceptions for capital equipment loans whose terms exceeded three years.

- ☐ Financing tax payments for 90 days at the nominal interest rate of 12%. Because the subsidiary had a \$2 million tax bill to pay in March, this was an obvious

After some debate, the company decided to maximize its local loans to obtain dollar loans. While the 23% net cost (including devaluation) was 7% higher than the 16% offshore loan cost, the company decided that this premium counted as insurance against a larger-than-forecasted devaluation. The subsidiary would not take out local dollar loans because of their expense and would use them only as a contingency buffer. Finally, the subsidiary turned to offshore dollar loans of \$5 million but wanted to avoid making the expensive mandatory deposit.

To do this, the subsidiary had to approach the Peruvian Central Bank (through a local bank) to determine the conditions under which it would grant an exception to the mandatory deposit requirement. The central bank stipulated that the loan term had to be three years and that the company had to pay a preferential interest rate no higher than what the country commanded in its international borrowing. (This rate was subsequently defined as LIBOR.)

Research turned up three alternatives—a commercial bank loan at LIBOR that would absorb the 10% withholding tax and the differential compensation paid to the bank by the parent company; a direct parent company loan at LIBOR with the parent company borrowing in the United States or Europe; and a bank participation loan at LIBOR with a 1/8% bank fee to be paid by the parent. The bank participation loan was attractive because it gave the parent anonymity at a nominal 1/8% cost and was more likely to gain the approval of the central bank as an external bank loan at LIBOR. It was also added insurance if the country's conditions ever changed for the worse since such a loan would be unlikely to be part of a debt moratorium.

Moreover, both the direct parent company and the bank participation loans offered U.S. tax advantages. By providing foreign-sourced income, they allowed the parent to use up any excess foreign tax credit. For example, \$5 million at 16% loaned to the subsidiary and borrowed at 13.5% by the parent would have an annual net benefit before taxes of \$125,000 or \$67,000 after taxes. For this company an annual foreign source income of \$800,000 gave a potential after-tax benefit of \$324,000.

The currency blues

MNCs must consider two kinds of factors in managing their currency exposure—reporting and operational. The reporting requirement is governed by the U.S. Financial Accounting Standards Board (FASB) Statement 8. Under this standard, a com-

pany must translate its balance sheet at the current exchange rate and charge to the profit and loss statement any net gain or loss resulting from asset-liability translation. Fixed assets are carried at historical exchange rates and excluded from the translation process. For reporting purposes, therefore, the key focal point is net exposed assets. From an operational viewpoint, however, the focus is the transaction itself, regardless of either time factors or other assets and liabilities.

Most international companies restrict their concern about managing currency exposure to satisfying the FASB's reporting requirements. Their strategy is meant to manage the balance sheet (operational hedging) to a zero net exposed asset position. Neither a revaluation nor a devaluation would cause any sudden exchange impact on the balance sheet. Other companies focus on daily transactions and hedge the impact of foreign exchange through currency swap arrangements or the purchase of forward cover (financial hedging).

With the assumption that these two considerations run at cross-purposes, companies have debated which kind of strategy is most important. Opponents of FASB 8 contend that the reporting requirement penalizes current-year profitability by treating unrealized gains or losses as if they were real and thereby distorts the profit and loss statement. Executives are driven to make "reporting" decisions rather than sound "financial" decisions in multicurrency environments.

The debate led to FASB 52, which differs in two ways from FASB 8. It provides some flexibility by introducing the concept of "functional currency." Company management may now decide whether the currency in which major decisions are made is the local currency or the dollar. FASB 52 also permits the establishment of a special account on the balance sheet through which translation gains and losses can be directly charged against the surplus without first being reflected in the P&L statement. Companies that choose the local currency as their functional currency can follow this route. They must, however, translate all assets (including fixed) and liabilities. For companies whose functional currency is the dollar, the provisions of FASB 8 still apply.

One important consideration should not be overlooked. The relief FASB 52 provides pertains only to balance sheet gains or losses. The larger impact of revenue translation on profits remains. In fact, an increasing number of consultants have advised their corporate clients to hedge net aftertax earnings through a combination of operational and financial techniques. The recent increased exchange rate volatility and the rapidly declining accuracy of exchange rate forecasts are probably responsible for the increasing inclination of companies to listen.

Putting out operational fires

International managers have developed a number of solutions for currency problems. Most of these techniques are familiar (for a complete rundown see the ruled insert). Stemming from the kind of complex trading transactions and intercompany transfer mechanisms companies have developed to get around roadblocks like those put up by the Peruvian government in the example, these techniques have many pitfalls managers should avoid. Because they have been developed in a haphazard, mostly ad hoc fashion, they need to be monitored carefully and controlled rigorously.

Local currency loans and hedging techniques, for example, generally carry premium costs in weak currencies. Many companies operate entirely with this kind of local loan and include the premium with the product or service. For those that cannot and must use strong currency loans—either because of cost or local banking restrictions—managers must religiously follow the probability and timing of currency changes.

Strong currency loans carry additional difficulties. Many countries with exchange controls designate minimum periods for foreign loans. While such controls appear to constrain a manager's freedom of movement in minimizing strong currency liabilities when the company has excess cash, they do not necessarily do so. The central bank is the point of control in a country and, as the Peruvian example illustrates, having a dialogue with the central bank on important points is often possible. In my experience, the key people in these institutions have been intelligent, knowledgeable, and pragmatic.

In one instance, we persuaded the central bank to permit a dollar loan "repass." This method allowed term loans of five to seven years to be repaid in two or three years, without a change in the country's balance of payments. With the assistance of Chase Manhattan Bank, we located a large Brazilian company with financing needs. With the permission of the central bank, the subsidiary paid the Brazilian company the cruzeiro equivalent of \$30 million. The creditor bank changed the original loan agreement and replaced the name of the MNC subsidiary debtor with that of the Brazilian company. All other terms and conditions remained unchanged. The central bank transferred the future right to obtain foreign exchange to the Brazilian company, which in turn, compensated Chase Manhattan and the creditor bank for services, change in creditworthiness, and change in interest rates with a front-end lump sum payment in cruzeiros. The loan was "repassed" without currency having to cross borders or affect the balance of payments.

To minimize currency impact, a company should quote the export price of a manufactured product in the currency of manufacture. One important exception: if the import content of the exported product is large and the import currency stronger than the export currency, the company may wish to reverse the currency of export billing. For example, a French plant importing from the Netherlands and exporting to Germany may wish to bill in deutsche marks.

Many export houses also hedge their sales through forward cover for six to nine months and factor the hedge premium into the export price.

Parallel market is a "semilegal" exchange market in a country with exchange control operating outside the venue of a central bank. In many of the smaller countries, such as Bolivia, Paraguay, and the Dominican Republic, it is the multinational's only source of foreign exchange. In others, such as Brazil and the Philippines, it is an alternate source for certain purposes.

Most managers are familiar with the technique of making intercompany loans at preferential interest rates with guarantees of the exchange rate. But companies should be open to variations on this theme. Two companies, for instance, had excess cash in El Salvador. Because of restrictions, they were unable to remit this cash in the form of dividends to the parent company. Both Company A and Company B, however, had subsidiaries in Guatemala. Company A loaned \$2 million excess cash to Company B's subsidiary in Guatemala, while Company B loaned \$2 million to Company A's Guatemalan subsidiary. The funds were then remitted to the United States from Guatemala.

If a devaluation occurs, the exchange losses suffered by the El Salvadoran subsidiaries of A and B are offset on consolidated books by corresponding gains in Guatemala. In this case, while regulations restricted dividend remittances to 10% of registered foreign investment in El Salvador, no such restrictions applied to loans. In order to ensure the approval of the central bank, however, the companies decided to lend to each other's subsidiaries. They chose the subsidiaries located in Guatemala because its government had good relations with the El Salvadoran junta and had imposed no restrictions on dividend remittances.

While dollar billing provides protection in many weak currency countries for the international airlines, oil companies, and aircraft companies, most other companies must bill in local currency. These companies must offset the impact of currency on profitability by anticipating price increases. In countries where the rate of currency adjustment is severe, companies can run into severe collection problems with dollar billings. One method that can help is financing through a third party like a commercial bank. Debtor

third party is a commercial bank but quite happy to delay or refuse payment to a supplier.

Anticipating currency changes

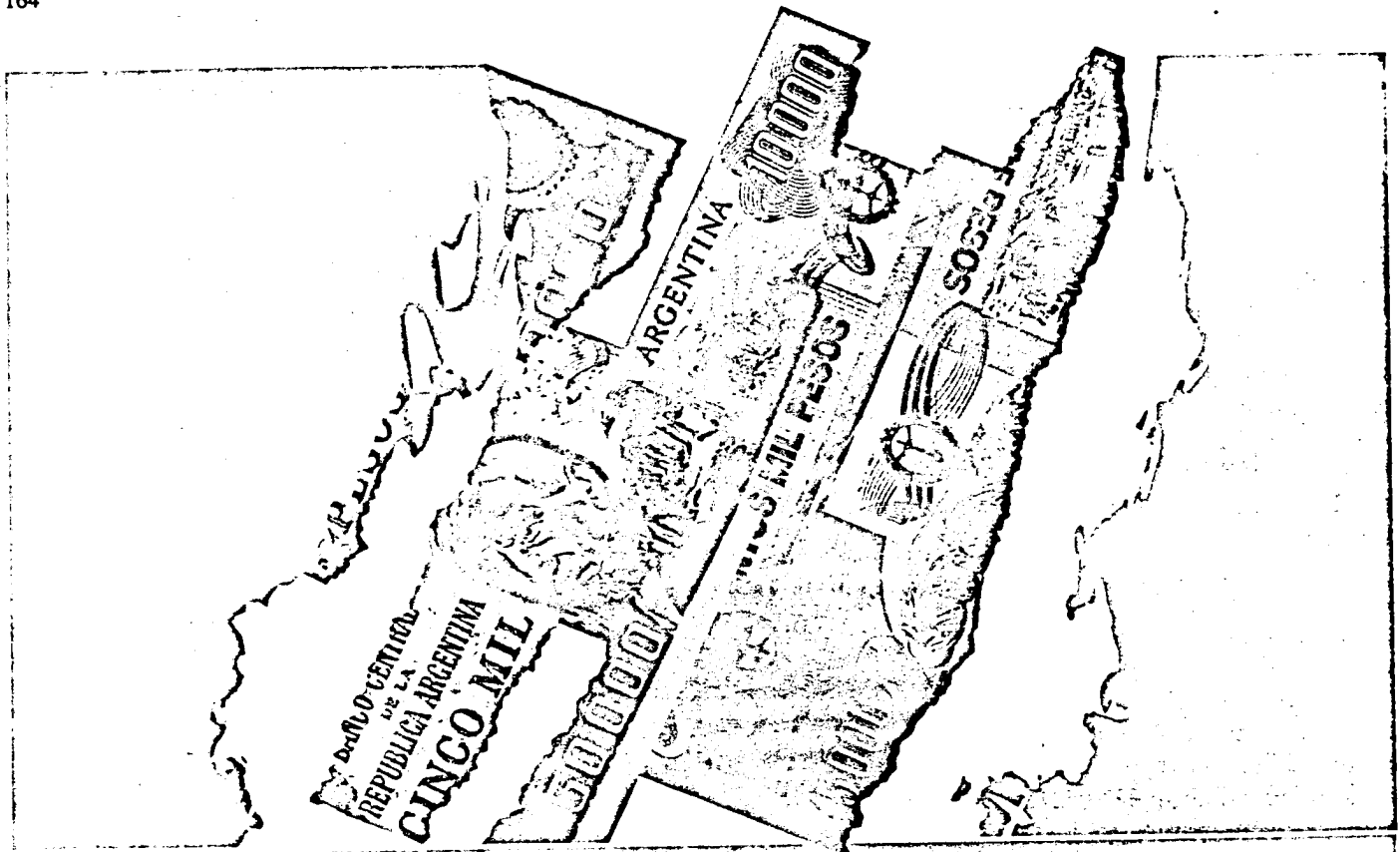
The amount of a currency change is important, but its timing is critical. Deducing that a country must change the value of its currency on the international market is easy; economists forecast devaluation as a matter of course. Their formula is very simple. Over time, a country must adjust its currency to take into account the difference between its own inflation rate and the trade-weighted average rate of its trading partners. The term *over time* holds the key. Because each country responds according to different criteria, it could mean one, two, five, or ten years, or perhaps never. Brazil adjusts regularly; Argentina substantially every five years; Venezuela hardly ever. France, under the Gaullists, absorbed inflation rate differentials and quite comfortably maintained a stable franc.

Predictions of amount are rarely fulfilled. The extent of the two-year decline in several key currencies vis-à-vis the U.S. dollar was beyond the imagination of economists. The Argentine peso declined 2,500%, the Mexican peso 600%, and the French franc and the Spanish peseta more than 50%.

Companies should look at five factors to try to understand the difference in each country's approach to currency change. They are instrumental in determining both its potential and its size:

Balance of trade. Economists focus on the difference in inflation rates because they assume that a disparity in labor rates creates an imbalance in the trade position over time; a prudent country will change its currency to adjust. There are two weaknesses in this assumption, however. First, very few countries are prudent. Second, a country's trade balance may depend on a high-yield product such as oil or gold; the labor rate is irrelevant. This is Venezuela's secret.

A country's reserve position. The International Monetary Fund requires that member nations report each month on their reserves of gold, special drawing rights, fund reserve positions, and foreign exchanges. *International Financial Statistics*, the monthly publication of the IMF, gives clues to the health of a currency based on the trend in a country's reserves. Delayed reporting is an even better clue. Argentina was four to five months behind in early 1981, and Mexico as much as eight months. Rather



Argentina: Economic Statistics
1975-1980 (in millions of pesos)

		1975	1976	1977	1978	1979	1980
Percentage of increase or decrease	Gross national product	(1 %)	(3 %)	4 %	(4 %)	12 %	1 %
	Cost of living	182	443	176	175	160	101
	Gap* (cumulative increase, adjusted for devaluation)	0	14	35	108	199	331
	Devaluation	510	351	117	68	61	23
Exchange rate at year end pesos per dollar		61	275	598	1,004	1,619	1,993
Foreign exchange in billions of dollars	Imports	\$3.6	\$2.8	\$3.8	\$3.5	\$6.0	\$9.4
	Exports	3.0	3.9	5.6	6.4	7.8	8.0
	Trade	(0.6)	1.1	1.8	2.9	1.8	(1.4)
	Services	(0.7)	(0.5)	(0.5)	(1.1)	(2.2)	(3.4)
	Current account	(1.3)	0.6	1.3	1.8	(0.4)	(4.8)
	Reserves	0.3	1.4	3.2	5.0	9.4	6.7
Import cover months for goods and services	External debt			7	11	19	25
		1	4	7	10	11	5
Gap calculation	Argentina's cost of living index (Arg. COL)	100	543	1,500	4,131	10,721	21,524
	United States' cost of living index (U.S. COL)	100	106	113	121	135	153
	Exchange index (EXCH)	100	451	980	1,645	2,654	3,267

*Gap (expressed as a percentage) = $100 \left(\frac{\text{Arg. COL}}{\text{U.S. COL} \times \text{EXCH}} \right) - 1.0 \times 100$

than risk releasing damaging information to the public domain, these countries withheld data.

Note that the countries' reserve positions, as stated by the IMF, may not all be liquid, since they include such things as receivables from other countries. Thus, a reported \$2 billion reserve may actually contain a zero cash foreign currency position.

External debt. The larger the external debt, the bigger the drain on the current account and the greater the country's vulnerability to interest rate changes and debt rollover. Peru's massive devaluations in 1978 were due to its inability to roll over maturing debt; the banking syndicates were unwilling to allow rollovers without IMF participation. The composition of the external debt is also important. If a significant percentage is short term, then the risk is high. As it entered 1981, Argentina had an external debt of about \$27 billion, of which reportedly more than 50% was coming due in 1981.

Interest rates. Differences in interest rates influence the movement of short-term money. Even in countries with tight exchange controls, the attractiveness of high yields, particularly in strong currencies such as the dollar, influences money to cross borders—surreptitiously, if not legally.

Politics. In most countries, politics is the most important of these five factors. In Japan domestic politics argue for weakening the yen; in France for defending the franc. In Venezuela a politically vulnerable president would rather deplete his country's oil fund than follow his central bank's advice and devalue the currency. Often, as in Argentina, Mexico, and Ecuador, politicians allow their currencies to sink only when reserves are finally exhausted.

Politics also plays a key role in investors' confidence. The election of Mitterrand in France could have been anticipated. In fact, many French companies hedged against this possibility. Given the image of the 1950s that most French citizens conjured up, the subsequent run on the reserves and the decline of the franc was certain. Even at seven or more francs to the dollar, this decline may not have yet run its course.

Keep a sharp watch for the "catalyst" for timing currency changes. In France, the catalyst was the election of Mitterrand. In Mexico, it was the oil glut and the disastrous residual impact of the mid-1981 confrontation with the oil buyers. In Argentina, it was the pending nomination as economy minister of Lorenzo Sigaut, who had very different ideas about devaluation than his predecessor, Alfredo Martinez de Hoz. The election of socialists in Sweden and Spain guaranteed

the peseta. Stimulation of exports even at the risk of a "beggar thy neighbor" policy was part of their electoral platforms and known well in advance.

Devaluation expectations are high for Venezuela and Brazil. In Venezuela the catalyst for change could be the near depletion of the oil fund or the presidential election, whichever comes first. In Brazil it could be the cumulative reluctance of foreign banks to participate in loan syndications and the need for a forced IMF rule.

I correctly anticipated the 1981 currency change in Argentina. On the political front, I knew that the next president, General Viola, would take office on March 31, 1981 and bring with him a new economy minister. It was uncertain what the minister's posture would be. Looking at the country's vital economic statistics (see the *Exhibit*), I saw that the country had already had minidevaluations of the currency amounting to 3% each month. The statistics for 1980 bore striking similarities to those for 1975. Both included negative balances of trade, declining reserves, and large current account deficits.

I calculated the inflation rate differential (the gap calculation) according to the formula in the ruled insert and monitored an increasing gap between the two countries. In fact, the cumulative gap was extremely wide and led me to conclude that the probability of a maxidevaluation was very high. It would be timed to anticipate the inauguration of the new president. As it turned out, my estimate of the timing was perfect. The first maxidevaluation of 10% took place in February, followed soon after by a 30% devaluation in April and a panic run on the peso.

Carrying greater risks but with them the potential for big rewards, the world of tomorrow promises to be far more volatile than that of yesterday. The world outside these United States is not a monolith. Each country is different and the spectrum wide, ranging from the traditional safe haven of a Switzerland to the turbulence of an Argentina.

To be successful, it is important to understand each environment and the risks involved. A thorough understanding of them, coupled with your knowledge of your own business, could help you develop an exposure management strategy that would mitigate risk, protect your investment, and maximize the rewards.

I have discussed many techniques that can serve as a basis for the development of a strategy. Once you have begun it, you will discover that many more techniques are developed and rediscovered each day. The process is a continual one, the horizon limitless. ☺

ASIAN BANKING/INDONESIA

HOW BIG A RISK IS INDONESIA?

Even its tough policies can't cope with a \$7 billion deficit. That's why Indonesia will be back to the markets soon.
By Donal Curtin

"Indonesia is not another Mexico," said the first foreign banker. "They have a very good economic team who have done a good job, and as long as there are no recession problems in the major economies Indonesia will pull through. They have been cutting back development programmes, they devalued the currency, and they have a borrowing capability that people are not generally aware of."

"If nothing had happened this country would have been in trouble," said the second foreign banker. "The fall in the oil price hit them badly, and they could have made the classic mistake of trying to continue spending rather than face the alternative. But they were real gutsy. They devalued, they rephased projects — precisely what they had to do. They have their troubles; who hasn't? But they are doing the right things."

"The world economy is down, world trade is down, and there are winners and losers because of that," said the third foreign banker. "Indonesia is not a loser."

Jakarta has a small foreign banking community, and these remarks are typical of the mood of guarded optimism among them. When Indonesia devalued the rupiah by 27.5% against the dollar on March 30, and followed up with what the Indonesians call a "rephasing", or indefinite delay, of major development projects, most observers reckoned that enough had been done to tackle the country's widening balance of payments deficit.

At the beginning of the year, on highly optimistic assumptions, the Indonesian budget for fiscal 1983 (the year from April 1983) predicted a current account shortfall of \$6.2 billion. In fact, on more realistic views the gap was heading for between \$8 and \$10 billion. The gap for fiscal 1982 was \$6.8 billion.

"These days, after the policy steps, an optimistic forecast of the balance of payments deficit would be between \$5 and \$5.5 billion, and a more realistic estimate would be between \$6 and \$6.5 billion," according to an economist with a foreign embassy in Jakarta. "From what visiting bankers tell me, a deficit around \$6 billion is financeable."

"We think the current account will be not much different from the \$6.2 billion deficit projected in the budget," said a government economist. "Oil income has gone down since that projection was made, but the policy adjustments bring the deficit back to that level."

The World Bank's annual report on Indonesia, which was presented to the government at the end of May, makes similar predictions. It expects a current account deficit of \$6.5 billion in fiscal 1983, falling to \$4 billion in fiscal 1984 and to \$3 billion in fiscal 1985.

The government's tough decisions on devaluation, slower development, a continuing freeze on public sector pay, lower subsidies — domestic fuel prices were raised sharply in January — and a tight credit ceiling of 15% have disposed investors to look kindly at Indonesia's prospects. In addition, the Indonesian government keeps a balanced budget and has a large volume of undisbursed debt available to meet its external funding needs. As developing countries go, Indonesia presents an image of decisive, efficient government.

But have the numbers significantly changed?

According to the World Bank, even though the current account deficit will fall steadily over the next three years, Indonesia will need to borrow over \$5 billion a year,

its total foreign public debt will go up by \$10 billion to over \$30 billion, and the debt service ratio will rise from 22% now to 26% in fiscal 1985. That forecast is based on fairly charitable views of probable Indonesian exports. If oil production rises to over 1.6 million barrels a day (the current Opec limit is 1.3 million); if liquefied natural gas exports double in three years; if non-oil exports grow by 9% a year in dollar terms (they fell by 10% in fiscal 1982) and if oil is \$32 a barrel by 1985, all will be well.

