Overseas Development Institute*

10-11 Percy Street London W1P OJB
Tel: 01-580 7683

Briefing Paper No 2 1983 March

DEVELOPING COUNTRY BANK DEBT: CRISIS MANAGEMENT AND BEYOND

The subject of this paper is debt owed by developing country (ldc) governments (or sovereign debt) to overseas banks, which is the largest part of a wider ldc debt problem and is currently in a state of crisis.[1] It describes how this state of crisis arose, how the immediate problems are being dealt with and some longer term issues. It needs to be remembered that while ldcs and the banking system are both affected by the current crisis, they are affected in different ways and may have diverging interests in its resolution.

Why do ldcs have a debt servicing problem?

In 1982 the potential threat to the banking system of a large exposure to ldcs became real as a substantial number of countries proved unable to service their debts in full. Most debtors are in arrears of principal only but in some cases – Argentina – there are arrears of interest. Several factors are involved relating essentially to a radically changed international environment and in particular to world recession. The foolishness of banks and the fecklessness of borrowers also play a part but are not the prime cause (after all, Western governments applauded the role of banks in recycling surpluses while it worked smoothly).

The current debt crisis has arisen directly from the recycling experience of the first (1973/74) and second (1979/80) oil price 'shocks'. The current account deficits of oil importers could not be financed by aid and private investment, and private bank lending increasingly predominated over official flows in balance of payments financing. Total ldc long- and medium-term debt rose, on World Bank estimates, to almost $500bn in 1981 from around $200bn in 1976 and just over $50bn in the mid-1960s (see Table 1). Of the increase in debt between 1976-81, two-thirds was to private banks. If short-term debt is included, almost all of which is to the banks, the magnitude of the debt increases by $100bn in the 1976-81 period. The overall share of the banks in ldcs' external debt rose from under 20% in 1967 to 40% in 1976 and 55% in 1982. Even in real terms, allowing for inflation, the bank debt of ldcs doubled in five years.

Ldcs' reduced export income

Much of ldcs' present debt was contracted when banks and borrowers expected levels of growth of trade greater than have materialised or now seem likely. Serious weakness in the oil market has transformed the balance of payments of *oil exporters*, OPEC, from an approximate $115bn current account surplus in 1980 to near balance, and a possible deficit, in 1982. Some oil-exporting countries, Nigeria, Venezuela, Indonesia and Mexico, have large deficits and/or foreign borrowing requirements at a time when oil prices are falling even in nominal terms. The position of most non-oil ldcs is much worse though they now stand to benefit from weaker oil prices. Their combined current account deficit excluding transfers was $45bn in 1979 rising to $88bn in 1981 and an IMF-estimated level of $97bn in 1982. *Non-oil commodity exporters* have experienced a 35% drop since late 1980 in the dollar price of internationally traded commodities to their lowest level in real terms for three decades. The *newly industrialising countries*, with a substantial share of manufactured exports – Korea, Taiwan, some ASEAN countries – inspire more confidence now than other non-oil ldcs but slow growth and protectionism in industrial countries threaten them.

Table 1. How much ldc debt?
(private and official – $bn)

	1976	1981	1981 (deflated to 1976 prices)[d]
Medium and long-term[a]	212	489	326
of which: official	88	180	120
private	124	309	206
Short-term bank lending[b]	39	140	94
Total	251	629	419
Committed but undisbursed loans[a]	74	110	73
Ldc reserves deposited with banks[c]	88	211	141

[a] World Bank reporting system. All ldcs (oil-importing and OPEC 'high absorbers'). These figures exclude military debt (about 10% of total) and Comecon debt (perhaps $80bn). There is under-recording also in respect of debt contracted through offshore banking centres.

[b] Bank for International Settlements.

[c] Based on IMF estimate.

[d] Deflation by unit values of exports of manufactures of industrial countries.