Indonesia's current account deficit might be a lot worse than the World Bank and the government expect.

Oil is all-important. At present Indonesia produces 1.3 million barrels a day; according to sources in Jakarta it has been able to find buyers at \$29.50 a barrel for the 900,000 barrels it exports. If demand picks up, and Opec production ceilings are raised, as the World Bank expects, Indonesia stands to earn over \$2.5 billion a year in additional revenue (assuming 250,000 barrels of the extra 300,000 a day are exported at today's price). That is an optimistic guess. Oil prices are still falling — Japan, Indonesia's biggest oil market, has recently negotiated price discounts with Iran — and if the next Opec price meeting were to lower the benchmark price to \$25 a barrel, Indonesia would lose some \$1.3 billion a year.

If there is no change in existing Opec



ASIAN BANKING/INDONESIA

current account deficit.

Will the March devaluation have any significant effect on Indonesia's non-oil exports? Again, there is room to doubt the optimistic figures now circulating in Jakarta.

In 1982, Indonesia's non-oil exports came to around \$3.9 billion (the latest incomplete figures show a total of \$3.81 billion). This was down by over 9% from the \$4.3 billion of 1981, and well below the peak income of \$6 billion in 1980. The world recession hit Indonesia hard, since virtually all the country's non-oil exports are industrial raw materials, with prices determined by world market conditions. Lower world trade has meant lower export volume, and generally lower export prices, for almost all non-oil exports.

The country's biggest non-oil earner, timber, was affected by a government decision to restrict exports of raw logs and to encourage the export of worked timber, such as plywood. Log exports fell, but plywood exports did not rise. Timber earnings were \$1.9 billion in 1979 and 1980. They fell to \$1.1 billion in 1981 and to \$900 million in 1982.

There are some signs that non-oil exports will do better in 1983 and 1984. Demand from the industrialized countries should be higher, and prices at least no worse. For Indonesia's second largest non-oil earner, rubber, prices are actually back to 1981 levels. For the time being, however, Indonesia faces a buyers' market for its non-oil goods, and foreign buyers appear to have been able to negotiate dollar price cuts for some commodities, exploiting the devaluation of the rupiah.

"Our non-oil exports are still declining," said an economist with one of the large state-owned banks, "although I think for 1983 as a whole export revenue will be about the same as in 1982."

Non-oil imports will certainly be restrained by the March devaluation, which raised the rupiah price of imports by 38%, and by government measures to restrict non-essential imports such as fruit. But the government is keen not to cut back too far. The one statistic every government official likes to quote is the 2 million new jobs that must be created each year to absorb the growth in Indonesia's labour force.

Thus real growth must be 3% a year if the growth is concentrated on labour intensive sectors, or, more realistically, nearer 5% a year. For fiscal 1982, government economists reckon that growth was around 3%, and for the current fiscal year they predict a slightly lower 2 to 3%. That makes it difficult to squeeze imports hard. Consumption goods comprise only a small fraction of total imports, with capital goods and raw materials forming some 85% of non-oil imports. Imports are closely linked to domestic economic growth, and the country will be doing well if imports are cut back to \$14 billion from the \$15 billion of

fiscal 1982.

Putting together net oil and gas income of \$6 billion, non-oil exports of \$4 billion, imports of \$14 billion and a services deficit of \$2,750 million (only slightly up on 1982) gives an estimate for Indonesia's current account deficit of \$6,750 million — unchanged from the fiscal 1982 level, and, unless there is a strong world economy coupled with firmer oil prices, unlikely to budge much from that level over the next two to three years.

Can Indonesia finance it? Not out of reserves. "If you had told me a year ago that the foreign exchange reserves were going to be less than \$5 billion, I would have been very surprised," one embassy analyst put it. Bank Indonesia's reserves are now little more than \$3 billion — equivalent to about two and a half months' imports, and not easily reduced further without straining the country's liquidity.

The state banks hold a further \$3 to \$3.5 billion in foreign exchange, and, according to one central bank source, it is hoped that restrictions on lending to lower priority sectors will induce the state banks to swap some of their foreign currency into rupiah. If that happens, the central bank might be able to spend up to another \$1 billion to meet this year's current account shortfall.

Running down the reserves can meet only part of the \$6,750 million gap (and, in any event, is a one-shot weapon). Most of the funds will come from Indonesia's treasure chest of undisbursed foreign debt, which, according to the World Bank's resident staff in Jakarta, amounts to \$12 billion. Of that, some \$7 billion is on concessional terms from the 13 member countries of the Inter-Governmental Group on Indonesia, and the remaining \$5 billion is a mixture of buyer and supplier credit and funds on international market terms.

The World Bank's staff calculates that \$4.2 billion of the undisbursed foreign credit lines will be drawn down by Indonesia during fiscal 1983, with the World Bank itself the largest single source. Projects supported by the Bank will receive between \$600 and \$800 million during the year. Another important component of the \$4.2 billion is the outstanding amount available under the terms of Indonesia's March jumbo borrowing of \$1 billion.

A current account deficit of \$6,750 million, capital inflows of \$4.2 billion and a \$500 million drawdown of foreign reserves would still leave Indonesia with \$2 billion to find — a figure higher than most bankers in Jakarta expect. Representatives of the major banks know that Indonesia will have to borrow again later this year. The general feeling is that there will be another jumbo of between \$700 million and \$1 billion, although some bankers would prefer to see a gradual series of smaller borrowings.

"A big borrowing is inevitable," said one banker, "and I think Bank Indonesia will

A statue in Jakarta commemorates freedom from the Dutch. Now Indonesia struggles to free the bonds of its payments crisis.

prices and production quotas, Indonesia foregoes \$2 to \$2.5 billion a year, and the current account deficit stays where it is. According to some preliminary guesswork in Jakarta the current account deficit is running at around \$7 billion annually. Taking a more pessimistic view still, if oil prices were to fall by \$4 to \$5 a barrel, the current account deficit would rise by about \$1 to \$1.5 billion.

However, there is room for higher LNG exports to offset any decline in the price of crude oil. Japan, which takes all of Indonesia's annual LNG output of 7.5 million tons, has contracted to take a further 3.2 million tons a year from East Kalimantan, starting in September this year, and a further 3.3 million tons a year from North Sumatra from January 1984. Korea is likely to take 2 million tons a year, according to an agreement signed in May. Together, new LNG contracts will double net LNG export income, which has been estimated at \$1.5 billion in fiscal 1982.

If the worst comes to the worst, and Indonesian oil sells for \$25 a barrel, higher LNG revenues will maintain the net export income of the oil and gas sector at around \$6 billion a year, but will not provide enough extra income to start closing the

ASIAN BANKING/INDONESIA

be leaning hard on its friends, although it will have to pay more — maybe 40 basis points over US prime, compared with the 20 points on the March jumbo."

Indonesia is likely to approach the markets for more than the bankers expect — probably for \$1.5 billion, possibly for \$2 billion. That is not an indictment of the Indonesian administration. Bankers give it credit for its successive steps to tackle the deficit, especially the devaluation, which was a classic success. The rupiah strengthened in the market immediately afterwards, and short-term capital outflows returned, sending short-term rupiah rates down from nearly 30% to under 20%.

Indonesia's need to borrow is structural. It was disguised for a time by the oil price rise in 1979, but the country has the archetypal developing economy — dependent on a narrow range of natural resources with volatile prices, lacking manufactured exports (except a few textiles and electrical appliances) and needing to import many of its raw materials and most of its capital equipment. In bad years, Indonesia even has to import the staple food, rice.

Its natural pattern of development is to run current account deficits, financed by development aid and, as development proceeds, by funds on commercial terms. At the end of 1981, 64% of Indonesia's debt was aid of one kind or another. Trade credits made up 10%. Market borrowings made up the remaining 26%, but that proportion is going to rise.

The world recession hit Indonesia hard, since virtually all the country's non-oil exports are industrial raw materials, with prices determined by world market conditions

Indonesia is not another Mexico or another Venezuela. It is not even another Nigeria. Bankers trying to assess Indonesia may be wise not to look on it as an oil economy. Its appetite for capital is greater than its export revenue from oil or gas, and a \$6 billion a year oil income, although some reassurance to lenders, tends to get eaten up by the import demands of an \$85 billion economy. The 1983 payments crisis is not so much a crisis as the normal pattern from now on. The best pointer to Indonesia's future may well be what happened after the 1979 oil price rise. Within 18 months, Indonesia was back in the red.

THE SUDDEN ATTRACTION OF LEASING

Indonesia's domestic banking system has been closed to foreigners for years. Now there's a way in through the back door: leasing companies.
By Donal Curtin

New leasing companies are starting up in Indonesia faster than fast-food franchises. For several years there were only five, all set up between the middle of 1975 and early 1976. In late 1981, however, three firms were set up, and in 1982, nine more. So far this year another five companies have been given operating licences, with a further eight at the halfway stage of provisional licences. And there is a long backlog of applications for licences at the Ministry of Finance.

Why the sudden attraction? Belatedly, overseas banks, finance houses and leasing companies have discovered leasing as the back door into the profitable but inaccessible world of Indonesian banking. In the late 1960s, the authorities closed off domestic branch banking; only 10 foreign banks and a joint venture involving Japanese banks had established operations before the door was locked.

In the early 1970s access became even more difficult, when foreigners were also cut off from the non-bank financial institution sector. Foreign banks that did not take a shareholding in one of the nine finance houses or in either of the development finance companies were left out of the boom in Indonesian banking in the late 1970s and early 1980s.

Leasing companies are giving banks that missed the bus a new vehicle for their ambitions. "Foreign banks are really setting up what — in the US — would be called industrial banks," said the chief executive of one of the new companies.

Even for banks with existing branch operations in Indonesia, a leasing company is useful. It enables the bank to skirt some of the tight restrictions on foreign banks, especially the prohibition on lending to companies outside Jakarta. Recently, Indonesian officials have taken a tougher line on defining a Jakarta company. A leasing office is also an extra outlet for the branch banks, which are restricted to one main and one sub-branch.

Apart from the advantages of getting



Rachman of Wardley-Summa: ideal links.

restrictions on branch banks, leasing should make a lot of money for the newcomers. It is not hard to get in — the minimum paid-up capital requirement is Rupiah (Rp) 3 billion (\$3 million), though it is likely that the minimum will shortly be raised to Rp4.5 billion (\$4.5 million). There must be an Indonesian partner, an agreement that majority control will pass to Indonesian interests within 10 years, and arrangements for training Indonesians in the leasing business.

The rewards look promising. The amount of business a leasing company can do is governed by a gearing ratio of 33 times capital. With a typical spread on lease contracts of 3%, it should not be hard to make a good return on equity.

So far, not much leasing business has been done. Leasing companies are not yet required to report their results, so the size and distribution of the leasing business is unclear. According to estimates prepared by the Indonesia Leasing Association, lease contracts worth Rp27 billion (then worth \$42 million) were written in fiscal 1980. That went up to Rp73 billion (\$110 million) in fiscal 1981 and to around Rp95 billion (\$135 million) in fiscal 1982. The three biggest companies — Orient Bina Usaha Leasing, an affiliate of Japan's biggest leasing company; Wardley-Summa Leasing, an affiliate of the merchant banking arm of Hongkong and Shanghai; and First Indo-American Leasing, an affiliate of Bank of America — have something like \$65 million, or roughly half, of the market between them. That is partly because they have had a head start.

But if the market is small and concentrated now, it is likely to grow and widen in the future.

"Indonesia is one of the last frontiers, at least in Asia," said Amir Abdul Rachman, assistant director with Wardley-Summa, pointing out that much of the country's private capital investment is financed by rolled-over short-term loans. "There is a lot of mismatching," he said, explaining the

ASIAN BANKING/COUNTRY RISK

JAPAN'S BANKS ASSESS ASIAN RISK

Japanese investors prefer Europe to their neighbours. But they like Singapore, Malaysia and Thailand.
By Donal Curtin

"Quite frankly," said the syndication manager of a leading Japanese trust bank, "Japanese investors — the trust banks and the life insurance companies — don't like to have a portfolio in Asia, except in Malaysia and Singapore."

"Some of the city banks are sophisticated enough not to mind a portfolio in Indonesia or Thailand, but the major institutional investors don't like it. That is the problem for Asian borrowers."

Sentiment has changed significantly in the Tokyo market. The change is not easy to detect from the terms that borrowing countries obtain in Tokyo, because administrative guidelines compress the differentials in spreads that would otherwise discriminate between strong and weak borrowers. But from what syndication managers say, Asian borrowers have fallen out of favour.

Some years ago the South-East Asian newly industrialized countries, such as Singapore and Korea, seemed to offer highly attractive lending opportunities. In a word beset by recession and default, they offered high growth, strong exports, firm government and tractable debt. Some of them — particularly Singapore, Malaysia and, possibly Thailand — still look good to Japanese lenders.

But the Philippines, Indonesia and Korea are now distinctly unpopular. Taiwan is also out, but for a different reason. Since the normalization of Japan's diplomatic relations with the People's Republic of China in 1972, Japanese banks have not lent to Taiwan.

At the bottom of every Japanese inves-

tor's Asian list is the Philippines. Trade financing, buyers' and suppliers' credits, are still being arranged, but many bankers in Tokyo would avoid sovereign lending.

"There are two sorts of risk in lending to the Philippines," said one executive with a city bank. "One is the general sort of country risk, the country's external position, its foreign exchange reserves and so on. And the other is what I call the Marcos risk."

Above the Philippines, but still regarded with disfavour, are Indonesia and South Korea. "These are countries with very ambitious development plans, and big increases in foreign borrowing, which are now a handicap," said one city banker. Both countries are in the market for yen syndicated loans — Indonesia for ¥24 billion (\$102 million) through the Industrial Bank of Japan (IBJ) and Sanwa Bank; and Korea through Korea Electric Power (KEPCO), looking for ¥10 billion (\$42 million) through Nippon Credit Bank and Sumitomo Bank, and through its Eximbank, which is raising ¥10 billion (\$42 million) through Yasuda Trust.

Bankers were generally reluctant to participate in these borrowings. "For many of us, we are at our country limits for Indonesia, which has its problems with the oil price," said one banker. Others pointed to the large volume of trade-related loans raised for Indonesian borrowers in Tokyo. "If Indonesia's borrowing is finished smoothly, it will be because of the position of IBJ in this market, not because of Indonesia," said another banker.

Tokyo lenders are worried by South Korea's high level of existing debt. "Korea is improving very much in various respects," said a syndication manager with a regional bank, "but its total overseas borrowing is so high — the third or fourth largest in the world. Even if its economy improves a lot, and inflation seems to be

going down and growth improving, financial institutions will still be worried about its total borrowing."

The surprise country in the country risk ratings in Tokyo is Thailand, which has risen in estimation as its neighbours have declined. "Thailand has been keeping a low profile for some time, and now it has a smaller level of external indebtedness than most Asian countries."

"Thailand is one of our best customers," agreed a syndication manager with one of the long term credit banks. "It is getting better recognition in the market because of the relatively low number of its borrowings in the past."

Thailand's image in the Tokyo market has improved to the point that it can command the going market rate on yen credits, 30 basis points over Japanese long-term prime. Thailand has only one credit in the Tokyo market, a ¥5 billion (\$21 million) cofinancing with the Asian Development Bank. "It's a bit too small to say anything about Thailand as a country risk," said one of the lead managers, "but it certainly seems to be quite popular."

At the head of the country popularity stakes is Malaysia. "There is no doubt about their essential creditworthiness," said the chief manager of a city bank's syndication department. "The balance of payments has deteriorated slightly recently, but it has basic strength from development of its natural resources, and Malaysia's management is good. Their civil service system is the best outside Singapore."

Only one country would surpass Malaysia if it came to the Tokyo market — Singapore. "It's best," said a long-term banker, "but unfortunately we have had little opportunity to lend to Singapore as a sovereign credit."

Other bankers echoed this complaint — proving once more that the way to get the best terms is not to borrow at all. □

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Chapter Eighteen

COUNTRY RISK

If I owe a million dollars, then I am lost. But if I owe fifty billions, the bankers are lost.

Celso Ming (Brazilian Economist), 1980

THE revolution in Iran had taken nearly everyone by surprise, and it brought a new urgency to an old question: how do you measure the political risks in a foreign country? With some prompting from governments and central banks, bankers began trying to assess more seriously the hazards of their operations. They turned not only to economists, but to diplomats, political scientists and intelligence experts to advise them in the fashionable new science called 'country risk'.

The problem was as old as banking, but the American banks had become more concerned since the late sixties when the influence of their own government over developing countries was visibly waning. 'It really began in 1967,' according to one political scientist, Stephen Blank of Multinational Strategies Inc., 'when Occidental Petroleum did their deal with the Libyan government which undermined the power of the big oil companies. In the next six years it became clear that American companies had lost the capacity to tell countries what to do: they had to begin studying what countries would do to *them*. By 1973, with the new power of OPEC, the transition was over.' The unpredicted success of OPEC had certainly undermined much of the confidence in the projections of economists. When the futurologist Herman Kahn had written his book *The Year 2000* in 1967 the words oil, energy and Saudi Arabia did not appear in the index, and after the price-increases which changed the balance of the world many economists still insisted that the price must come down. As the bankers lent more money to unstable countries like Zaire or Indonesia, they began to feel the need for political as well as economic assessments; and the collapse of the Shah revealed all the shortcomings of their information.

There was something inherently comic about this attempt to measure

THE MONEY LENDERS

the immeasurable, to award credit-ratings to countries as if they were hire-purchase customers. The spectacle of bankers, with all their zeal for precision and objectivity, giving marks to nations for good behaviour could never be altogether convincing. What could they learn from their hotel suites of the gossip in the bazaars, the mutterings of revolution in the back alleys? How could these immaculate men wander inconspicuously in the souks of the Middle East or drink in the shebeens of Johannesburg? How could they calculate whether Bangladesh or Sri Lanka was the more ripe for revolution? They might think that they were establishing rational systems and yardsticks to measure the world; but they were always deeply influenced, directly or indirectly, by the assumptions of their foreign ministries and governments. They were still following some kind of flag.

While each bank made its own assessment of country risk, the market revealed its own consensus in terms of the length and profit-margins of the loans (the 'maturity' and the 'spread'). The magazine *Euromoney* compiles its own 'league table' of country risk, based on its statistical analysis of syndicated loans, grading sixty-six borrowing countries in order, and awarding them stars from seven to one. In 1979 the list began with three seven-star countries, France, China and Britain, and ended with six one-star countries (Gabon, Ethiopia, Guyana, Madagascar, Niger and Pakistan). It had some remarkable juxtapositions: the six-star countries included five communist countries – Russia, Czechoslovakia, Hungary, Bulgaria and East Germany – alongside western countries like Italy and Canada and newly-industrialised countries like Korea or Columbia. In the roll-call of three-star countries, White South Africa was sandwiched between black nations like Malawi, Cameroons and Tanzania. The market revealed no colour bar, no ideological bias.¹

'I think I can say I was the inventor of the whole subject called country risk analysis,' said Irving Friedman, with characteristic modesty; and it was true that Citibank, after Friedman joined it in 1974, set up a more formalised and self-conscious study of risks than other banks, as we saw in Chapter 10. As Citibank began lending more to the third world, Wriston built up a team to assess credit risks, led by Friedman and the vice-chairman, Al Costanzo, and he insisted that they had independent powers to defy any pressure to lend.

Other American banks took their own steps to strengthen their political analysis. 'We're much more sophisticated on the economics side than on the politics,' admitted the senior international economist at Morgan's, Rimmer de Vries;² and in 1980 Morgan's tried to establish

¹ *Institutional Investor* produces a rival grading: see Chapter 1.

² *Euromoney*, July 1980.

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their own careful rating of countries, so that they could compare them with their ratings of American companies in the same system. 'But we have to be very security-minded,' one man in Morgan's explained to me; 'once a country discovers that it's got a low credit rating, there's hell to pay.'

The Bank of America was determined to set up a specially thorough system after the mistakes of Iran. As Richard Puz, the head of the World Banking Division, expressed it to me in California: 'In Iran our predictive capacity was weak: at that time the visibility of non-quantifiable factors was secondary to hard numbers. We didn't realise how rapidly American support would disappear.' The Bank of America devised a classification to make full use of its worldwide staff and decentralised offices. It was unlikely, as their chief international economist Robert Heller explained, 'that all relevant information can be compressed into just one single number';¹ so they gave countries a three-point rating, in the form (for instance) of 82AC.

The first number, ranging from 1 to 100, expresses the 'debt service capacity index' based on an international data bank covering eighty countries. The first letter represents the 'judgmental economic indicator' based on questionnaires sent out to the bank's country or regional managers, which are then checked at headquarters 'for global consistency'. The second letter expresses the 'judgmental political indicator', which focuses on three areas - governmental control, potential for social unrest, and external factors, assembled from replies from 'on-site knowledgeable officers' and revised by senior managers in San Francisco. 'The country manager,' as Puz explains, 'can get so close he can't see the wood for the trees.' But the difficulty with such classifications (it seems to me) is that they can't see the trees for the wood. An indicator like 82AC might describe a country like South Africa, with excellent economic statistics and prospects but high potential for social unrest. But once the AC goes down to AE, the E can quickly cancel out all the benefits of the A.

The Chase characteristically turned to ex-diplomats and ex-CIA officers to provide its political intelligence. David Rockefeller had already set up an International Advisory Group, which included Henry Kissinger, meeting four times a year; as the Chase moved deeper into doubtful countries, they took on more political scientists and economists, with beards and moustaches which stood out among the clean-shaven orthodox bankers. They even prepared a special new service to clients called 'Chase World Outlook', full of computerised

¹ Robert Heller: 'Bank of America's New Country Evaluation System.' *Euromoney* Conference on Country Risk Assessment, New York, October 30, 1980.

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calculations about country risks; but it was soon clear that they could not say candidly what they thought about (for instance) Saudi Arabia, whose deposits were crucial to the bank; after spending three-quarters of a million dollars they abandoned the project. Rockefeller's personal influence still prevailed. In 1980 he set up a three-man 'Country Risk Management Group', with their own patrician approval, headed by the former head of the western hemisphere division, Francis Mason, and including Archie Roosevelt, a former CIA officer, and Ridgway Knight, the ex-ambassador who had often accompanied Rockefeller on his journeys.

'If you sat in on a meeting of the country risk committee,' said the Chase's chief economist, Robert Slighton, who also once worked for the CIA, 'I think you'd be impressed by how much they knew, but appalled by the difficulty of transferring that knowledge into policies for loans. We can't afford to go into a country when it looks good, and pull out when it looks bad. . . . In retrospect, we overloaned in the seventies: there's a much more hostile environment projected for the eighties.'

'Operational banking' (Slighton continued) 'consists in a constant war, a continuous adversary process between credit officers and loan officers - it takes place at every level, and it can be very bloody. In assessing the country risk, the most critical questions are, first, the likelihood that the political consensus will be intact; second, can economic policies respond to a sudden shock? A country that doesn't redistribute its wealth is a bad risk; if a loan helps a country to redistribute, that's desirable. In general, we'd rather lend to a country that's had its revolution.'

Why did the banks, with all their different systems and attitudes, still reach the same conclusions about so many countries, even when they were all wrong? Why did they still behave like starlings or lemmings? In the nineteenth century banks would take their own risks in lending to unreliable countries, as Barings backed the United States. But they were now much more reluctant to get out of line with each other: 'There's no opportunity so good,' as one Chase man explained, 'that we want a hundred per cent of it.'

'Facts make their own decisions,' Wriston told me at Citibank when I complained about this uniformity. 'If you all look at the same facts it would not be unusual to come up with the same answer. . . . In those days Mr. Rothschild made his fortune by getting carrier pigeons to tell him who won the battle of Waterloo. Now today, when the President frowns in the Rose Garden, it is in the rate of the dollar in thirty seconds. The information explosion puts the facts at everyone's command.' But

¹ Interview with author, March 12, 1980.

others are more worried about the 'theory,' Wilson Schuler says. 'The institution feels the Indians looked to their economists; but they can't predict together. And they both special inform opinion - like the Ca

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European bankers like calculations of country and hunches. 'They like to be intuitive,' said a British banker, 'the atmosphere in Washington is like waving a wand.' 'What an uncreditworthy one more Arab banker: 'It was because the Europeans could also be more than they realised. The stampedes towards Poland. The French banks, not themselves from the chaos. The banks had a long tradition of conservatism; but the Big Four

¹ *Euromoney*, July 1980.

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others are more worried by the sameness of view. 'I have a medicine man theory,' Wilson Schwartz explained to me at the Chemical Bank: 'Every institution feels the need to have someone to foretell the future; the Indians looked to their medicine men, and the institutions looked to their economists; but while economists may explain *why* things happen, they can't predict *when* they'll happen; so the banks tend to flock together. And they look more and more towards the IMF - which has both special information, and special authority to enforce their opinion - like the Catholic Church in the Middle Ages.'

The Iranian revolution had sent shock-waves through the American banks not only because none of them had predicted it, but because it revealed the full impotence of Washington to protect American interests. It was much less useful to consult the State Department if it had so little ability to influence events, and the oil crisis had brought home the vulnerability of the United States to any oil-producing country. 'I can tell you that as a US bank in Mexico we get treated like dirt by the Mexican authorities,' Francis Mason said in 1980: 'It is nothing personal against Chase Manhattan Bank. I think they take a particular delight in making certain that the British banks or the Canadian banks or the European banks get the business that we do not.'

The American bankers, as they worried more about country risk, were turning less to the State Department for advice and more to the World Bank and the IMF (see Chapter 21), who were gradually relaxing their discretion about their nation-clients: 'It was like the dance of the seven veils,' one banker observed: 'each time they'd reveal a little more.'

European bankers liked to make fun of the Americans' elaborate calculations of country risk compared to their own personal judgments and hunches. 'They like to fool themselves that they're strictly objective,' said a British banker, 'but they're always influenced by the political atmosphere in Washington. A new fashion can change their judgment like waving a wand.' 'Why did the Americans all regard Egypt in 1973 as uncreditworthy one moment, and credit-worthy the next?' asked one Arab banker: 'It was because Kissinger told them to.' Yet the Europeans could also be more influenced by their governments' attitudes than they realised. The herds of German bankers had their own stampedes towards Poland, encouraged by guarantees from Bonn. The French banks, nearly all nationalised, could never separate themselves from the changing moods of the Quai d'Orsay. The British banks had a long tradition of being more distinct from their governments; but the Big Four deposit banks which were now responsible for

¹ *Euromoney*, July 1980.

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most of the loans were much less adventurous than the old merchant bankers like Barings and Rothschilds, and their executives followed in well-worn tracks (like Barclays in South Africa) or simply followed the American herd (like NatWest in Iran). As for the Japanese, they worked more closely with their Ministry of Finance than anyone. Whenever all these nationalities came together in a big syndicate they were easily persuaded to play follow-the-leader.

Who was the real leader, and who was taking the risk? It was an obvious question, but curiously difficult to answer. It was complicated, as we have noted, by the fact that foreign countries could never really go bankrupt like domestic companies and that bankers could no longer seize their assets by sending in gunboats. 'The trouble is,' as one senior Chase executive said, 'that we aren't used to the idea of a foreign default.' By rescheduling or restructuring their loans as in Zaire the bankers could keep on postponing the moment of truth.

The question was specially serious in three countries with huge mounting debts which each represented a different kind of political risk: Brazil, Turkey, Poland. Each of them showed little prospect of paying back the money, each had a very chequered political history, each was attracting still more loans. But who was really responsible for the risk?

BANKING ON BRAZIL

For over a century Brazil had been the object of great expectations and extreme uncertainties. In the mid-nineteenth century both Brazil and Argentina had been talked of as a 'new America', luring entrepreneurs, capital and immigrants from Europe. While bankers eventually gave up hope that the Argentinians could ever run their country sensibly, they continued to look to Brazil with optimism. But in the meantime it had accumulated the biggest debt in history.

By 1980 Brazil owed no less than sixty billion dollars, much of it to commercial banks, headed by Citibank. That might seem small compared to loans inside the United States: it was the cost, for instance, of only four Metro systems on the scale of Washington's. It seemed manageable compared to the size of the Brazilian economy. Brazil was the colossus among developing countries, with a land-mass bigger than that of the United States, half the total area of South America. Its population, now 120 million, had been doubling every twenty-five years; its gross national product was the tenth biggest in the world; it produced the world's biggest coffee crop, a harvest of soyabeans second only to America's, and a third of the world's iron ore. It had a team of forceful and expert technocrats and managers. It was a kind of microcosm of world development, with pockets of extreme riches and poverty. By

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But Brazil's foreign debts could only be repaid by exports which earned foreign currency; and by 1979 more than three-quarters of those exports went to servicing its debt – a 'debt-service ratio' which banks normally regard as dangerously high. Brazil, unlike its rival debtor Mexico, had little oil of her own; each time the oil price went up, the prospects of repaying the debt were more distant.

It was a matter of critical interest to American banks, and particularly to Citibank which had put many of its eggs into the Brazilian basket over the last six decades. Wriston regarded Brazil as a triumphant example of how Citibank had not behaved like the herd. 'I know lots of people who have been waiting to invest in Brazil for thirty years,' he explained: 'Their judgment is that it is a land of tomorrow and tomorrow is not here. Our judgment in 1914 was that today is here, and we've been there ever since. . . . Our view is that it has a lot of problems, but they are all going to work out and we are not at all upset about them – that's a very great difference of view between other banks.'¹ Citibank had built up a large domestic banking business inside Brazil, including a half-share of an important finance company, the Banco Crefisul de Investimento. The more the other banks kept away from Brazil, the more lucrative was Citibank's business, and Brazil contributed an important share of its global profits: in 1976 as much as twenty per cent. 'Citibank will continue to benefit from a relatively high-yielding portfolio,' said its *Financial Review* in mid-1978, 'for several years to come.'

Brazil's most recent boom had dated from 1964 when the populist government of President Goulart had been overthrown by military leaders dedicated to rapid expansion. They appointed as economic overlord the academic economist Roberto Campos, who cut back the runaway inflation and invented the idea of 'indexation' to link wages to inflation. He was succeeded by his protégé Delfim Neto, who presided over a phenomenal boom, generating a growth of up to fourteen per cent a year. Delfim, whose family came from Naples, had a style which was larger than life: with his fat shape, his tireless talk and enormous energy and appetite – he was said to consume five dozen oysters at a sitting – he soon became a superstar on the bankers' scene. He made no secret of his strategy: by borrowing heavily from the banks he wanted to lock foreign capital into the Brazilian system, so that the West would have a vested interest in its success. There was a very dark side to the Brazilian miracle: the desolate north-east, with the decaying rubber towns along the Amazon, was hardly touched by it; the boom city of São Paulo was surrounded by some of the world's worst slums; the govern-

¹ Interview with author, June 13, 1980.

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ment resorted to torture to subjugate the Indians; and the gross inequality outraged many liberals including Robert McNamara at the World Bank. But this did not affect the assessments of the commercial banks; Citibank had formed close links with the military government, and Rockefeller at the Chase – who were also big lenders – argued against any interference over human rights.

With the oil crisis of 1973 Brazil's future suddenly looked bleaker. The giant industries, the skyscrapers, the highways and car plants had been built on the assumption of unlimited cheap oil; and the four-fold increase wrecked the balance of payments and boosted inflation. A new President, General Geisel, sent Delfim into exile to be ambassador in Paris, but continued with expansionist policies, pushing ahead with new steelworks, shipyards and nuclear power stations, while inflation went over forty per cent. Most bankers found Brazil now much less attractive, but Wriston at Citibank saw the opportunity both to profit from the high returns and to cement the bank's relationship with Brazil. By 1977 Brazil seemed to be on the road to recovery, and other bankers including the Japanese again began piling in, bringing the margins down again. Citibank had been shown to be a good friend of Brazil, and the Brazilians appreciated it: 'We feel much safer with Citibank,' explained one government economist, 'because we know they've got so much at stake.'

By 1979 Delfim was back as economic overlord under the new President Figueiredo. He was again bent on high growth, but the new oil crisis and strikes in São Paulo brought new dangers. Inflation was back to over eighty per cent, with growth of only six per cent. Delfim promised that Brazil would become less dependent on oil by financing a vast project to produce alcohol from sugar, on which Brazilians could run their cars: and when the bankers met at their annual meeting of the IMF in Belgrade in 1979 he persuaded them to raise a jumbo loan of 1.2 billion dollars for the new alcohol programme, backed by the Brazilian government itself. It was a historic loan, led by Morgan's and three other American banks, with a margin of less than one per cent above the standard rate of interest, running for twelve years. It was a triumph for Delfim who had personally persuaded many leading bankers against much of their current advice about country risk. But many big banks, including Bankers' Trust in America and the German Big Three, stayed out of it; and the Japanese banks, who had been warned to cut back their foreign loans, only contributed 125 million dollars.

Brazil was still on a tight-rope and in February 1980 Delfim toured America and Europe to try to raise confidence; in New York he breakfasted with Wriston, and saw McNamara who had flown up from Washington. But most bankers were still sceptical and insisted on high margins or spreads: 'I didn't expect to be greeted by a bunch of adding

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machines,' Delfim complained.¹ He was now having to dip into Brazil's precious reserves; and he dreaded that he might have to borrow from the IMF which would cut back on Brazil's bid for economic freedom. Brazil always showed two different faces to the world: one moment it was the new America, competing over-confidently with the rich nations; the next it was the most vulnerable of all developing countries. By 1980 Brazilians were again talking of being part of the third world, and suggesting that the world institutions should be restructured for their benefit.

Brazil remained an expensive question mark for both bankers and governments. Would it at last stand on its own feet as a major industrial power? Or would the economic crisis bring about a political crisis which would make it unable to pay off its debts? 'If there is a real threat to the international banking system,' one veteran London banker observed, 'it could well begin in the slums of São Paulo.' Had Wriston made his huge profits from Brazil because he understood the country better than others, or because he knew that his government could not let Brazil go down? And who was really taking the risk – the bank, the American government, or the International Monetary Fund?

TURKEY IN TROUBLE

The bankers faced a more highly charged political scene in Turkey, the traditional 'sick man of Europe', which like Iran had been a bankers' nightmare since the mid-nineteenth century, and which stood on the frontier of the western alliance with the Soviets. In the post-war years, supported by massive aid, Turkey had staggered from one economic crisis to the next, teetering between democracy and military rule. In the early seventies the economy made some recovery with help from remittances from Turkish workers in Germany, but the oil crisis soon hit the country with double severity: the workers were sent home while oil imports further wrecked the balance of payments.

The potential bankruptcy of Turkey now looked like threatening the solidarity of NATO. The Bonn government pressed the German banks to lend money to this traditional sphere of German influence and trade, where the Deutsche Bank had spread itself a hundred years earlier; and American and other European banks were attracted by the high margins. By 1976 the Turkish government was guaranteeing high interest rates through convertible lira deposits and the big American banks, with Citibank and the Bank of America in the forefront soon rushed in to take advantage of the quick profits.

¹ *Institutional Investor*, August 1980.

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By January 1978, when a new Prime Minister Bulent Ecevit was elected, the banks were losing their enthusiasm for Turkey as rapidly as they had acquired it. There was mounting violence between extreme left and right, the bureaucracy was corrupt, and the economy showed no sign of recovering. The government had borrowed three billion dollars in short-term loans which had to be renewed, but after one massive rescheduling the banks were reluctant to roll it over, and they were soon cutting off credits, leaving Turkey with little time to adjust. The Turks turned to the International Monetary Fund, which raised two massive loans – the second of which, for 1.6 billion dollars, was the biggest in its history, amounting to 625 per cent of Turkey's quota. The Fund hoped that their 'seal of approval' for Turkey's austere programme would reassure banks; but as the Fund moved in, so the bankers began moving out, stealthily withdrawing more of their interest and part of their capital; in 1979 they made net withdrawals of 340 million dollars.¹ The Bank of America, which had rapidly retreated, became a dirty word in Turkey and changed its name for its remaining operations.

The mandarins at the Fund in Washington were bitterly critical: 'The banks overlent when the going was good, and now they show no responsibility,' one of them complained to me, for once losing his cool: 'The IMF cannot act as the banks' debt-collector – we didn't go in to let them get out.' The Turks now had a total foreign debt of sixteen billion dollars, and half of their exports (including their foreign workers' remittances) went to repaying the debt; while the bankers were resisting the pressures from the IMF to reschedule their loans. Turkey – now once again under a military government – remained a crucial member of NATO: but the bankers, having made their quick profits, were glad to leave it to western governments and the IMF to cope with as best they could.

THE POLISH PREDICAMENT

Of all the frontiers between banking and politics, the most critical but unmapped were in Eastern Europe, where the bankers moved out of the protective system of the IMF and into the heart of the communist system. Since the Eastern Europeans had rejected Marshall Aid in the post-war years they had formed their own self-enclosed economic system of 'Comecon', and their central banks had been closely interlinked with Moscow. The Soviets underpinned and supervised their lending more strictly than the IMF, with all the rigour of orthodox bankers, with no misgivings about usury, and with large supplies of gold

¹ *Financial Times*, November 13, 1980.

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to fortify the reserves. As the Eastern Europeans began to trade more with the West and to buy more western technology and food, they began to borrow to finance their trade. The first western bank to open a branch in Eastern Europe was the Crédit Lyonnais, the French bank which had been the chief lender to Tsarist Russia in the 1890s, and which Lenin in 1916 had regarded as one of the key imperialist banks¹. By 1964 the ubiquitous David Rockefeller was visiting Moscow, talking at length with Khrushchev, and soon afterwards the Chase became the first American bank to open a representative office, at 1 Karl Marx Square, in Moscow. The relationships between the communists and Rockefeller were the subject of continual amusement and irony. The communists regarded him as a king of capitalism, wielding far greater powers than he really enjoyed: 'Nobody knows how to revere, blandish and exalt a Rockefeller,' said George Gilder, 'half so well as the Marxists.'² Rockefeller on his side saw the communists as more reliable and enduring clients than many capitalist democracies: 'In terms of straight credit risk,' he explained, 'the presumption is that there is greater continuity of government in certain socialist states than in non-socialist states.'³

From the late sixties the western banks began lending increasingly to the countries of Eastern Europe, including the Soviet Union itself, reassured by the so-called 'umbrella theory' which assumed that the Soviet Union would give its economic support to any country in trouble, like the IMF and the central banks in the West. With the great expansion of the Eurodollar market in the early seventies the banks became more interested in lending to Eastern Europe, independently of trading connections, encouraged by the political atmosphere in Bonn and Washington. In West Germany the Ostpolitik, or opening to the East which Willy Brandt had initiated, encouraged the banks to extend their area of influence into the communist countries. In the United States Henry Kissinger and others maintained that western lending could help to distance the Eastern European satellites from their Soviet masters, while the Polish-Americans pressed for more liberal loans for their cousins. There was a general belief in the West that any economic improvement would have a liberalising effect on Eastern European policies; and many Marxists were suspicious of western lending for that reason.⁴

Bankers were inclined to see the whole of Comecon as coming into the

¹ See Charles Levinson: *VodkaCola*: New York, Gordon & Cremonesi, 1978, p. 28. See also Feis, p. 216 ff.

² Peter Collier and David Horowitz: *The Rockefellers* (paperback edition), New York, Signet, 1977, p. 427.

³ Martin Mayer: *The Bankers* (paperback edition), p. 483.

⁴ See M. S. Mendelsohn: *Money on the Move*, p. 104.

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same category of risk, assuming that one country would be helped by all the others; and they lent with almost equal confidence to Hungary, Czechoslovakia and the Soviet Union itself – as the credit ratings (see page 254) suggested. The bankers widely assumed, in the words of *Institutional Investor*, that 'Moscow would not allow any Comecon member to default or even reschedule, for economic, political, strategic and image reasons . . .'.¹

Poland was always a special case. It had the richest resources of minerals of any of the six countries of Eastern Europe, including coal, sulphur, copper, zinc, silver and lignite. But it also had more headstrong leaders, more determined workers, and inefficient industries. Poland's industrial backwardness had long been the despair of bankers: back in the twenties the young Jean Monnet (later the father of the Common Market) had helped to arrange a loan to Poland and had found Polish industry 'only just emerging from medieval conditions'.² Now the Marxist ideologues had brought their own mismanagement both into Polish industry and agriculture. Poland had, in the words of one distinguished economist, 'a combination of wildly over-ambitious, gravely flawed, voluntarist economic policies; incompetent planning and management; and an especially unstable body politic . . .'.³

When Gierek took over as Prime Minister in 1970, after food riots which had led to the fall of Gomulka, he looked to the western banks to help revive the economy. The Brandt government in West Germany pressed the banks to provide loans, and the American banks, as well as government agencies, followed with loans – many of them into very dubious industrial projects. The First Chicago Bank, in the midst of a Polish-American stronghold, was specially active in Warsaw, and set up its own office there. The western loans certainly helped to improve the standard of living, and Gierek presided over a boom which was very visible in the form of more cars, TV sets and consumer goods. But the industrial managers failed to achieve much improvement in industrial production, and behind the outward boom there was economic confusion, about which the bankers were allowed to know very little. The bankers still felt secure under the Soviet umbrella; but, by the same rules, they could do nothing to interfere with national sovereignty.

By 1976 Poland looked much less attractive to bankers: there was a crisis in agriculture, and Gierek put up food prices which precipitated a new workers' revolt. Some American banks now felt that they had lent

¹ See *Institutional Investor*, July 1976. Also Richard Portes: 'East Europe's Debt to the West', *Foreign Affairs*, July 1977.

² Jean Monnet: *Memoirs*, London, Collins, 1978, p. 103.

³ Richard Portes: 'The Polish Crisis', *Western Economic Policy Options*, London, Royal Institute of International Affairs, February 1981, p. 8.

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COUNTRY RISK

quite enough; Alvin Rice, of the Bank of America, testified in 1977 that Poland 'would have a difficult time increasing term indebtedness to any American bank that I know of'.¹ And some international economists were becoming seriously worried. 'We cannot simply continue to ignore the debt, supposing that it will go away as quickly and rapidly as it has accumulated,' wrote Professor Richard Portes in July 1977: 'We have clearly left it to the bankers for too long already.'² Yet in the same year the Chase Manhattan was leading a 600-million-dollar loan to Eastern Europe, including Poland, to finance a new gas pipeline with little information about how the money would be used.³ In the following year Poland raised a new syndicated loan worth half a billion dollars. The western bankers, after all, were short of reliable borrowers; and the Polish government negotiator Jan Woloszyn was one of the most respected of all international bankers.

By the beginning of 1980 the Poles were negotiating to borrow another half a billion dollars and in April they invited western bankers to Warsaw to discuss terms, promising that Polish industry was being reformed, and that the banks could monitor it. Then came the crisis of July 1980, with unprecedented strikes, the power struggle between labour unionists and the government, and the capitulation to higher wages.

The western attitudes were full of paradoxes. American conservatives who abominated labour unions were now boundless in their admiration of the Polish strikers. American labour unionists were refusing to import Polish goods in support of their Polish comrades, while Polish Americans pressed for more credits. The workers in this communist state were wielding a power enjoyed by few other workers in the world. If Poland had been under the IMF umbrella (as Romania and Yugoslavia were), the IMF could have been required to be thoroughly stern towards a country with such a huge debt which was now giving in to inflationary wage-claims. But it was Moscow, not the IMF, that was the ultimate disciplinarian in Poland; and the western governments were urging the bankers not to pull back but to make further loans. The bankers' confidence in Eastern European discipline was thoroughly undermined, and they could not be at all sure which side their loans were really supporting. Was it the communist government or the dissident strikers? 'Why should the US or others in the West,' asked the *Washington Post*, 'pay for the privilege of making Poland safe again for Soviet-style state socialism?'⁴

¹ House Banking Committee: *International Banking Operations*, Washington, 1977, p. 721.

² *Foreign Affairs*, July 1977.

³ See Nora Beloff 'The Comecon Bumble-Bee', *The Banker*, London, May 1978.

⁴ November 23, 1980.

THE MONEY LENDERS

Poland was now altogether a very doubtful proposition. Yet just as the Polish government was issuing a statement condemning the strikes in Lublin, bankers were meeting in the London offices of the Bank of America to approve the new loan. By August a consortium, including eleven American banks and the Moscow Narodny Bank, had signed the agreement. The loan had been reduced to 325 million dollars, at a higher interest rate and with strict terms of supervision; the bankers were insisting that the money must be prudently spent, and had at last extracted more economic information from Warsaw. But no one could be very confident about where it would end up. In the meantime a German consortium led by the Dresdner Bank had raised a new jumbo loan in which other German banks felt compelled to join: 'We weren't forced to,' as one smaller participant told me, 'but we knew that if we didn't we would be left out of other good things in the future.' The Bonn government encouraged the loan, but could not guarantee it: it only undertook to use all its influence to create political stability in Poland.

The total Polish debt was now alarming – twenty-four billion dollars, of which more than half was owed to commercial banks – led by the Germans, and followed by the British and Americans. The cost of repayments in 1981 was reckoned to be more than the total value of Polish exports. The commercial banks were now feeling much more aware of their insecurity in Poland, at a time when other big debtor countries like Brazil were also looking more doubtful. For no one could be confident of who would guarantee its debts, and enforce its financial discipline. Many bankers assumed that Poland would have to look towards the Soviets for much of their future borrowing; but they could no longer be sure that it was still under the Soviet umbrella, and the West was offering no more than a parasol. Several bankers privately admitted that they would feel much safer if the Russian tanks rolled into Poland.

As for the Poles, they had little to show in exchange for their mountain of debt. The succession of loans had fed their economic expectations and temporarily pushed up their standard of living; but they had done little to improve the basic economy, and had left the Poles apparently still more dependent on their Soviet money-masters. As for the theory that western loans would help to wean the Poles away from their communist loyalties, it had the most ironic consequence of all: for the Polish strikers had taken the idea of freedom altogether too literally, and the West was now as anxious as Moscow to damp them down.

The western bankers, having made handsome profits out of indiscriminate loans, now looked to their governments to help them out. They had held long and tense discussions in the Paris Club – the traditional casualty station of international banking – under the chairman-

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COUNTRY RISK

ship of the French Treasury, while the Poles had to come to terms with the rescheduling - or as they preferred to call it, restructuring - of their impossible debt. It was now clearly too dangerous to be left to the bankers. The ultimate country risk lay with the governments who faced the bleak task of trying to bring Polish finances back on the road towards realism, and Washington, London and Bonn shared the same financial worries as Moscow. While the Polish crisis had created a dangerous political tension between the superpowers, it induced a common interest between their central bankers.

By the end of March 1981 the crunch had come. The representatives of the Polish Central Bank met in London with representatives of twenty-three western banks, and explained that they could not make the repayments on debts that were due. A week later Warsaw confirmed by telex that they could not repay loans amounting to a billion dollars. The western bankers appointed a task force of twenty banks - including Lloyds and Barclays from Britain, the Dresdner from Germany and the Bank of America and Citibank from the United States - to undertake the painful process of rescheduling, while the political situation was constantly deteriorating: 'Never before,' wrote Peter Montagnon in the *Financial Times*, 'has a country on the financial brink in this way also been under threat of invasion from abroad.' The European banks, more heavily exposed than the Americans, wanted a speedy agreement to ensure that no single bank called a default and to try to revive the shattered Polish economy. The Americans, more mindful of lawsuits, wanted to freeze all loan agreements to give time for a more equitable agreement; and the Chase, which had been in the forefront, insisted that its loans to copper mines be treated separately. The bankers tried to insist on more information about the Polish economy, while the Soviets accused them of 'economic blackmail'; and at the time of writing (July 1981) the threat of invasion still hung over the negotiations. The unhappy love affair between bankers and the communists was emphatically over.

Turkey and Poland were both part of the same story. In both countries the bankers' herds had first fallen over themselves to lend without circumspection and then all retreated together. Their interest in both senses had been essentially short-term. Now, as they became more worried about their country risk, they looked again towards the world institutions - which had been left on the sidelines in the great lending boom.

RISK MANAGEMENT

HOW CORPORATIONS SHOULD MANAGE

It's as vital for manufacturing companies as for banks. But there are differences in approach. By Bharat Bhalla

Foreign risk assessment is a term normally used to mean *political* risk assessment. It is a way of selecting countries of reasonable political stability and acceptable risk for investment. In its fuller sense, foreign risk assessment should enable management to devise and develop strategies for avoiding, accepting, transferring, and adapting risks present in the total foreign investment cycle, from planning and initiation to divestment. In this sense, *assessment* becomes *management*: a strategic response to an uncertain environment affecting international investments.

Foreign risk involves defining, monitoring, and controlling risks. To be effective, foreign risk assessment must be linked with the specific business of each company, because the relevance and intensity of risk varies between industries and between products. Specific risks and sources of risk relevant to a specific business must be identified. Once this is done, monitoring and controlling risks becomes easier. Risks are products of change in regulations, policies, practices, institutions and decision makers.

Following the initiative of commercial banks in the US, multi-national manufacturing companies are developing in-

house expertise for foreign risk assessment. This effort is limited to major companies. Most manufacturing companies use input from outside agencies or commercial banks. This arrangement overlooks the uniqueness of individual industries and products. Banks deal in a homogenous product — money, a necessity for all nations. But manufacturing companies deal in heterogeneous products which are discretionary items for host countries. Banks lend liquid assets likely to be retrievable at any time. Manufacturing companies make permanent investments, mostly in fixed assets, which cannot be retrieved quickly without loss of value or ownership. As lenders, banks are primarily concerned with the creditworthiness or the debt-servicing ability of a borrowing country, which is not necessarily affected by the instability of its government, and is rarely damaged permanently.

A manufacturing company is equally interested in creditworthiness, but is much more interested in assessing socio-political-economic factors which could threaten the safety and profit-making ability of its physical assets. For banks, these factors are incidental to a country's balance-of-payment situation. Foreign risk management is much more comprehensive and complicated for a manufacturing company than for a commercial bank.

Foreign risk is defined as a change causing uncertainty about the business environment of a country. Economic uncertainties are changes in the environment that adversely affect the operational ability of assets. Political uncertainty embodies a threat to the safety of financial, human, and physical assets and emanates from

changes in government or policies. Most policy changes are made in response to socio-economic needs, so, for a manufacturing company, foreign risk has both economic and political dimensions.

According to its source, foreign risk can be classified as general or specific. General risks originate outside the country being assessed and vitiate its overall business environment. Their impact affects all foreign investors, in varying degrees. General risks include:

- War: regional or global.
- Economic shocks: from oil cartels, droughts, protectionism.
- Financial instability: LDC debt, oil dollar recycling.
- Corporate citizenship: UN and OECD sponsored guidelines.

Specific risks are changes within the sovereign state, unique to that country and resulting from policy changes made by its government.

There are three tiers of specific risks: country risk, industry risk, and project risk.

Country risk refers to the uncertainty caused by economic, political and social instability of a country and its ambivalent attitude towards foreign investment. It affects the initial foreign investment entry decision and the physical safety and ownership of assets subsequently.

Industry risk is caused by a change in the host government policy towards foreign investment in a particular industry, which is considered vital to national economic interests. Changes are expressed through official economic and budgetary statements and through institutions created to review, monitor and evaluate foreign investments.

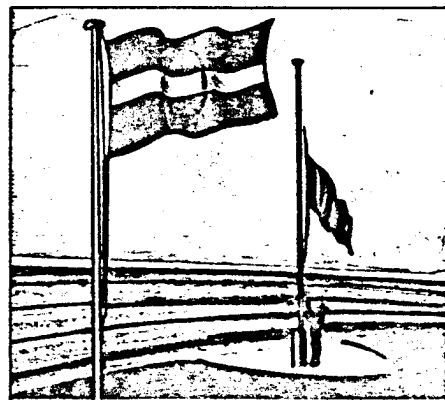
Bharat Bhalla is director of foreign risk management at The Continental Group, Inc.

INVESTMENT RISK EXPOSURE



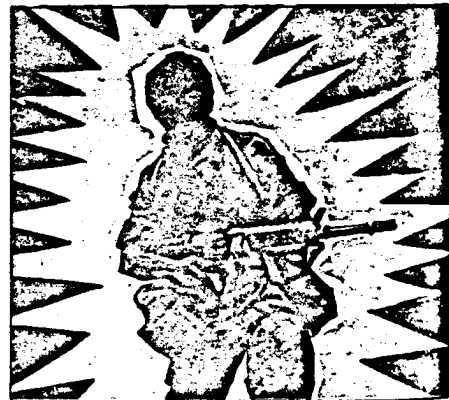
Political instability

Analysis Military is willing to restore civilian rule after 10 years. New constitution is being drafted and parliamentary elections are scheduled. **Impact on proposed investment** Transition to civilian rule likely to be frustrated by social disorder and military may be forced to retain some control.



Expropriation

Analysis Did expropriate most foreign investments and nationalized basic industries. However, Government is anxious to allow foreign participation with local private and state enterprises. **Impact on proposed investment** Remote possibility of expropriation of joint ventures with minority participation.



Terrorism

Analysis Hiring of expatriates is limited to 10% of a company's total employment. Normally, expatriates cannot be employed for more than three years. **Impact on proposed investment** No threat to expatriates' lives, but prudent to manage through local personnel.

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OLD WEIGH UP COUNTRY RISK

Project risks affect foreign investments in a particular project through a 100% owned subsidiary or a joint venture with a local partner. These risks relate to five operational aspects of a foreign investment: marketability, operability, profitability, remittability and the integrity of assets.

process is relevant for both new and existing investments.

FIRM is used in the planning stage of an international investment decision, to avoid unnecessary risk by selecting countries which are relatively stable and offer a market potential.

quality of its administration and the frequency and character of its change; and the legitimacy of the government, evident in public attitude towards and support for its leaders and political institutions.

Economic risk, reflecting the market potential of a country, was measured by:

- Demographic structure: Size, growth and density of population; growth and quality of labour force; and urbanization.

- Infrastructures: Adequacy of financial, human (administrative, managerial and skilled) and physical (communication and transportation) facilities.

- Economic structure: Sectoral contribution to gross national/domestic product and its changing character; extent of industrialization; and resource balance.

- Demand structure: Size, growth and density of per capita income, and regional market potential.

- Economic growth: Level, rate, and quality of growth reflected in gross national/domestic product; the importance and changing composition of foreign trade.

The level, growth, and density (distribution evenness) of per capita income is the most critical variable in assessing economic and socio-political risks of various countries. Per capita income reflects the character, quality and level of economic growth of a country, and also the quality of its economic policy makers and managers.

There is a correlation between socio-political instability and uneven income distribution. As the per capita income (PCI) increases beyond a certain level, political risk starts declining, and economic risk begins to emerge and become dominant.

Banks lend liquid assets. Manufacturing companies make permanent investments which cannot be retrieved quickly.

The purpose of foreign risk management is to identify the nature and sources of uncertainties surrounding a particular foreign investment and to develop appropriate strategies.

How can this goal be achieved? The following system has proved effective in identifying uncertainty and transforming it into manageable risk. This is achieved by a four-phase continuous iterative process consisting of:

- Foreign investment risk matrix (FIRM)
- Country risk profile (CRISP)
- Investment risk analysis (IRAN)
- Foreign investment risk audit (FIRA)

These states are interdependent and aim at developing feasible strategies for accepting, transferring, adapting and avoiding risk inherent in four phases of foreign investment: entry, growth, maturity and decline. This foreign risk management

In 1976, 114 market-oriented countries were evaluated for risk connected with the packaging industry. Each was rated on a risk matrix for short and long-term political and economic risks. Political risk was rated on an alphabetical, and economic risk on a numerical scale:

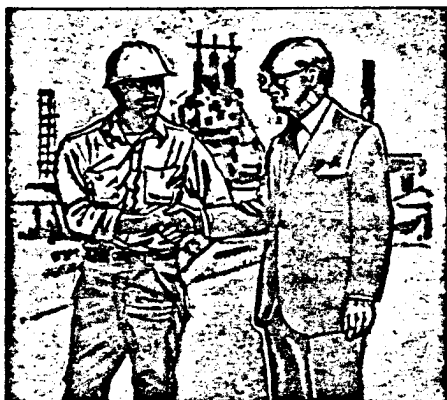
Political risk:

- A Stability
- B Moderate instability
- C Volatile instability
- D Substantial instability

Economic risk:

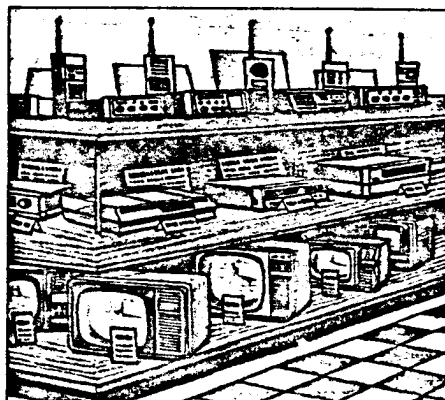
- 1 Acceptable risk
- 2 Moderate risk
- 3 Major risk
- 4 Unacceptable risk

Political risk was assessed in terms of the stability of the government, judged by the



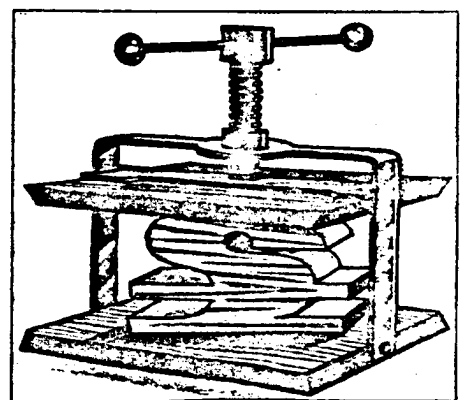
Co-determination

Analysis Workers allowed 10% profit sharing up to a maximum of 50% of equity. Law still applicable with certain exceptions. Workers' equity participation excepted in fishing and forestry. **Impact on proposed investment** Limits profit potential and management authority of enterprise.



Price controls

Analysis Food products are strictly controlled. Industrial goods producers are required to inform the Government only 24 hours in advance of price increases. Normally, cost coverage allowable. **Impact on proposed investment** Limited ability to support profits through increasing prices.



Depressed economy

Analysis IMF imposed an austerity programme, slowing down economic growth. Five year real GNP growth unlikely to exceed 2 to 3%. Debt service liability estimated \$5 billion in 1985. **Impact on proposed investment** Auster environment will constrain consumer market growth.

RISK MANAGEMENT

The per capita income of each of the 114 market-oriented economies was calculated by dividing the gross domestic product of a country by its population for each year. This series was calculated for 10 years (1965 through 1975) expressed in 1975 US dollars. The analysis of level, growth, and density of per capita income for these countries yielded specific results:

Countries with a per capita income of up to \$1,000 suffer from great inequality of distribution (5 to 10% of the population enjoying 25 to 50% of the national income). This was more pronounced in countries with a per capita income of up to \$600 and in countries whose economies depend for growth on one, or few, staple products or resources. Economic inequality and social disparity becomes much more emphasized as these economies start growing and diversifying. These economies continuously threaten the survival of the government and political institutions of their countries. The government's response is repression, or inconsistent economic policies that appeal to popular nationalism. These countries offer the maximum economic and socio-political risks.

Countries with a per capita income from \$1,000 to \$3,000, derived from a diversified economic base, show increasing balance in income distribution. The economic and socio-political risk of these countries is manageable.

Countries with a per capita income of \$3,000 and higher, from a diversified base and evenly distributed, generally enjoy a stable political system. But as the income level increases, economic risks increase. Economic constraints are expressed through policies aimed at protecting local interests; the social overtones of such policies often burden industry with increasing social costs and even allow

Country risk profile

Political stability	Internal: Political structure and institutions
	Power centres Ideological foundation Cultural foundation Bureaucracy
Social stability	External: Axis with superpowers (US and USSR)
	Regional economic and defence alliances Relations with neighbours Population density Demographic balance Level of education Family structure Ethnic composition Religious cohesiveness Labour and labour unions Income distribution
Economic stability	Economic goals (attainable or ambitious)
	Economic policy and management Economic and structural growth Economic infrastructure Resource availability Energy independence Role of foreign investment

labour participation in the management and profits of the enterprise.

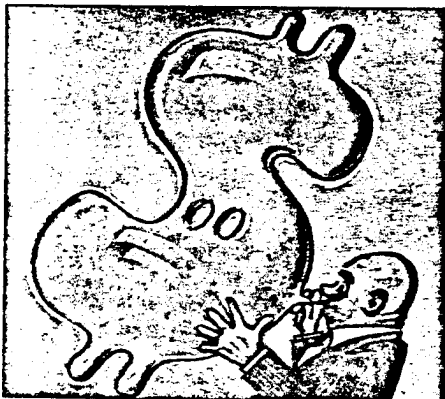
Within this overall distribution, countries experience growing economic and political turbulence during the transitional phase from one income level to another.

Of the original 114 market-oriented economies, 26 countries with a population of less than 5 million and per capita income of less than \$500 were dropped, as they lacked the market potential for packaging products. Fourteen countries with a population of less than 5 million and a per capita

income of over \$1,000 did not offer a market by themselves, but were considered as part of a regional market.

Chart 1 shows the location of 88 countries on the risk matrix, their population range, income level, and the compounded annual growth rate in their per capita income from 1965 to 1975. (The allocation of countries on the risk matrix is somewhat arbitrary and is being further refined.)

The risk matrix does not assign any specific priority for selection of countries by the product companies. However, it



Inflation

Analysis Currently 70% but likely to slow down to 30% by 1984. Real wages are sustained through indexation adjusted frequently, more than once a year.

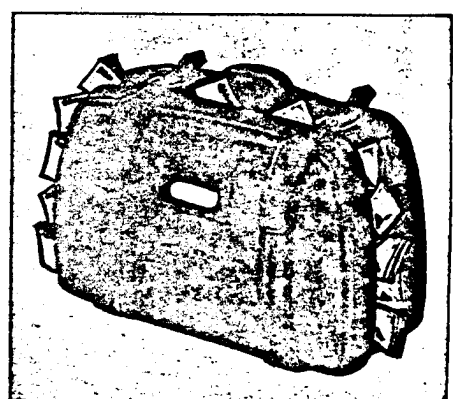
Impact on proposed investment Cost impacted due to indexation, rising benefits, and subsidies.



Devaluation

Analysis Exports being supported through mini-devaluation. 40% devaluation in 1979 and 25% in the next two to three years.

Impact on proposed investment Translation losses in the first three to four years.



Exchange controls

Analysis No exchange controls but limited availability of foreign exchange due to large debt burden. Foreign investment covered under Decision 24 of the Andean Pact.

Impact on proposed investment Annual profit repatriation limited to 20% of capital.

RISK MANAGEMENT

helped product companies to select initially countries in which to concentrate diversification efforts during the plan period.

The results of FIRM were reasonably accurate and reliable. In view of subsequent events, there were not many surprises.

Once a country is selected and an investment effort is initiated by a product company, foreign risk management concentrates on risk acceptance strategy. This is at the heart of foreign risk management, and is managed through the country risk profile (CRISP).

CRISP develops an understanding of the total business environment of a country. The main emphasis is on identifying sources of external and internal tensions and their potential threat to the socio-political and economic structure of the country; and on identifying risks relevant to the entry and operation of the planned investment.

CRISP is comprehensive but concise. It provides an analytical description of a country's business environment in its historical and future perspectives within the framework of the table on page 69. Economic projections are made over a 10-year period based on a country's present state of development, realistic economic policies and goals, and external financial and resource dependence.

Information developed at this stage is crucial. It enables a company to make a 'Go' or 'No Go' decision. It provides economic and other assumptions necessary

to develop an investment project. It specifies risks to the proposed investment and indicates feasible strategies, including capital and ownership structures, and outlines the basis for obtaining the host government's approval of the proposed investment. Information is available for monitoring investment after it becomes operative.

Once a decision is made to proceed and an investment proposal is confirmed by a product company, the investment risk analysis (IRAN) is carried out to verify that the indicated return on investment is realistic and consistent with the economic assumptions included in the CRISP report; and that the investment structure (capital, ownership, management, etc.) is designed to insulate the proposed investment from anticipated risks.

The exposure analysis is rigidly focused on risks already identified as ones to which a specific investment will be exposed in a particular country. The results of this analysis are summarized on pages 66, 67 and 69.

The final phase of foreign risk management is foreign investment risk audit, FIRA, aimed at adapting and avoiding unnecessary risks. FIRA has three specific objectives:

● FIRA is a continuing process and is helpful in foreseeing changes in the local environment which affect existing investments. It takes the surprise element out of

the situation and enables management to take preemptive action. Although it is impossible to anticipate or predict all changes, even a partial success helps to minimize the impact of an event. The monitoring of the host country environment is limited to changes already identified through CRISP as critical for the company's investments.

● FIRA facilitates the monitoring of changes in the local market which may warrant no further investment, or an eventual withdrawal. This assessment is used in developing an exit strategy without jeopardizing re-entry prospects.

● FIRA assists the development of economic information, and monitoring and evaluation of critical issues which form the basis of strategic planning. These issues include: world and regional political stability, energy outlook, international financial stability, economic interdependence or protectionism, and co-determination. These are reviewed and analyzed for a 10-year period, consistent with the company's strategic plan duration.

FIRA may be difficult and time consuming. However, it becomes manageable if, at an early stage of investment development (CRISP), areas of concern critical to one's business are identified. This allows operational and strategic significance of critical factors to be evaluated.

Foreign risk management is a strategic

Foreign Investment Risk Matrix (Firm)

Chart 1

Pop - Population range, 1965-75 PCI - Per capita income, 1965-75, in 1975 US\$ Figures in brackets show compounded annual growth rate in PCI, 1965-75

Acceptable

Economic

Stable

Socio-political risk

A	Japan France, Germany (Fed Rep), UK United States Pop 53-215m PCI \$4000-\$7500 (2.0-7.0%/yr)	Australia, Saudi Arabia Austria, Belgium, Netherlands, Denmark, Norway, Sweden, Switzerland Canada Pop 5-23m PCI \$5000-\$8500 (2.7-4.1%/yr)	Hong Kong Portugal Pop 5-6m PCI \$1600-\$2000 (5.2%/yr)	Cyprus, New Zealand, Israel, Kuwait, Singapore Libya Iceland, Ireland, Finland, Luxembourg Costa Rica, Jamaica, Trinidad & Tobago, Uruguay Pop Less than 5m PCI Over \$1000 (1.9%/yr)
	Greece, Italy, Spain Pop 9-56m PCI \$2000-\$3700 (2.5-6.0%/yr)	South Africa Mexico Pop 26-60m PCI \$1300-\$1500 (2.4%/yr)	Malaysia Algeria, Ivory Coast, Tunisia Ecuador Pop 6-16m PCI \$600-\$1000 (2.7-5.5%/yr)	India, Indonesia Pop 139-633m PCI \$140-\$250 (1.6-4.6%/yr)
C	Argentina, Brazil, Venezuela Morocco Colombia, Peru Pop 13-113m PCI \$1200-\$2500 (0-6.5%/yr)	South Korea Morocco Colombia, Peru Pop 7-45m PCI \$500-\$1000 (1.4-8.0%/yr)	Philippines, Sri Lanka, Thailand Cameroon, Kenya, Zimbabwe Pop 7-45m PCI \$225-\$500 (1.5%/yr)	Pakistan Angola, Ghana, Madagascar, Mozambique, Senegal, Sudan, Tanzania, Uganda, Zambia Haiti Pop 5-73m PCI \$175-\$500 (5.0-2.0%/yr)
	Iran, Iraq, Syria, Turkey Chile Pop 8-41m PCI \$800-\$2000 (0.4-7.5%/yr)	Egypt, Nigeria Pop 38-68m PCI \$350-\$800 (2.6-4.7%/yr)	Bolivia, Central America (El Salvador, Guatemala, Honduras, Nicaragua), Dominican Republic, Paraguay Pop 2-6m PCI \$375-\$750 (0.7-4.8%/yr)	Afghanistan, Bangladesh, Burma, Nepal Ethiopia, Mali, Zaire Pop 6-70m PCI Less than \$150 (Negative)

RISK MANAGEMENT

tool, and the method used for it is analytical. While political risk analysis is basically qualitative, economic risks are weighed heavily in quantitative terms. The end product is the outcome of informed judgement. The quality of this judgement is affected by one's experience in international business development activities.

The basic premise underlying foreign risk management is that, without understanding a particular country, it is extremely difficult to identify precise sources of risk to a specific foreign investment. This requires knowledge of that country's political system, structure, institutions; power centres and their interaction; quality of economic management; social, ethnic, and religious cohesiveness; and regional and global position.

There is no short cut to historical perspective. It requires patience and perseverance in investigating published literature and eye-witness reports. The comprehension of a country helps the assessment of one's business potential there, and the identification of specific risks to the investment.

The historical perspective should always be supplemented by a visit to the country. A visit should be used to verify available economic data and to gather additional information helpful in making a realistic

forecast of overall economic growth and of variables like labour costs, inflation and exchange rate, affecting the feasibility of the proposed investment; to establish the quality and size of infrastructure facilities necessary to support projected market growth; to assess the magnitude of income disparity and the rate at which this gap can be narrowed down; and to understand the quality of the current administration, its ability to manage the economy effectively in the future, and its ability to survive under pressure.

The knowledge gained during a country visit is helpful in judging its overall investment potential and the specific risks to the proposed investment. This judgement can be biased if the visit is confined to contacts mainly with the official agencies. Certainly, they must be visited and heard to get the official view. But a conscious effort must be made to learn the dissenting or adversary view from various sources — leaders of the opposition parties, labour leaders, small or medium-sized businessmen, academicians, and journalists.

This method has proved effective in predicting events and their approximate timing, and helpful in managing risk exposure. The fates of dictatorial régimes in Nicaragua, Iran, and South Korea were predicted six to 12 months before they

became historical facts.

Changes in economic policies and events affecting investments in various countries were also predicted with reasonable accuracy.

Foreign risk management is essential for all manufacturing companies already engaged, or planning to engage, in international diversification through foreign direct investment. Growing uncertainty is caused by changing political relationships amongst 167 sovereign nations, their independent and frequently changing economic policies supporting local or national interests, and the demand for establishing a new world economic order, in which resource-rich countries are guaranteed a true economic rent for their resources from consuming nations.

This economic and political turbulence calls for a rigorous environmental assessment by multi-national companies to transform uncertainty into a definable, predictable, insurable, and manageable risk. Foreign risk management does this. As a strategic tool, it pays for itself.

It helps companies avoid bad and unprofitable investments. It minimizes the risk exposure of committed investments, helps to avoid further risk exposure and develops the sense of confidence necessary for international diversification. □

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International Outlook

EDITED BY SOL W. SANDERS

BRAZIL COULD MAKE OR BREAK A LATIN AMERICAN 'DEBTORS' CARTEL'

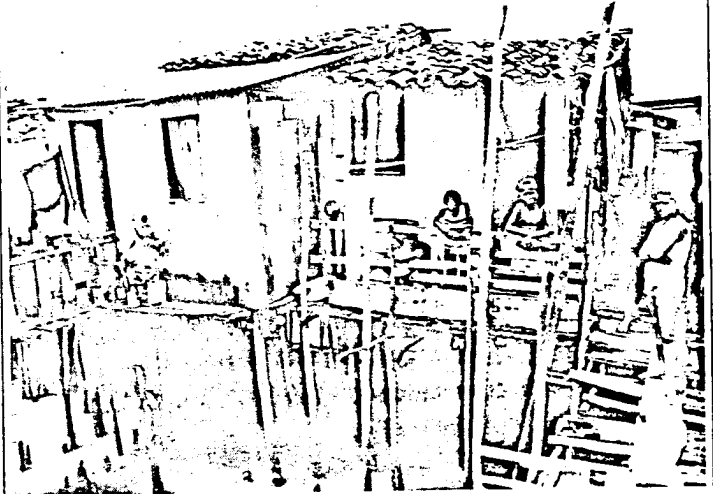
The specter of a "debtors' cartel"—a combine of countries that would call for a debt moratorium—is hovering over a meeting of the Organization of American States in Caracas on Sept. 5-9. Originally proposed by Venezuela, and opposed only by the U.S., the meeting will discuss "a Latin American response to the international economic crisis." U.S. bankers hope the meeting will serve only as a sounding board for debtor countries' complaints.

So far heavily mortgaged countries have resisted a unilateral repudiation of debts, because such a move would reduce them to cash-and-carry trade with the rest of the world. Bankers also count on divergent interests among the debtors to thwart any agreement. Mexico, for example, has swallowed the strong austerity medicine prescribed by the International Monetary Fund (IMF) and improved its credit position (page 49). Thus it is unlikely to go along with Venezuela, the most vocal advocate of a still-nebulous "global debt negotiation."

Brazil, the most critical Latin country, has opposed a moratorium, using belt-tightening to maintain access to new money by meeting payments on its \$90 billion debt. But it is already more than \$2 billion in arrears. And support is growing inside Brazil—and outside—for the argument that its economy cannot continue to carry its present debt load. If that view were to overwhelm the essentially conservative Brazilian bureaucracy, the world banking structure would face a crisis.

A FRESH START. "Brazil is a developing country with serious internal imbalances and an external impasse, both of which require implementation of realistic economic policies," says an August newsletter of Banco de Boston, the Brazilian branch of First National Bank of Boston. "A good start would be... ample renegotiation of the foreign debt, which is understood to be stretching out maturities with necessary rate adjustment." Without that, the report says, austerity will exacerbate Brazil's two-year-old recession (BW—Apr. 8).

A number of smaller foreign banks believe the latest IMF renegotiation was just another quick fix that, like an earlier one in February, will fall apart when Brazil cannot or will not implement its draconian measures. Their solution is a major restructuring of the Brazilian debt—at significant cost to U.S. banks, Brazil's biggest creditors. In May the IMF and foreign banks stopped paying out about \$1 billion in new financing, because Brazil was not meeting commitments to reduce the public-sector deficit. Since then, however, Brazil has increased taxes, lowered consumer subsidies, reduced government in-



A SHANTYTOWN IN THE STATE OF BAHIA: FOOD CONSUMPTION IS DROPPING, AND 40% OF BRAZIL'S WORKERS ARE UNDEREMPLOYED

vestments, set caps on interest rates and rents, and stiffened price controls. Bankers are most heartened by a curb on salary increases, limiting them to 80% of the inflation index, although the measure still requires congressional approval.

But some argue that these tourniquets are causing gangrene. Economists predict the gross national product will drop by as much as 4% this year, after last year's estimated 1% increase. Banco de Boston says that 40% of Brazil's 47 million workers are underemployed, and, despite an annual 2.5% population increase, food consumption declined for the third year. The impressive trade surplus of \$3 billion through June was based on a 23% import cut. Industries are stagnating from lack of imports, and local banks are refusing to lend at artificially low rates. Inflation is now at 142%; July's 13.3% was the highest monthly rise in history.

The clamor is rising, with some businessmen advocating debt repudiation. Brasília's technocrats have resisted, not only because they believe continued access to new credits is essential but also because they feel that, as the largest debtor, Brazil has enormous leverage on world capital markets. This attitude is enhanced by Brazil's traditional aloofness from Latin American cabals. But the heady atmosphere of rhetoric and desperation in Caracas could generate new pressures. ■

CHINA TRIES THE SOFT SELL IN TIBET

China's leaders have switched from harsh repression to more benevolent rule in Tibet, hoping to demonstrate the benefits of autonomy within a reunited China—an arrangement they are also offering on even more liberal terms to Hong Kong and Taiwan. But a little freedom extended to the Tibetans is proving, from Beijing's point of view, a dangerous thing. Tibet offers little evidence that Beijing's program has eased bitter resentments against Chinese domination.

In 1951, Tibetans yielded to Chinese Communist pressures for more control over their country—beyond the traditional Chinese "suzerainty"—in return for pledges not to tamper with Tibet's Buddhist faith or impose a socialist economy. Although those promises were much less generous than those now being offered Hong Kong and Taiwan, the Chinese reneged after an abortive 1959 uprising and began sacking monasteries and communizing the land. In 1980, after a fact-

CAN'T PAY? WILL PAY, BUT IN SULTANAS

Barter need not bring you unwanted diesel engines.

By Rupert Birley

Barter is also known as compensation, buy-back, counter-purchase, switch, reciprocal trading, pay-back, bilateral trading and parallel transactions. The Indonesian Department of Trade calls it: "The implementation of linking government procurements from imports with Indonesian export products, excluding petroleum and natural gas."

To the Rumanians it's "parallel business"; to the Russians "compensation".

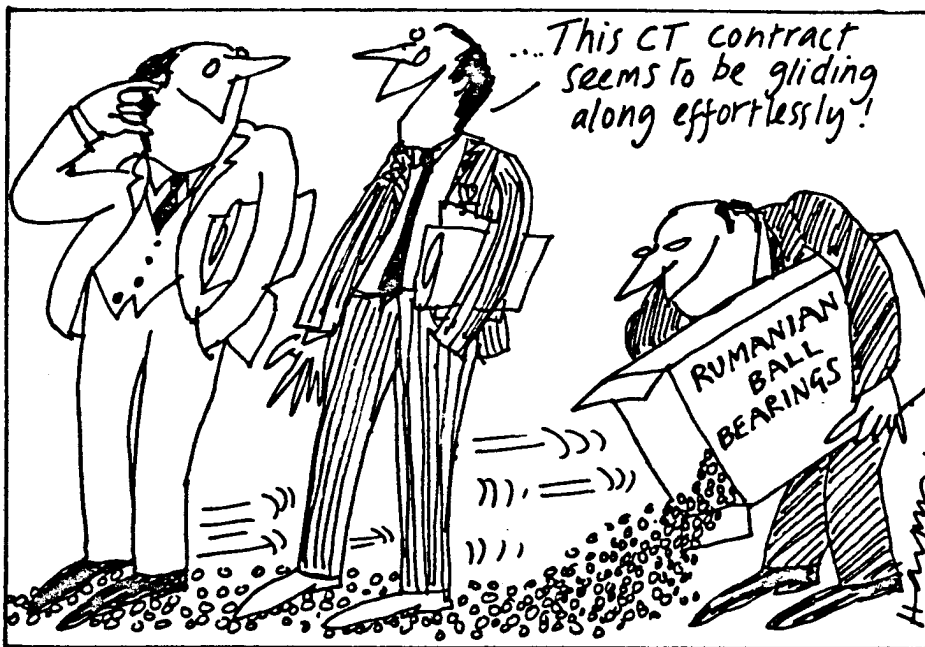
Barter deals between east and west are now extremely rare, since western manufacturers dislike being landed with a lifetime supply of Yugoslav hams. But between eastern European countries and developing countries, and among developing countries, barter goes on.

Payments are effected in soft, non-transferable currencies, known as clearing dollars or clearing roubles. Imbalances often arise, because one partner cannot absorb goods equal in clearing units to those he has sold to the other. In the 1950s and 1960s, the heyday of these agreements, there developed a sophisticated trade in clearing surpluses known as switch (because it involved the switching of goods from a communist country to the open market).

For example, an imbalance might build up in the Polish/Greek clearing agreement (which is defunct since Greece joined the EEC) because Poland had not bought from Greece as much as it had sold. A switch trader would buy the rights to 250,000 clearing dollars from the Poles for \$225,000 (a discount of 10%). The clearing dollars would then be sold for \$235,000 (a 6% discount) to a European sultana merchant who used them, through the Greek Foreign Trade Bank, to purchase Greek sultanas at a discount to what he would pay in hard currency. This multilateral use of bilateral agreements would reduce the imbalance between Poland and Greece — and generate trade which otherwise might not have taken place.

Barter, countertrade or CT used to be an exotic feature of trade with eastern Europe. Experts in it had names ending in "owsky" and "nyi", and could usually be found in Vienna. Nowadays, information about CT is more widespread. Banks are hiring CT experts as fast as they can find them.

The international trading houses such as Philipp Brothers, the Man Group, Marc Rich and Cargill should be ideal vehicles for transactions of this sort. They are secretive about what they do, as their business



requires discretion. Rumours abound of CT deals involving the trading of New Zealand lamb for Iranian oil, and Thai rice for Brazilian maize, but nobody is prepared to be precise about who put these deals together.

There are signs, however, that these trading houses are now coming out into the open. André, Lausanne, is one trading group which has for many years successfully run a CT department in conjunction with its mainstream trading activities.

Others, such as the Man Group, are also beginning to adopt a more systematic approach to CT. Tradax, Cargill's subsidiary in Geneva, is now head-hunting CT experts.

Barter trade has increased. But how important is it in terms of world trade? The US Department of Trade predicts that it will account for 10 to 20% of world trade in the 1980s. Reliable statistics are, however, non-existent. Western exporters are reluctant to divulge details about deals which have been condemned by western governments, by the IMF and GATT as distorting multi-lateral trade, and by Europe's trade unions as encouraging the dumping of goods on western markets with consequent losses of jobs. The Osteuropa Institut München recently studied estimates of the share of CT in total east-west trade, which ranged from under 10% to 77%.

CT has now expanded far beyond Comecon countries. The Indonesian government in 1982 made 100% CTs in non-oil and gas commodities obligatory for all government-awarded contracts. The penalty for non-compliance is 50% of contract value. According to sources in Indonesia, contracts signed on this basis

already amount to \$250 million.

Other ASEAN countries are following suit — much to Japan's dismay — while oil producing countries, such as Venezuela, Iran and possibly Nigeria, are offering otherwise unsaleable oil in lieu of payment for capital imports. Mexico and Brazil are now refusing to discuss imports even of raw materials unless some form of CT is considered.

CT, however, is not restricted to LDCs or countries with unmanageable foreign trade debts. As any aerospace executive will tell you, willingness and the ability to handle CT is often decisive in winning contracts in western Europe. In 1980, the Austrian Government decided to buy Mirage jets because the French accepted a measure of CT; Rolls Royce's sales to Finland entailed



COUNTERTRADE

the marketing of various Finnish consumer items such as TV sets; Messerschmitt Bolkow Blohm are now negotiating sales to Italy and Belgium, both of which will entail a large percentage of CT.

During his state visit to Indonesia in January, Canada's Prime Minister, Pierre Trudeau, argued that contracts worth \$160 million, won by Canadian firms for the \$1.3 billion Bukit Asam Mining Development project in South Sumatra, should be exempt from CT.

The Indonesian government, however, stuck to its guns, even threatening to renege contracts already awarded to Canadian firms. In late February the Canadian government notified Jakarta of its full acceptance of the CT policy.

As governments have reconciled themselves to what many consider a necessary evil, the advisory services they offer have improved. Before Trudeau visited Indonesia, the Canadian government had completed a fact-finding mission in Europe on all aspects of CT. The US Department of Commerce and the UK Department of Trade and Industry provide explanatory booklets.

Perhaps the best service is provided in France, where in 1977, following prompting by Raymond Barre, then Prime Minister, ACECO (Association pour la Compensation des Echanges Commerciaux) was set up by France's five leading banks and the Paris Chamber of Commerce and Industry. Funded by subscriptions from member companies, it gathers and distributes detailed information about developments in CT all over the world.

A similar service offered by the Evidenz-

büro, which was set up by the Austrian Federal Chamber of Commerce, the Ministry of Trade and Industry and Association of Industrialists.

US and UK banks have been, with few exceptions, latecomers. Citicorp and European American Bank have recently set up their own CT departments.

Three European banks, Kleinwort Benson, Crédit Lyonnais and Creditanstalt Bankverein, have gone into the CT business in a big way.

The Creditanstalt Bankverein, Austria's leading bank, has for many years owned AWT (Allgemeine Finanz-und-Waren-Treuhand), a trading subsidiary. AWT has had considerable success in negotiating and discharging CT contracts on behalf of the Creditanstalt's clients. Business in eastern Europe has dried up; it is now concentrating more on its *à forfait* business. The Creditanstalt also has an 11% stake in Hungary's Central European International Bank, the first western-financed bank to operate in Comecon.

Crédit Lyonnais has set up its own CT department, and participates — in partnership with France's other banks — in ACECO and in COOPINTER (Société de Cooperation Internationale), whose speciality is CT in Rumania. Crédit Lyonnais joined forces with the US-based Lissauer Group to form Greficomex in 1980.

In addition to the Merban Corporation, which has had considerable experience with CT, Lissauer also owns Associated Metals and Minerals, New York, Leopold Lazarus, London, Metall & Rohstoff, Zug, and Oxyde, Amsterdam, all of which supple-

ment the financial expertise of Crédit Lyonnais with solid trading back-up. This marriage of bank and trading group has been a success, because purchases in CT are handled within the group and are not farmed out to third parties (as is often the case with other CT subsidiaries of banks).

The Centro Internationale Handelsbank (Centrobank) in Vienna was originally the brainchild of Kleinwort Benson. Founded in 1974 by a consortium of banks led by Kleinwort Benson (and including the Bank Handlowy, the Polish Foreign Trade Bank), Centrobank was conceived as a merchant bank in the historical sense of the word, with its banking and trading activities equally balanced. Centrobank has a reputation for innovation. Under the joint management of Gerhard Vogt, a former grain dealer who syndicated sales of Austrian grain to Poland, and Kazimierz Glazewski (who was appointed president of Bank Handlowy in February this year) it has pioneered many new techniques in countertrading, such as the use of evidence accounts. It is now setting up an office in Jakarta to handle Indonesian CT.

CT is often a vital element in a trade financing package for the Third World.

Here the banks are useful. As sources of commercial knowledge and credit information, they complement the role of the traders. But problems arise when the banks try to go it alone through subsidiaries which lack focus and whose employees end up as jacks of all trades and masters of none. Because they can rarely act as principals to the CT deals under their supervision, they often play the role of the honest broker, with a consequent reduction in profit. ▶

COUNTERTRADE VARIES FROM AIRPORT CONSTRUCTION TO COKE

Countertrade or CT includes:

A INDUSTRIAL COMPENSATION

i) Buy-back agreements

These are agreements not worth less than \$20 million lasting from five to 25 years, that involve the delivery of industrial plant, with 100% repayment in the resultant manufactured products.

Examples: Occidental Petroleum's agreement, signed in 1974, to supply the USSR with two ammonia plants, with repayment over a ten-year period in ammonia; Davy Power Gas and ICI's 1977 agreement to supply the USSR with two methanol plants, with repayment in methanol.

ii) Co-operation agreements

These do not entail CT in resultant products.

Examples: PepsiCola's 1972 agreement with Nixon's help to sell the USSR Pepsi concentrate in exchange for vodka; and the agreement in 1977 between Cementation International and the Polish Ministry

of Foreign Trade for the construction of a complex at Warsaw airport. This involved the employment of Polish construction crews on CI's contracts with Third World nations, plus the purchase by CI of Polish construction material.

iii) Joint venture agreements

These involve western equity participation with the partner.

Example: Honeywell's joint venture with Yugoslavia for the manufacture of computers.

B COMMERCIAL COMPENSATION

This covers the smaller transactions, between \$10,000 and 1 million, lasting from six months to three years, with two separate contracts (one for the sale; the other for counter-purchases in non-related products).

i) Pre-compensation

The western supplier purchases before he sells. Whatever he purchases qualifies as a credit to be offset against subsequent deliveries.

Example: R. J. Reynolds sells Camel

and Winston cigarettes to Hungary on this basis.

ii) Parallel transactions

The counter-trade is carried out after delivery by the western firm.

Example: The sale of machinery worth \$250,000 to the Rumanians. The seller has to purchase Rumanian machinery products equivalent in value to 50% of the sales contract within a specified period (usually 12 to 18 months). Failure to do so is subject to a penalty, anything from 5 to 100% of sales contract value.

iii) Framework agreements (goodwill or gentlemen's agreements)

These are what every exporter hopes for. Whereas non-fulfilment of (i) results in no sale, and of (ii) a penalty, framework agreements rely on goodwill.

Example: Rolls Royce supplies components without which Rumania's domestic airline would grind to a halt. The best endeavours clause in the sales contract merely refers to "Rumanian products".

COUNTERTRADE

Although many banks offer a CT service to their clients, it is very rarely a profitable exercise. Centrobank is, perhaps, the exception.

"Most banks are not structured to handle these deals," said John Burge, general manager of Fendrake (a Kleinwort subsidiary involved in trade and trade finance) who is also Kleinwort's liaison man with Centrobank. "This is a trading business with trading risks. On the other hand, the banks do lend credibility to an esoteric style of business."

The boom in buy-back deals in the late 1960s and early 1970s led to the setting up of trading units specialising in CT by large manufacturing and engineering groups. With characteristic over-saturation, the big Japanese corporations such as Mitsubishi, Marubeni and Nissho-Iwai set up permanent offices in all the Comecon capitals, which they have maintained ever since, long after their European rivals decided that theirs did not justify the cost.

The corporations' own CT subsidiaries have had experiences similar to those of the banks. The Germans, French, Austrians and Italians have had the most success.

Industriehandel, Daimler-Benz's equivalent, has had success, not only in using CT as a means of maintaining sales to cash-strapped markets, but also in turning it into a profitable business exercise. Such is its expertise that it has been known to take over and discharge CT obligations on behalf of other companies.

The UK and US groups have recently been making up for lost time. British Aerospace, Hawker-Siddeley and Rolls Royce are already CT veterans, while GKN, Courtaulds and Massey Ferguson have expanded their trading departments.

Rockwell International Trading Company has in the last two years educated Rockwell's various divisions in CT, and has already identified several areas where counter-purchases can be streamlined into the group's existing purchases.

Tins of Ham & Ham & Ham

One European telecommunications group was saddled with a CT contract in Poland. They established that the CT contract permitted purchases of copper wire, which was required in large quantities for their own manufacture of telephones. The Polish copper wire, however, required certain modifications. Research revealed that the cost of installing the machinery to modify the wire in the Polish factories more than justified the vast savings made in discharging their CT obligations internally.

Not everyone, however, gets it right. In one US group Christmas bonuses have been, still are, and will forever be measured in tins of surplus Yugoslav hams.

What new business there is in Eastern Europe now is to

stipulate unsaleable products (such as oil-drilling platforms or Diesel Motors). As a result, independent traders are asked to help with CT contracts which are no longer flexible enough to be handled internally. A major German supplier of steel products to the Rumanians, until recently, successfully and profitably arranged counter-purchases of pulp and paper.

With the introduction of more stringent CT measures by the Rumanian government, however, they were informed by their Rumanian buyer that in future only purchases of "related products" would be acceptable. It was "suggested" that ball bearings would be ideal. The German company has no internal need or marketing outlets for ball bearings, but is anxious not to lose its sales to Rumania. It has, therefore, no choice but to seek the support of outside traders to offload the ball bearings on its behalf.

East German efficiency

If the company is lucky, it will find a trader already buying Rumanian ball bearings. A deal can usually be struck whereby a small commission is paid to the trader if he will link his purchases to the supplier's CT contract. (This usually entails the insertion of a clause into the purchase contract along the lines of: "The FOB value of this purchase contract will be considered as fulfilment of company X's counter-purchase contract no. . . .")

Failing this, companies tend to turn to independent CT specialists. These are often ex-employees of large trading companies who have set up on their own. They often distribute news sheets to their clients, quoting commission rates for particular products from particular countries (i.e. 16% for Rumanian machine tools) and are invariably to be found at the eastern European trade fairs, scurrying from stand to stand brandishing their business cards. The best known is Wilhelm Schulz, whose Bremen-based company, Wilhelm Schulz KG, has been successfully broking CT contracts for over 20 years.

Many companies are indebted to one-man operations in Lausanne, Vienna or Berlin for fixing CT problems.

With the contraction of CT business in eastern Europe, independent specialists have fallen on hard times. The survivors are attempting to adapt themselves to Third World CT.

Since they advocate CT as a good way of increasing trade, and are trying to extend it, the East Europeans and their imitators might be expected to possess a few skilled CT specialists themselves. The answer is officially "no", but unofficially "yes".

East Germany, with customary Prussian efficiency, provides standardized CT contracts, and offers extensive guidance on how best to expedite the business.

administratively by the Third World countries insisting on it. Indonesia, the only country outside eastern Europe to introduce official CT regulations, has until now relied heavily on the expertise of specialized organisations such as Centrobank. Everyone is praying that they will not follow the eastern European example too closely (and particularly not the Yugoslav example, which is utterly chaotic). There was a scare in 1980 when rumours began to circulate that the Chinese were consulting the Yugoslavs on CT.

Unofficially, the experts exist. Interagra is run by Jean-Baptiste Doumeng, the French Communist who grew rich by "exploiting flaws in the capitalist system". It is known for its sales of EEC surplus butter and meat to the USSR, and it has just completed a barter deal with Vietnam, the newest recruit to Comecon. Companies associated with Italy's and France's Communist parties have built up profitable sidelines in the field of CT. Many subsidiaries of eastern European trade organizations in the west have realized that linking their existing sales to CT obligations is an easy way of earning commission. This is fine for western suppliers, but negates the already dubious benefits of CT for those who imposed the system in the first place.

In the 1960s and 1970s, CT in eastern Europe always involved counter-deliveries of shoddy, finished products which could not be marketed through normal channels. Raw materials, such as coal, sulphur or sugar, were never eligible for purchase within the framework of these contracts.

Today the reverse is true with CT in Third World countries. Global recession and slumping commodity prices have forced these countries to offload their commodity surpluses by means of reciprocal trading arrangements: oil from Venezuela and Iran; cotton from Mexico and the Sudan; rice from Thailand, Pakistan and Burma; timber and rubber from Indonesia . . . the list gets longer every day.



Vietnam is on the other side of the world. Even El Salvador seems remote. But if turmoil comes to Mexico, there is no way the U.S. can avoid being dragged in. Here's why the current Mexican crisis, so threatening to the U.S., goes deeper than the usual complaints about oil prices, foreign debt and corruption.

Can Mexico pull through?

By Norman Gall

Miguel de la Madrid: the president as priest and king.

"Muchas gracias, Señor Presidente, muchas gracias." The president of the republic was seated in a crowded tent pitched on the small cattle fairground of the *municipio* of Tlaquiltenango in the dry hills of the Valle de Vazquez in the state of Morelos. Near here, seven decades ago, the guerrillas of Emiliano Zapata dodged federal troops during the bloodiest phase of the Mexican Revolution. Now the descendants of these guerrillas were patiently waiting their turn to present their requests and make their complaints to the highest authority. Each of them would get just 30 seconds to present his or her case.

The speeches are brief because the meeting has been very carefully arranged. "Señor Presidente: Valle de Vazquez covers 12,000 acres, of which roughly 11,000 are dry hills and only 1,000 can be farmed when it rains. We are 2,000 inhabitants. With the money you have given us, about U.S. \$63,000, we have invested in fences and pastures and water troughs and a corral, benefiting our families. Lastly, we peasants of Valle de Vazquez ask you urgently to provide us with an irrigation system to better use our land. For all this, we thank you."

Notwithstanding the republican and revolutionary trappings of his office, the president of Mexico is a priest and a

king. He travels often among the dusty villages of his realm, as do few of the world's heads of state, in a continuing ritual to renew the security and legitimacy of the rule of the *Partido Revolucionario Institucional* (PRI), which has governed Mexico for the past half century.

The presidential pageant is accompanied by flags, flowers, mariachi bands, speeches, recitals of the conquests of the Revolution and vows of support for the president of the republic, who brings gifts for his people. The pageant triumphantly passes through a blur of baked Indian faces on baked village streets, half hidden by banners and posters bearing portraits of Zapata, the Indian with glistening eyes who rose from the mass of peasants whose communal lands had been stolen. Zapata refused to be bribed and had to be killed. In death as in life, however, then and now, he haunts the essentially conservative leaders of the Revolution, who have been unable to cure many of the sufferings that led him to rebel. All the more reason for the president to listen, and try to help. The populace must not think of the government as being remote and unresponsive.

"Señor Presidente: The lands of Morelos are turning to dust," announces Manuel Peralta Subdiaz over the loudspeaker in Tehuixtla, the next stop for the presidential motorcade. "We are the state that most needs conversion of dry farmland for irrigation. But the participation of the officials in charge of the irrigation programs has been

mean and devious. Please help us. *Muchas gracias.*"

Big problems and small ones, the president is expected to solve them all. The priestly and kingly functions of the Mexican president come from the Aztecs, whose emperor declared himself to be a god. The incessant presidential touring began in the reign of General Lázaro Cárdenas (1934-40). This hulking, taciturn son of a small-town pool-room proprietor became the towering figure of the Mexican Revolution after he nationalized the foreign oil companies in 1938. It was Cárdenas who established the ritual that, 45 years later, Miguel de la Madrid is now observing. In those days the provincial revolts and counterrevolts still had not ended, and a presidential presence in the interior was a political imperative.

President de la Madrid does it somewhat differently, however, from most of his predecessors. Instead of giving a speech in each village, the newly inaugurated (December 1982) president listens with great care to the speeches of others in the ritual acted out before him. Behind his

crisis since the armed phase of the Mexican Revolution and the Great Depression of the 1930s. But today we are a bigger and more complex country. In 1930, after the civil war ended, we only had 16.5 million people. Today we are 75 million Mexicans. The size of our economy is much greater, and so are the dimensions of our crisis. For the first time in this century we are going through 100% inflation and economic stagnation at the same time.

Nevertheless, I don't think you can compare Mexico with other countries where economic problems have led into social and political crisis. Although Mexico still is backward in several aspects of its economy and its society, it has been continually modernizing ever since the Revolution.

We have a stable political system, very stable when you compare it with the rest of Latin America and political systems elsewhere in the world. Moreover, Mexico is endowed with large and diversified natural resources. We are the world's fourth-ranking country in oil and gas



silence may lie the brutal fact that the president of Mexico now has little to promise and less to give. Nevertheless, small requests are made and often granted. Symbolism counts for much.

In Tehuixtla the merchants of the municipal market asked the president for a desk and chair, filing cabinet, typewriter, 30 folding chairs and a roof for their stalls. In another request, Hipólito García Albarrán told the president: "Man does not live by bread alone. He needs entertainment. For this reason we have formed a brass band that we wish to expand with two trombones, four trumpets, three saxophones, a drum and a pair of cymbals."

The requests were granted. The President has renewed his ties, and his party's ties, to the people.

Miguel de la Madrid: We shall overcome our difficulties.

The following are excerpts from an interview with Miguel de la Madrid, president of Mexico, conducted in Spanish by FORBES Contributing Editor Norman Gall:

The U.S. and Mexico are increasingly interdependent and so people in the U.S. are worried about Mexico. Our people discuss the possibility that Mexico may become another Central America or another Iran. You yourself have referred many times to the gravity of this crisis.

De la M. Approved For Release 2008/01/23 : CIA-RDP97R00694R000200870001-3

reserves. We have abundant mineral resources, most of them still to be discovered. We have abundant farming and cattle land whose productivity gives us a wide margin for improvement. Mexico already has reached 14th place in the world in fisheries production, and we are only beginning.

For thousands of years, the presence or lack of water has been a matter of life or death in Mexico. Recently Mexico has been lacking water.

De la Madrid: I agree that water is one of the great problems of Mexico. Our hydraulic resources are very unevenly distributed. They are concentrated in the tropical south-east, where the problem is flooding, swamps and runoff of valuable water to the sea. On the other hand, the central plateau and the north, where three-fourths of the population is concentrated, can be considered desert country by standards of rainfall.

Over the past half century, one of Mexico's great achievements has been the building of gigantic hydraulic works—dams, irrigation canals and deep-draft wells—that have brought increasing amounts of land under cultivation. Nevertheless, water remains scarce. Large areas of farming and cattle land depend on rainfall, and, as you have said, there is great scarcity of water in the cities just as the cost of extracting, transporting and distributing water is increasing.

exico. We must learn

how to use it better. In the future we must build more small dams and irrigation canals to maximize development of our water resources. The result will be a new culture of water that will create greater awareness in Mexicans of problems of scarcity by raising the price of water.

Water is far from being the only necessity subsidized by the Mexican government.

De la Madrid: One of our economic strategies is revision of our policy of subsidies, which have grown to be an important part of the budget and have put us under heavy pressure.

Growing deficits, caused by artificially low prices of public goods and services, to a great degree explain the inflation we are now suffering. Adjusting these prices will imply some sacrifices and some important changes of

co or the rest of the world. We are achieving this by increasing government income—raising sales taxes and prices of public sector goods and services—and by cutting public spending. This is an enormous sacrifice, painfully affecting living standards and expectations. But I am convinced that there is no other choice.

In Mexico our deficit comes from a low tax burden, not because rates are low but because of inadequacies in administration of the revenue system. There still is much tax evasion.

Mexico City has become the second most populous metropolitan area in the world. Isn't it cheaper and more viable to resettle people in other places?

De la Madrid: The cost of the city's expansion is extremely high and it represents an injustice to the rest of the republic. Subsidies have made the city more attractive and have stimulated migration even more. In our new Development Plan for 1983-88, one basic goal is decentralization of national life. Within our system of freedom—of work and movement—we cannot impose coercive measures to block people from coming to Mexico City or to expel them. But we can take measures to encourage them to move to new poles of attraction that are being developed in other regions.

Many millions of Mexicans do not produce or earn enough to live. This is why subsidies were started. They seem to paper over a basic imbalance between population and resources.

De la Madrid: We are convinced that we should reduce our rate of population growth. In the 1960s the population was growing by 3.5% yearly. Today the rate is going down, and we intend to reduce it to 1% by the end of the century. Over the past decade the government has been supporting family planning, and this will continue.

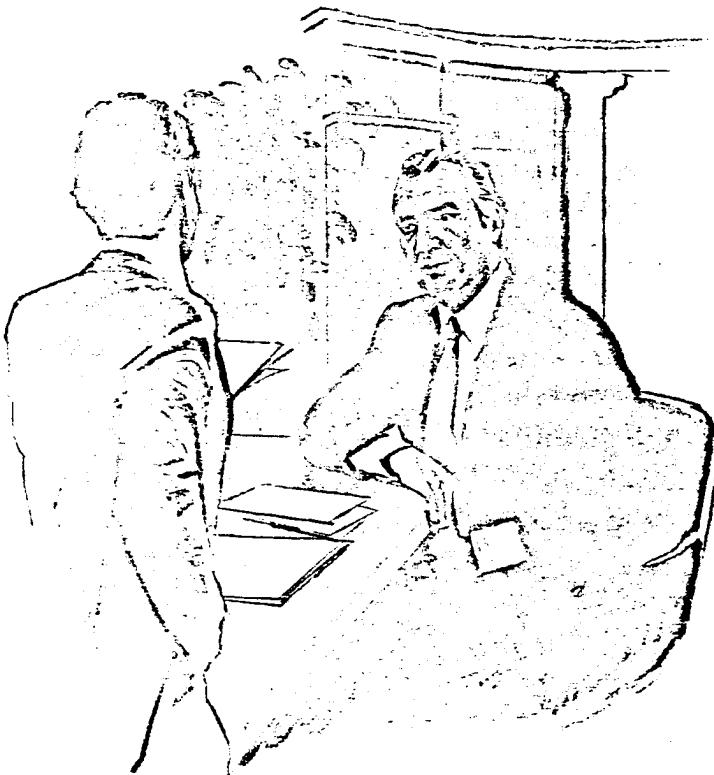
It is true that many of our people live at the subsistence level. But many others have achieved standards of living that we could not have dreamed of a few decades ago. We also must take into account the improved capacity provided by technological innovation, in Mexico and throughout the world. Thus, with better use of our own natural resources and with improved technology, we can continue aspiring toward dignified standards of living for all our people, even when this means changing many patterns of past behavior.

Some critics say the basic problem in Mexican economic policy is the domination of the public sector over the private sector.

De la Madrid: Mexico wishes to continue living in a mixed economy and will take measures to ensure that the public and private sectors coexist. We are introducing more realism into pricing policies to ensure sufficient profitability for private business to work and invest. We are promoting a reasonable equilibrium between the public and private sectors by helping companies with their financial difficulties, by recognizing the realities of prices and by stimulating private activity through fiscal, credit and tariff policies. Over the next few months, once we pass the worst phase of our economic crisis, I expect the private sector to resume its role as a force for economic growth. As for prices, we cannot free them all at the same time because this would accelerate inflation. But I must remind you that in December, the first month of my government, we freed half of our price controls.

Many thanks, Mr. President.

De la Madrid: Your questions penetrated our reality. They are my questions as well. I ask myself them every day.



habit. But it will bring us closer to economic rationality.

At the same time, we must realize that Mexico was a much weaker country four or five decades ago than it is now. We have modernized and absorbed new population that has grown at the world's highest rates. Our school population is now 24 million, more than the whole Mexican population in 1940. We have taken great strides in education, health and housing in a country that, before the Revolution, was primitive, lacking institutional stability and internal communications. Mexico today has reasonably good communications. Although the tasks ahead of us are great, I feel that our potential is sufficient to overcome these temporary problems.

In the 1950s and 1960s Mexico became known internationally for its prudent management of its public finances. How did these finances get into so much trouble?

De la Madrid: Our public sector deficit reached 18% of the domestic product last year, which is one of the main causes of our present inflation. Our program of economic reorganization for 1983 aims to bring this deficit down to 8.5%. This is a gigantic effort, without precedent in Mexi-



"From the highways you can see groups of peasants in the open fields kneeling around statues of the Virgin, desperately praying for rain. It did not rain last year, nor this year either. If it does not rain by mid-June the crops are lost. . . ."

Geography is destiny.

In interviews with reporters from the U.S., Mexican Treasury Secretary Jesus Silva Herzog has repeatedly said: "I don't think Mexico is capable of living with a stagnant economy beyond 1984." He said it again in an interview with *FORBES* in his spacious offices in Mexico City's colonial-era National Palace. He was giving a clear message to Mexico's creditors. It was: If you squeeze us too hard or too long, you will end up losing everything.

Yet Mexico continues to struggle bravely to put its financial house in order—imposing tough sacrifices on business and consumer alike. To its credit, it is doing so with a will that the U.S. Congress has failed to display in curbing fiscal extravagance in this country. So why does the principal architect of this austerity, the urbane Silva Herzog, harp constantly on the limits to this austerity? Because he is aware of the political realities of his situation.

It is easy enough to say that wasteful government spending, egregious policy errors and shameful corruption are at the root of Mexico's current near-insolvency. All this is true, but it is not the whole story, nor does it get to the root of the situation.

Where did Mexico go astray after 40 years of economic growth that was one of the wonders of the world? Why did its public sector deficit zoom from 3% of gross domestic product in 1970 to 18% in 1982, while inflation went from 5% to 100%? Inflation, swelling deficits and overconsumption are global problems today, but an event specifically Mexican also contributed to the end of stable growth. This was the student demonstrations in several cities that preceded the 1968 Olympics. These uprisings led to the death of an estimated 200 people when the army and security forces attacked demonstrators in Mexico City's Plaza of the Three Cultures.

The demonstrations shook the ruling politicians and brought shivers of terror to a people aware of the potential for violence that always lurks just beneath the Mexican surface. Novelists and poets have long recognized that there is an almost mystical tendency to violence penned up in Mexico—and sometimes it bursts out.

The politicians responded by yielding more and more to "populist" demands. And what does "populism" really mean, stripped of its rhetoric? It means taking money from investment and putting it into the stomachs and pockets of the people. It has its virtues, but it also has its delayed price.

Mexicans now call the *docena trágica* (the tragic dozen years) under the presidencies of Luis Echeverría (1970-76) and José López Portillo (1976-82). This is not to say that the ordinary Mexican was rolling in affluence during those years. He certainly wasn't. But with resources scarce and population soaring, the nation could ill afford populist demagoguery. Sacrificing investment for consumption is dangerous for any economy, but especially bad for Mexico. Why? In a word: Water.

When writing about Mexico, most journalists concentrate on the surface events—the price of oil, corruption, industrial inefficiency, the crushing burden of international debt, the flight of funds abroad. They rarely mention water. And yet water is in the most profound sense Mexico's greatest need. The nation has plenty of land, but it is desperately short of water. It is for the most part an arid land, lacking rivers and lakes. Short of water, it cannot wring from its soil sufficient food for its swelling population—75 million now, soon to be 100 million.

Under Mexican irrigation conditions, it requires 3,000 tons of water to produce 1½ tons of corn—enough to feed eight people for a year. The cost and difficulty of getting this much water severely limits Mexico's ability to raise food. This year Mexico will have to import half the grain it needs, thus losing precious foreign currency that could otherwise help service its debt, supply its industry and import badly needed capital goods. It's a vicious cycle. Lack of water drains away capital that otherwise might help solve the water problem.

History records that, along with an international financial crisis, internal drought was one of the factors that brought down the long dictatorship of Porfirio Díaz (1876-1911) and brought on the bloody Mexican Revolution that began in 1910. But now drought has become a permanent curse, not only because of Mexico's natural aridity but also because the population has grown so much faster than water resources.

Listen to Governor Tulio Hernández Gómez of the tiny state of Tlaxcala, near Mexico City. "The absence of water changes people's moods. From the highways you can see groups of peasants in the open fields kneeling around statues of the Virgin, desperately praying for rain. It did not rain last year, nor this year either. If it does not rain by mid-June, the crops are lost because corn planted after that is killed by the autumn frosts before it ripens. Peasants either plant corn or move to the cities."

Mostly they come to Mexico City, cradled in the central valley of the country. This valley was once largely covered

volcanic soils, made highly productive by large-scale irrigation and drainage works, supported one of the world's largest urban centers by the 7th century A.D.—Teotihuacán, the ancient ancestor of Mexico City, with a population of 125,000.

But now there are 16 million people, not 125,000, and each year Mexico City adds 900,000 people, more than its entire population in 1920. "This city is an absurdity," says Elias Sahab Haddad, executive director of the Valley of Mexico Water Commission. "We know this. But it is a fact, a reality." On the average, the inhabitants of this overcrowded absurdity sleep six to a room—and a lot more than that among the two-fifths of the population living in squatter settlements. Even on a subsistence basis, they require vast amounts of water. In the Valley of Mexico the excessive extraction of water from underground beds has led to a steady sinking of the land on which the city is built, by some 30 feet during this century, forcing abandonment of important buildings such as the Basilica of the Virgin of Guadalupe, the national religious shrine. As for the ancient lakes, they are long vanished.

Mexico's creditors and friendly nations would do well to remember all this when Mexico appeals for debt extensions and for fresh loans. The problems facing any Mexican government are almost overwhelming.

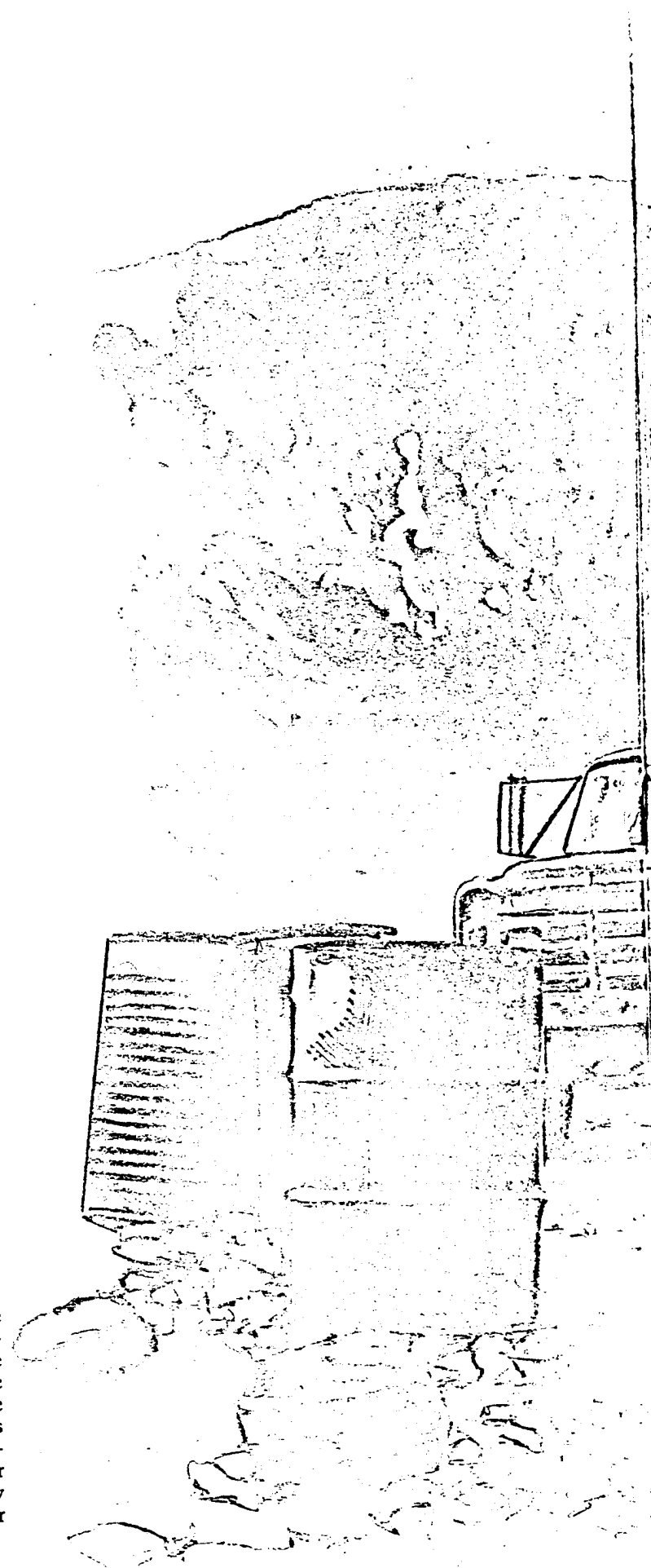
One of the most highly regarded people in President Miguel de la Madrid's cabinet is Silva Herzog. A potential presidential successor, in 1988, Silva Herzog coolly analyzed the situation for *FORBES* and explained how the government faces grave risks in striving to bring consumption down to a level the economy can afford: "There is no consciousness or understanding among the [Mexican] people that the government needs income to meet basic social needs. They tell each other that their tax money goes straight into the pockets of corrupt politicians.

"With oil and with the heavy foreign borrowing that the oil made possible, the government could avoid living within its means. The government could paper this over and still hand out more and more because lots of foreign money was coming into Mexico over the past six years: \$50 billion in bank loans and \$50 billion for oil exports.

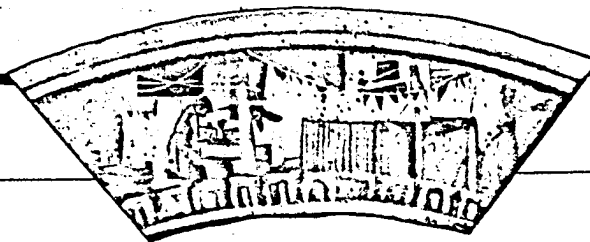
"But now the easy money is spent, and we are deeply in debt. We have become somewhat unpopular by decreeing big increases in taxes and in prices of gasoline and electricity, which have been kept artificially low by state corporations for many years, and more steep increases are coming.

"We intend to meet our commitment to the International Monetary Fund to cut our public sector deficit from 18% to 8.5% of GDP this year. This is an ambitious and extremely painful undertaking. Last year the Mexican economy shrank by 0.2%. This year it will continue contracting by between 2% and 4% of GDP, and in 1984 there probably will be no growth at all."

But until Mexico regains its capacity to invest, it has little hope of dealing effectively with its hydraulic problem. This will require billions of dollars. Gigantic schemes are being implemented to pump water uphill into the Mexico City metropolitan area from coastal or intermountain valleys lying between 3,000 and 6,000 feet below the metropolis, over distances and on a scale never before attempted anywhere, in order to more than double the city's water supply by the year 2000. The first stage of this effort, the Cutzamala System, already is partially complete and, when finished, will pump 19 tons of water per second uphill to an additional height of 4,100 feet. But by the time it is finished, Mexico will need yet more water and more water.







"He is talking about the possibility of bloodshed, of possible revolution, of the potential influx of millions of Mexican refugees into the U.S. Mexicans know only too well that when things go wrong in their country they can go very far wrong indeed."

Technologically it is feasible to build such projects, but financially it is a crushing burden for a society that needs so many other things, too, and has so little capital available. The capital and operating costs of these efforts are very hard to measure in money because the Mexican peso is so unstable now in terms of the world's major currencies. The energy costs probably are more meaningful. If gas or heavy fuel oil were used to pump 19 tons of water per second over these heights and distances, at prevailing efficiencies of oil conversion and pumping, then 4.3 million barrels of oil would be absorbed yearly at a cost, in terms of forgone exports, of \$125 million at the current OPEC benchmark price of \$29 per barrel. For the nearly 55 tons per second of new water flow now planned, the energy cost for pumping alone would be \$362 million per year.

"We cannot pay for the pumping of water to Mexico City," says Andrés Moreno Fernández, head of the city's water system. "Instead, we must stop the growth of the city." And not only Mexico City suffers. Some 16 million urban Mexicans live in squatter colonies where many depend for water, not on pipes or wells, but on a weekly visit by a water truck—and the truck doesn't always come. But still people pour into the cities, seeking food, water and a chance at earning a few pesos.

The failure to manage water resources has helped to destroy many civilizations. It may sound melodramatic to people in the U.S., who take water for granted, but many Mexicans are asking each other whether the PRI regime, which has ruled Mexico for more than half a century, is now reaching that stage of hydraulic disaster. Water and food are closely related. Mexico's politicians and technocrats have been very active on the food supply side. Over the past half-century they have more than doubled the area of irrigated land for farming. However, because of fast population growth, the irrigated acreage per capita is less than half what it was 50 years ago. Moreover, all the easy dam-building and irrigation projects have been done, while the population keeps growing. In other words, both in the city and the countryside, Mexico has entangled itself in the hydraulic trap while following the commendable and sensible goal of trying to keep Mexican bellies full.

Food and water were not the only priorities in the post-1968 surge of spending on subsidies to consumption. These were years of giant giveaways. To facilitate them, the government systematically enlarged its role in the economy. When they can't enlarge the bureaucracy anymore, politicians can do the next best thing for patronage by absorbing private business into the bureaucracy. In these

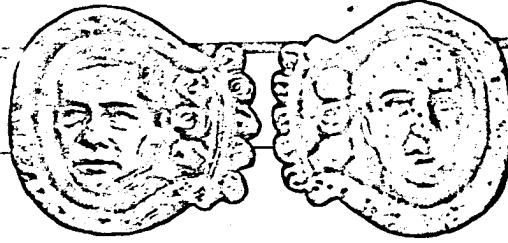
years the number of state corporations grew tenfold, from 84 in 1971 to 845 in 1976 alone, while subsidies and transfer payments rose from 3% of GDP in 1970 to 15% in 1982. "Until recently each big-spending presidential administration was succeeded by one of austerity that cleaned up the mess," a leading physician explained. "Since 1970 we have had two big-spending governments in a row."

"Besides direct spending, there were vast price subsidies to keep the price of necessities in check. Our policies of excessive subsidies gave us the problems we have today," says Planning and Budget Secretary Carlos Salinas de Gortari, a small, wiry, 35-year-old political economist with a Harvard doctorate. These subsidies embrace a bewildering variety of goods and services—from corn and sugar and gasoline to water and electricity and rail and bus transportation. There are even public coin telephones costing less than one-seventh of a U.S. penny per call (\$0.0013). Ramón Aguirre Velázquez, the presidentially appointed mayor (*regente*) of Mexico City, told *FORBES* that "these subsidies are part of a redistribution of national wealth to achieve social justice." At the cost, alas, of badly needed private and public capital investments and, ultimately, of national solvency.

Such subsidies, improvident though they were, helped keep the political peace after the violence of 1968. So when Mexico's Treasury Secretary warns that there are time limits to his government's ability to impose austerity, he is not only complaining about the political inconvenience involved. He is talking about the possibility of bloodshed, of possible revolution, of the potential influx of millions of Mexican refugees into the U.S. Mexicans know only too well that when things go wrong in their country they can go very far wrong indeed.

They are only too aware of the events that overwhelmed the long dictatorship of Porfirio Díaz and led to a civil war that dragged on for nearly two decades and killed or starved over 2 million Mexicans. It was a civil war in which U.S. citizens died. At one point, in 1914, U.S. troops occupied the port of Veracruz. Later the fighting spilled over into the U.S. Southwest when Pancho Villa's guerrilla forces raided New Mexico and General "Black Jack" Pershing led U.S. soldiers across the border in retaliation.

All this was long ago, but there are parallels between then and now that are close enough to worry thoughtful people on both sides of the border. Too much, of course, can be made of historical parallels. Miguel de la Madrid is no Porfirio Díaz, and for decades Mexico has had one of the world's highest rates of economic growth. The development of its oil resources provides a



"It is a flight from reality to expect countries like Mexico and Brazil to divert up to 5% of their annual national incomes and a much larger share of their foreign exchange earnings to paying interest on foreign debts."

huge new source of wealth. Since its revolution, whose violence lingered on until the 1930s, Mexico has enjoyed a political stability matched in the hemisphere only by the U.S. and Canada. It is Mexico's good fortune that—in spite of the well-known larcenous tendencies among its politicians—it has a trained, talented leadership, equal in some respects to any in the world. The ruling party, the PRI, is to the Mexican Revolution what the Vatican is to St. Peter. The party rules in a direct succession from the middle-class leadership of the old revolution. The leadership is continually renewing itself with young men and women.

President de la Madrid himself is only 48 years old. Several cabinet ministers and state governors are much younger, while party chieftains often are in their early 30s.

But while there are some things to be grateful for in present-day Mexico, anyone who thinks the crisis has passed is deluding himself. President de la Madrid, just nine months into his six-year term of office, must move fast to restore solvency before the necessary austerity becomes intolerable. His task is made trebly difficult by the ruling party's slackened grip on the reins of power. After liberalizing the election law over the past decade—partly in response to protests after the 1968 massacre—the long-ruling PRI has been suffering both losses and unaccustomed close calls in state and local elections. One obscure town in Oaxaca state has actually come under Communist rule, with backing from Salvadoran peasants camped there. Just last month the PRI lost control of capitals in two key northern states—Chihuahua and Durango—as well as Ciudad Juárez, a border city of almost 1 million people. In these same northern states—where, not incidentally, the Mexican Revolution erupted—the PRI faces a strong challenge from the conservative, Catholic-oriented *Partido de Acción Nacional* (PAN). Conservative PAN may be, but its growing strength limits the president's freedom of action.

Dealing from a declining position of power, with this legacy of other presidents' mistakes and with the ancient problem of water, is a crushing job. Whether sitting under a tent hearing peasants' complaints or sitting in his air-conditioned offices dealing with big problems of economics and politics, President de la Madrid is acutely aware that hell hath no fury like a populace suddenly deprived of the largesse it has grown accustomed to.

For nations, geography is destiny, and Mexico's geography is particularly grim. Writing nearly 180 years ago, the German naturalist Alexander von Humboldt reported:

vents the collection of a great mass of water. . . . Saline substances cover the surface of the soil. Through this abundance of salt, the table land of Mexico bears a great resemblance to many places in Tibet and the saline steppes of central Asia."

Humboldt was writing about a Mexico with 5.8 million inhabitants—sparsely populated like Tibet and central Asia. But this same arid land today must support 75 million people. This is not to say that Mexico cannot support a large population, but it cannot do so without huge capital expenditures for hydraulic works, for agriculture, for job- and capital-creating industry. Whence is the capital to come, while at the same time keeping the populace minimally content? That is the grim geographic and financial reality.

The foreign lenders who sent \$81 billion to Mexico with virtually no strings attached still delude themselves. It is obvious that Mexico and other developing countries do not have, and never had, the cash-generating capacity to repay the foreign loans they have piled up over the past decade. The money is gone. The interest burdens alone have become too big to manage. It is a flight from reality to expect countries like Mexico and Brazil to divert up to 5% of their annual national incomes and a much larger share of their foreign exchange earnings to paying interest on their foreign debts continually over the next decade or two. Payments on this scale would wipe out their chances to earn an economic surplus that must be invested in meeting urgent national needs.

Mexico is trying to meet its obligations and impose a degree of discipline on government spending, but we in the U.S., should listen carefully to Treasury Secretary Silva Herzog when he says: "I don't think Mexico is capable of living with a stagnant economy beyond 1984. This would carry an additional risk of social and political instability."

Abstract words, those: "social and political instability." What do they mean? They mean that decades of peace and progress in Mexico could end in bloodshed and disorder, with incalculable consequences for the U.S. In the long run, helping Mexico to handle her horrendous problems is much more useful to the U.S. than collecting bank loans to the last peso. And how can the U.S. help? By supplying food, technology and capital to our neighbor on favorable terms. This wouldn't be charity. It would be simple common sense. Of the Mexican-U.S. relationship, John Gavin, Ronald Reagan's ambassador to Mexico, recently declared: "In the w... orce." That says

COVER STORY

It stunned the world when its economy crashed 11 months ago. But now Mexico's economic team offers new hope that a gradual comeback may have begun. By Alan Robinson

to believe that if it doesn't hold firm the damage will be minimal, but I'm not sure about that. Any considerable drop in petroleum prices would be very damaging to Mexico. All calculations would have to be redone. I think the economic cabinet must be making frequent pilgrimages to the Shrine of Guadalupe [Mexico's national shrine]. I'm praying a little myself."

Some bankers put their trust in President Reagan's strong sense of Mexico's strategic importance to the US. "Take the worst scenario we have got," said a foreign banker. "That would include oil prices

than for the same period last year.

"That's fine, just fine," one banker said. "We like to see a decent frugality. They are right on target, I would say. Now let's see what they can do about inflation."

The National Consumer Price Index went up by 22.5% in the first three months of the year, with the monthly rate declining from 10.9% in January to 4.8% in March. But for a shopping basket of only basic items the average monthly increase was 13.1%.

Finance Minister Jesus Silva Herzog has forecast an annual inflation rate of 70% this calendar year, against 98% for the last

IS MEXICO MAKING

Some bankers will remember August 20 1982 to the end of their days: they have a chilling recollection of the moment they heard the news that Mexico had announced it could no longer service repayments of principal.

The months that followed brought one rescheduling announcement after another, including one that is at least as significant as that of Mexico — Brazil. The perception grew, and remains to this day at many banks, that Mexico, which probably triggered the Brazilian rescheduling, could be written off for the indefinite future.

That perception may still be correct. But in Mexico itself foreign bankers are more hopeful, though their hopes may be based on faith as much as facts. "Mexico can come through this," said a British banker in Mexico City last month. "They have another 18 months on the tightrope, but they seem to have developed a good sense of balance."

Most local bankers believe that the government of President Miguel de la Madrid has the right policies to contain the crisis. "The IMF says Mexico is on schedule in meeting the aims set out in the letter of intent," said a US banker. "That's good enough for me." A second US banker was even more hopeful. "They seem to be doing most things right," he said. "If nothing unforeseen hits them they could be back on the road to economic growth by the end of 1984."

The unforeseen, however, worries many bankers. "I want to believe, but I don't believe, that OPEC will hold firm on [oil] prices," a Swiss banker said. "I also want

falling to \$18 or 20 a barrel, food production hit by the current drought, interest rates going up, the government failing to control inflation, massive unemployment, hunger marches and anything else negative you can think of.

"I'm sure the US would do everything in its power to keep Mexico stable," he said. "And it can do a great deal. It isn't in the interest of the US or of banks to let Mexico go down to default. We cannot afford the economic and political consequences. Not that I think it's coming to that. It hasn't gone that far. Mexico could pull itself out of this hole, with a little help."

Mexico had no economic growth in 1982, expects GDP to shrink between 2 and 5% this year, and will, at best, have marginal growth in 1984, according to the current consensus. "That is what worries me most," said a German banker. "True, the government has kept the lid on so far, but how long can it keep on controlling the pressures from labour for higher wages?"

"When I think about the next two years my hair stands on end. The social risks of the IMF programme are enormous. On paper, the first quarter results are promising: the Mexican authorities have been diligent and the IMF is happy. But I can't say that I'm happy. I'm worried. The Mexican Government is taking a calculated risk. I only hope it can contain the growing discontent."

The Government's main financial aim is to keep the public sector deficit to pesos 1.5 billion (\$10 million) or 8.5% of GDP, against 18% last year. In the first quarter, the public sector deficit was 23% lower

calendar year. "I feel that inflation will reach at least 80% in 1983," a French economic analyst said. "It could be more, of course. The anti-inflation policy is working more slowly than is required. Although the government has raised the prices of its own goods and services, and will continue to do so, in an attempt to reach healthy price levels and thus slow inflation considerably, I don't think we shall see a great reduction in inflation this year."

The private sector quickly jumped on the bandwagon of rising prices and the government freed many prices from controls. Even controls on products in the shopping basket of the index were slackened. The response from organized labour, which is one of the pillars of the ruling Institutional Revolutionary Party (PRI), was sharper than ever before. But the PRI's system of control was not changed and a wage demand of 50% was halved by the labour leaders. Even this had not been granted by early June.

"To sum up," said the French economist, "they are on course with the deficit and way off course with inflation."

Preliminary estimates show a trade surplus of \$3.4 billion for the first quarter of 1983, compared with a \$708 million deficit for the first three quarters of 1982. Imports were cut to the bone, down 70.8%, with capital goods imports down 81.3%, consumer goods 71.5%, and raw materials 64%. Exports were \$4.8 billion, up 11.1% over the first quarter of 1982, with oil sales contributing 82.3% of the total. The share of non-oil exports were down 28.2% on the

first quarter of 1982.

Border transactions and tourism provided a surplus of \$379 million. Mexicans have been spending less abroad, but visitors in Mexico have also been spending less. "The results on the trade account are excellent," said a British banker. "The Mexicans have shown themselves capable of great discipline and sacrifice." But a German banker was less enthusiastic. "Good results on paper, again," he said. "Results achieved by cutting imports and eliminating economic growth. But these results also jeopardize jobs."

then I would think the single rate would be subject to slippage," a Mexican Government economist said. "In that way we hope to keep the peso competitive and avoid the necessity for another brusque devaluation."

A US banker commented: "Devaluation is out of the question for now. Last December they overdid their big devaluation in order to buy time — to get stability for the rest of this year. These rumours are uninformed, but none the less dangerous for that. I'm told that Mexican pesos are being taken out and exchanged for dollars, but I don't think the traffic is significant

whole thing just keeps rolling along for as long as is necessary. That's life in the world of finance, my friend."

Most foreign bankers in Mexico believe that the nation has options other than foreign borrowing. "You would be surprised," said a German banker, "if you knew how many very big international corporations are sniffing around for investment opportunities. Given Mexico's potential and the current exchange rate, investment is much cheaper and likely to become more productive. In spite of my own reservations, I would agree that now is

ING A COMEBACK?

Last month Mexico shuddered with devaluation rumours once again. "It doesn't make sense," said the Briton. "The peso is undervalued by any system of measurement. What we are seeing is a kind of re-occurring psychosis."

The special parity for dollar-denominated deposits was abolished on March 15, leaving a dual parity for the peso: a free market rate which has been stuck at 149.40 buy and 147.90 sell since last December, and a controlled rate with a daily slippage of 13 centavos and an average value of 106.20 pesos to the dollar during March.

"The Government intends to continue the slippage until the free and controlled rates are united, near the end of the year,

yet."

Most bankers agree that devaluation is unlikely in the near future. Mexico's foreign debt is close to \$85 billion. "About 90% of the debt is in dollars, so you can imagine the effect of another plunge for the peso," an American banker said.

"Sure, the debt burden remains despite rescheduling," he said. "If the worst happens we just have to find a way of pushing the problem further away. To the end of the century, if necessary, or further. As long as there is an outside chance that Mexico can pay we must give it that chance. That's my view. In the long term Mexico has everything going for it. And of course we keep collecting interest and fees and the

the time to invest here if you are going to invest at all."

"Invest?" a US banker said. "Sure I would invest in Mexico. There has never been a better time for it."

"On balance I would recommend investment in Mexico now," said a British banker. "I know there is some interest in Britain and I'm sure the Americans are on to it. Of course, there are risks, some might say considerable risks, but that is what the game is about, isn't it?"

"I would be extremely cautious about recommending investment at this time," said a Swiss banker. But he added: "I understand there is a great deal of interest."

The Mexican challenge

Mexico met the first quarter economic target set by the IMF, but there's a long and rocky path ahead. Total external debt is some \$85 billion. At end-1982, \$59 billion was public debt. And more than half the total matures before the end of 1985.

Being negotiated now is the rescheduling of \$19.7 billion of public sector debt maturing by end-1984 and \$15 billion of private debt. Deadline: August 15 (that may be extended).

The public sector rescheduling proposal is for an eight-year maturity with four years' grace at either 1½% over Libor or 1¼% over US prime. The private sector debt proposals are outlined in the interview. Remember that Mexico's debt burden is still being increased.

Commercial banks advanced \$5 billion of new money in March while the IMF granted a \$3.9 billion extended fund facility. Repayment of the commercial loan begins in 1986. Disbursement of this loan and the IMF funds depend on

Halfway to a cure ...

Public sector debt by maturity date (\$ billion)

	Before rescheduling	After rescheduling
1983	9.4	1.5
1984	5.4	1.3
1985	9.7	9.7
1986	5.1	5.1
1987	7.5	12.3
1988	4.7	9.5
1989	3.5	8.3
1990	1.1	5.9
after 1990	4.3	4.7

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IMF targets for Mexico

Public Sector Deficit	%GDP
1982	16.5
1983	8.5
1984	5.5
1985	3.5
Current Account Deficit	US\$bn
1982	6.5
1983	4.25
Inflation	%
1982	90-100
1983	55

COVER STORY

The Mexican Government, meanwhile, has been saying repeatedly that its foreign investment regulations are "flexible enough" to allow majority foreign ownership in new projects, "if they are in Mexico's interests".

In the long run, everyone agrees Mexico's economic recovery is possible only after economic recovery in the US and the other industrialized nations. "The signs seem to be good for a US recovery," the Swiss banker said. "But it won't be quick and the benefits will take time to filter through to Mexico. I see no escape from austerity in the short run."

"I wish I was as sure as the Americans seem to be about their economic upturn," the German banker said. "If it does come, and if it lasts, Mexico will obviously benefit. At the moment Mexico wants to export very badly, but there are no markets for non-oil products."

According to the Mexican Government economist, "we need to export our way out of the mess and so we need an economic revival among the industrial nations, especially the US, which is our biggest trading partner."

The new mood of cautious hope contrasts strongly with the gloom-and-doom messages being put out by some of the same bankers only six months ago.

"In my opinion, bank representatives don't stay long enough in one place to understand it," said the German banker. "We over-react; our head offices over-react; we frequently don't have the proper information and most of us lack a feel for the country we work in. Now there is some optimism about Mexico. I can only hope it is well-founded. A few months ago nobody had a good word to say. The judgements you hear today are coming from the same people. We can be very changeable, I'm afraid."

Even if Mexico's public sector debt problem can be solved over time, there is still much concern over the treatment of the private sector debt. Until now (see interview) little has been published to show how Mexico will handle that.

If bankers see Mexico in a more hopeful light, a major cloud on the world's financial horizon would disappear. It's still too early to judge, but so far this year Mexico has moved in the right direction. □

G Invest? Sure I would invest in Mexico. There has never been a better time for it **J**

MANCERA OFFERS NEW HOPE

Along with Finance Minister Jesus Silva Herzog, it is Miguel Mancera Aguayo, governor of Mexico's central bank, who is most often cited as an architect of any recovery in Mexico.

Mancera has a formidable technical reputation at home. He is one of the strongest members of President Miguel de la Madrid's financial team and is a close friend of the President. His colleagues, admittedly with a vested interest, say he's brilliant.

Mancera is also a very private man. Aside from obligatory public appearances, he avoids publicity.

As an economist he is fundamentally opposed to exchange controls. In the waning months of the Lopez Portillo government, in the thick of an economic and financial crisis, he sensed the way the wind was blowing and produced a pamphlet telling Mexicans why exchange controls would not work for their country. It was a brave, last-ditch attempt to stem forces that were moving the Government toward a course that Mancera saw as disastrous.

It cannot have been an easy decision for a man who likes his privacy. He and his pamphlet were attacked by the partisans of exchange controls. In the ensuing battle he seemed increasingly alone. Three months later, President José Lopez Portillo nationalized the private banks, imposed a full range of exchange controls, and demanded Mancera's resignation. Carlos Tello, the architect of the new controls system, took over at the central bank.

During the last three months of the Lopez Portillo administration, Mancera's arguments took on a prophetic look. Almost everything he had said would happen as a result of exchange controls happened. When President Miguel de la Madrid took office on December 1 1982 one of his first actions was to bring back Mancera to the central bank with the task of gradually and carefully dismantling the controls his Government had inherited.

It was a considerable personal triumph for Mancera, but he never succumbed to the temptation to say: "I told you so." He will discuss neither his departure nor his return. He simply went back to his desk and got on with the job.

Mancera was born in Mexico City on December 18 1932, studied economics at the Instituto Tecnológico de Mexico and

took a master's degree at Yale University before going on to the Bank of England for a special course of financial studies. He has been a professor of economic theory at several Mexican institutions and at the Latin American Monetary Studies Centre.

In 1957, he went into government work with the Presidency Commission on Public Investment. The following year he joined Banco de Mexico, where he held various posts, culminating in his appointment as director general. The generally-agreed prognosis is that he will stay there for the duration of the de la Madrid administration.

Mancera refused to answer questions of a personal or political nature, declined to discuss economic theory — his own or anyone else's — and studiously avoided judgements on the IMF's strict adjustment programme for Mexico.



COVER STORY

**Miguel Mancera Aguayo, Mexico's
central bank governor:
"Moderate optimism."**

above that envisaged in the programme.

Thus, short of unforeseen difficulties such as a collapse of the oil markets, we do not expect to return to the external credit market in 1983.

How would you describe the progress made in meeting the terms of the IMF agreement?

A few days ago, the Executive Board of the IMF made an evaluation of the compliance with the adjustment programme currently under way. They certified that Mexico has satisfactorily fulfilled all the requirements of the programme.

The directors praised the determination and forcefulness with which the Mexican authorities have moved to implement the economic adjustment programme supported by the extended arrangement with the fund. The size of the imbalances, both external and internal, that had been building up during recent years made a severe cutback in domestic demand unavoidable. Fund directors recognized that the Mexican authorities had responded with the necessary resolve and that the adjustment programme was being carried out without hesitation.

They noted that the results of the first few months of the year were encouraging and indicated that the programme was on track, though perhaps with higher inflation and lower growth than had been forecast. We are, therefore, able to draw \$325 million of additional resources from the IMF and \$1.1 billion from commercial banks within the next few weeks.

While the first balance of payments results indicate that the external sector is adjusting rapidly, other results of the programme will take longer to become apparent. But we are sure the programme is appropriate to curb inflation, correct imbalances and lay the foundations for sustained growth in output and employment.

Banco de Mexico has come up with a strategy to enable private companies to deal with their foreign debts. Can you explain it?

The tight liquidity situation which we are undergoing has led us to devise several mechanisms to deal with the private debt. The first deals with interest past due to foreign banks, which could not be paid in the period August 1982 to January 1983, due to our precarious international reserve position. We entered into an agreement with creditor banks by which Mexican debtors will deposit in the Bank of Mexico the peso equivalent to the foreign exchange required to meet payments at the controlled rate.

The Bank of Mexico opens a dollar account in the name of the foreign creditor, which earns a market interest rate, a procedure by which foreign banks avoid having to list these loans as non-performing assets. ▶

The drop in oil prices has cut Mexico's export earnings. How serious is that?

It was an unfortunate development for us, since, given our export platform, it meant a loss of \$1.4 to 1.5 billion in 1983. But, this loss will be compensated by the drop in market interest rates. The financial programme for 1983 was constructed in late 1982 on the basis of an effective average interest rate of 14¼%. At present we have an effective average interest rate of about 12.2%. Since current public and private external debt is estimated at over \$80 billion, this will be reflected in a substantial decrease in interest payments, and will yield some \$1.4 to 1.5 billion in foreign exchange savings.

So, as you see, in the short run the decrease in international interest rates will offset the reduction in oil prices. In the medium run, it is likely that lower energy

prices will help to strengthen the economic recovery, which is under way in the industrial world. Mexican non-oil exports, both commodities and manufactures, will benefit from that recovery.

Will you need more credits this year?

I do not believe we will require additional credits beyond those programmed. There are several reasons for this. First, and most important, we now expect a much stronger balance of payments position than originally envisaged. Preliminary figures show a current account surplus for the first quarter of over \$1.5 million, which contrasts markedly with the \$3.4 billion deficit for the same period of 1982. This surplus is basically due to a strong positive trade balance of over \$3.5 billion. Secondly, public expenditure is under tight control and the fiscal deficit is on target, eliminating the need for external finance over and

These sums are being transferred abroad as foreign exchange becomes available. Over \$90 million, or 15% of the total deposits, have already been transferred and another 5% is to be paid within a few days.

The second mechanism, which is similar to the first, was established to deal with suppliers' credits. This allows the Mexican importers to pay pesos to the Bank of Mexico for an amount equivalent to their debts to foreign suppliers at the controlled rate of exchange, and to obtain in return a dollar denominated certificate of deposit which earns a Libor interest rate payable semi-annually.

The dollar certificate of deposit issued in favour of the Mexican importer may be assigned or pledged in favour of the foreign supplier, allowing him to obtain other financing or to retain it as a security for payment. These CDs bear no maturity date and the regulations issued on February 28 state that the terms of payment of these debts will be defined by next August 1983. The reason for this delay in defining the terms of payment for these debts is simple: the Ministry of Trade is in the process of registering these suppliers' debts, the total amount of which is still unknown to us.

The third mechanism is for special forward cover procedures for the repayment of obligations outstanding at December 29 1982 by the Mexican private sector with financial institutions, payable outside Mexico.

This mechanism offers four procedures for settlement, based on coverage of the forward contract (principal only or principal plus interest) and on financing by private borrowers (from their own or borrowed resources). In all cases a prior agreement to restructure maturities by the foreign creditor is required.

The forward cover scheme will be handled by the Fideicomiso para la Cobertura del Riesgo Cambiario (Fund for Exchange Risk Coverage), FICORCA, which assumes only the obligation to deliver the foreign exchange to the domestic borrower on the basis of a repayment schedule agreed between the local borrower and the foreign creditor.

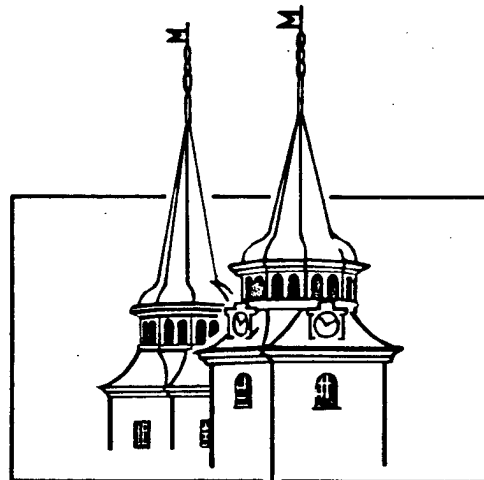
Does any of this imply a subsidy for private sector debtors?

The FICORCA schemes are entirely voluntary, do not imply any subsidy and do not imply the absorption of commercial risks. FICORCA only assumes the exchange risk and, through the required restructuring, provides firms having liquidity problems with the necessary breathing space to overcome them.

To qualify for the various forward cover alternatives, the maturity of the outstanding loan or the refinancing loan should exceed six years, with three years of grace, when only the principal is subject to coverage, and eight years, with four years of grace, when both principal and interest payments are covered.

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COVER STORY

You mentioned various alternatives. What are they?

There are four possibilities under the FICORCA scheme. The first offers immediate delivery by the Mexican debtor of the peso equivalent of the total value of the obligation abroad, converted at special rates that are more appreciated than the controlled market rate, depending on the maturity of the loan. The delivery of pesos guarantees access to foreign exchange to cover the amortization due from the Mexican borrower over a period of six or more years, with at least three years of grace. The rates applicable for transactions effected to June 5 1983 are these:

The rate for the debtor

Final maturity (in years)	Grace period (in years)	Exchange rate (pesos per \$1)
8	4	77
7	3	83
6	3	87

The second arrangement is like the first, except that FICORCA will provide financing in pesos to local firms without sufficient liquidity to enable them to make the necessary delivery of pesos as in the first case. In this case, interest payments abroad are not covered and the local debtor must

continue to pay these at the prevailing exchange rate for the peso in the controlled market on the date on which the payments are remitted.

With the third arrangement there is immediate delivery of local currency equivalent to the total outstanding foreign obligation at the controlled market rate. But the forward cover includes principal and interest on the external liability.

The fourth arrangement is like the third, except that FICORCA provides domestic financing for the local currency payment by the domestic borrower, as in the second arrangement. In all instances, the forward cover does not transfer the foreign liabilities to FICORCA and the domestic borrower remains responsible *vis-à-vis* the foreign creditor.

Let me also mention that officially guaranteed private sector supplier credits present a special problem with which we are trying to deal. Our policy has been that, in every scheme, we consult with our creditors and establish mechanisms that are generally accepted. This was the case with our bank restructuring, for public and private sectors. It was virtually impossible with suppliers' credits, because there were thousands of creditors. Moreover, we are still determining the amounts.

To deal with these credits, which are private for us but, because of the guarantees, are public for our creditors, we have pro-

posed the following arrangements. The Mexican Government and the export credit or export guarantee institutions would jointly determine the amount of officially guaranteed commercial debt owed by Mexican private sector borrowers or importers to either financial institutions or suppliers in each country, derived from commitments made on or before December 20 1982.

A financial institution of the creditor country would extend a line of credit for the full amount outstanding to an official institution in Mexico, which would enable it to pay in full all outstanding guaranteed debts matured, or that will mature, from commitments entered before December 20 1982 by the Mexican private sector.

These lines of credit would be made available at market rates. These credit lines could be medium term, with an adequate grace period, and would be consistent with the terms of restructuring and with the availability of new money for the public sector. A minimum of six years, with three years of grace, is suggested, equal to \$5 billion of new money.

If a Mexican private company could not deliver the pesos to the Mexican public sector institution that had assumed the guaranteed debt from the foreign creditors, that debt would be covered by the original export guarantee agency of the relevant country. We have already adopted such a scheme with the Banco Exterior de España,

This announcement appears as a matter of record only.

May, 1983

Istituto Centrale per il Credito a Medio Termine Mediocredito Centrale U.S.\$ 40,000,000 Medium-Term Eurodollar Loan

Arranged by:

Morgan Grenfell & Co. Limited

Managed and provided by:

Arab Banking Corporation (ABC)	Bahrain Middle East Bank (BMB)
Bankers Trust Company	Dai-ichi Kangyo Bank Nederland N.V.
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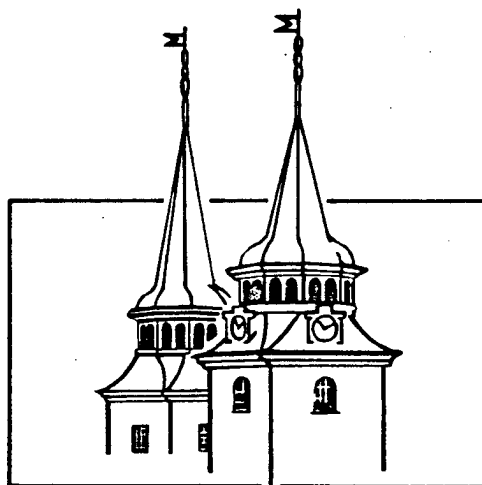
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IT DOESN'T PAY TO IDLE

Should a bank keep every dealer within limits?

By Robert Winder

Two slightly different ways of monitoring worldwide exposure have been developed by the network operators Geisco of the US and I. P. Sharp of Canada.

Both systems are based on a microcomputer on the dealer's desk, into which all deals must be entered. Once the dealer has keyed in the facts about the deal, the computer will check all the limits which that deal may threaten — country, currency, counterparty or a dozen other limits. If the deal is good, it may be entered; if not, it may still be entered, but the computer will record the breaking of the limit and issue reports on the deal.

The worldwide processing networks give the head office of a bank immediate access to information about the activities of all its branches. Said I. P. Sharp's Leo Bettes: "We're talking about the nervous system of a bank, the integration of its various operations." Bettes estimated that 300 banks needed such a system.

At Geisco, Peter Greenhill explained: "If a bank has branches in New York, London and Singapore, it's quite possible that the Singapore branch may have dealt up to its

limit in a currency, and be turning down deals, when there is unused limit in the other two centres. The other two centres may not even be dealing at that time. It's a waste of a bank's resources at a time when they're looking to cut risks."

Deutsche Bank has cut its overall limit by around 20% since taking the Geisco system in 1980.

Most banks, however, have already invested a great deal in developing their own control systems in-house. And many bankers expressed reservations about the idea of global limits. One told *Euromoney*: "Limits are set locally because it's important to know the markets. It's hard for a New Yorker to set the limit for the Japanese discount market, and much better to have people in Tokyo who can do it."

Another drawback of such systems is the pressure they put on dealers. Some dealing room managers insisted that dealers should not be distracted by systems which query every deal. But Greenhill rejected this. "It's not really an extra screen and keyboard," he said. "It's a replacement for the bank's own in-house files, which the dealers update anyway. If you use Global Limits properly you can run your entire dealing room operation on it. It helps dealers because the information's live, they can ask it questions. And of course, once a deal is

made, all the limits are automatically adjusted."

He added: "It's insurance. Every bank is thinking about ways to control risk, and consolidating information from all the branches is an essential part of their thinking."

I. P. Sharp's system allows two dealers to deal with the same client simultaneously, but the Geisco system prevents this. Greenhill argued: "We want to avoid a situation where the same limit is being broken by two dealers at the same time. It's the same as the reason why dealers should enter the deals themselves. If they hand over to clerks there'd inevitably be a lag, in which time limits could be broken by accident."

Essentially both systems operate on the basis that they give the banks a framework in which they can insert their own definitions of limits, and the size of those limits. They can then use the systems' real time capability for dealer support, and their reporting facilities for management information. It is possible to limit deals maturing on a single day to avoid bunched payment schedules, as well as limiting them on a currency or counterparty basis.

In the Geisco system, there is a moral twist. To prevent two deals being done simultaneously, dealers must not hesitate too long once they have begun to deal. If they do, a message comes up on the screen. It reads: "You have been idle too long."

TRACKING THE BIG PROJECTS

EBC's new computer system helps reduce project finance risk. By Robert Winder

When William Blackwell became head of European Banking Company's project group in 1977, his first requirement was a computer modelling system, to help him control the immense risks involved in financing natural resource projects.

Most banks use all purpose modelling systems like Visicalc or Micromodeller to track the effects of variables on a project's profitability. The biggest banks, though, have developed their own, more adaptable systems. Citibank's International Command is used by over 60 companies for consolidation of accounts, and for construction of models for future performance. The bank is now working on refining the system.

Blackwell was determined to evolve a package precisely tailored to the demands of natural resource projects. It took three years of work with Core Laboratories of Texas, who had expertise in the petroleum industry, before the system was ready.

It is called Ebcare, and it differs from

generalized modelling systems in the extent and detail of its applications. The system is modular, so the functions can be used individually as well as collectively. It contains modules for scheduling productivity, pricing and costing, taxation and sensitivity analysis, as well as the facilities for all the standard economic parameters. The sensitivity analysis module assesses the interaction between different variables, permitting the user to identify the effect of each adjustment to the whole project. The system is multiple currency, and contains pre-programmed routines for the US and the major European tax structures.

But Andreas Crede, head of the Ebcare project at European Banking Company, said that Ebcare has creative uses: "In situations where you have a marginal development it's hard to structure a loan and remain confident. With Ebcare you can be much more precise about the vulnerability of a project to adverse conditions."

For many years bank economists have used computers to construct models for country risk, projecting the balance of payments of indebted countries and reaching general conclusions about their creditworthiness. But Crede argued that

computers are better suited to modelling specific projects. "Country risk is very difficult to quantify accurately, in economic terms," he said, "and often, strategic or psychological reasons for lending override the data, as in the case of Mexico. The advantage for computers in project financing is that it is coherent; a project has a natural logic and life of its own. Scientific analysis in these cases has much more value and importance, and you can be much more confident with the results."

Crede is aware that even Ebcare remains a tool, dependent on the assumptions it is given. "It's actually quite a hard taskmaster," he pointed out. "But it's usefully hard. It forces you to be very careful about what you give it, and since it works by asking you questions, it makes you consider things you might prefer to neglect."

The development of Ebcare is a sign that banks are becoming increasingly concerned with the control of risk. As Crede said: "In project finance the bank takes all of the downside risk and none of the potential for gain, as an equity investor would. In a climate of increasing uncertainty Ebcare is simply our solution to the risks involved in this kind of finance." □