[1] Ldc governments, predominantly the poorer ones, also have debts to Western governments and include such major debtors as India, Egypt and China. In fact, sovereign debt owed to overseas banks is concentrated among a small number of middle income ldcs (Mexico, Brazil, Venezuela, and Argentina account for over one half) and the poorest ldcs owe relatively small amounts. We shall not deal with Comecon debt to the banks which is a lesser but large problem and one with many common causes and features. A further complication which we shall ignore is private debt by individuals or companies in ldcs to Western banks; in the case of Mexico and Chile, for example, there have been servicing difficulties on private as well as sovereign bank debt.

*The Institute is limited by guarantee.

Interest rates

Up to 75% of ldc bank debt has a *variable* or *floating* interest rate. Banks prefer this since it guarantees a fixed return over the cost of short-term money. Interest rates in the main industrial countries peaked at 19% (libor rate) and an annual average of 16.5% in 1981, compared with 5-6% in the mid-1970s when much medium-term debt was contracted. The impact of higher interest rates varies considerably between borrowing countries. In some cases (eg Venezuela and Colombia) external debt is largely or wholly offset by overseas deposits, so reducing the burden of high interest rates. In general, however, a 3% increase in the libor rate costs ldcs $10bn p.a. gross; in Brazil, interest payments alone accounted for 40% of 1982 exports. Even though nominal interest rates have recently fallen, *real interest* rates remain at historically high levels. For much of the 1970s ldcs, like other borrowers, enjoyed negative real interest rates, but in the last two years these have been strongly positive. In 1981 a combination of high US$ interest rates and falling export prices produced an average real rate for (non-oil) ldc borrowers of 30%; and even if annual fluctuations in prices are smoothed out, the adjusted real interest rate for ldcs has been around 8% in both 1981 and 1982.

Difficulties in borrowing

From 1980-82 export earnings of non-oil ldcs fell while debt service rose sharply. In part, this was met by a contraction of reserves; those of non-oil ldcs fell by $40bn. To avoid a sharp contraction in import capacity these countries have needed to sustain a substantial net inflow of capital and have relied heavily on the banks. However, the banks have themselves reacted to the diminishing debt servicing capacity of major ldc borrowers by increasing the proportion of short-term to long-term loans and, then, by restricting new lending, thus making the problem worse.

Some ldcs also have a cash flow problem caused by increasingly large amounts of short-term borrowing falling due for repayment within a year. The repayment of longer term ldc debt ($44bn in 1982) is now overshadowed by the amount of short-term debt needing to be refinanced or 'rolled over' ($140bn). The traditional banking view of country risk assessment is the ability of borrowers to service medium/long term loans and interest on short-term loans. Short-term credits, by contrast, have been treated as trade-related and easily refinanced. This traditional view no longer holds for two reasons. First, an increasing amount of short-term borrowing in some countries (Mexico, Brazil, Venezuela and Argentina) is not trade-related but is used on an emergency basis since medium-term credit has become difficult to negotiate. Second, the large short-term borrowers are particularly vulnerable to a sudden lack of confidence from lenders. Mexico's recent problems arose primarily from bankers' lack of confidence in its ability to repay or roll over almost $40bn of short-term debt in 1982. Even Brazil, which has a better structured debt, has been unable to roll over $20bn of short-term loans. Once credit is withheld, or shortened further, a debt crisis becomes inevitable.

It should be stressed that the above problem has arisen mainly because of a few Latin American borrowers. Mexico alone accounted for 40% of the increase in short-term debt in 1981 and 30% in 1980. Venezuela has a major short-term debt problem even though its medium term debt servicing capacity is not in serious doubt. As can be seen from Table 2, high cash flow requirements correlate but do not always coincide with a high debt service ratio as traditionally defined.

There is also growing evidence of a decline in new lending as banks have endeavoured to reduce exposure to ldcs considered vulnerable. The Bank for International Settlements (BIS) records a sharp

Table 2. Developing country bank debt and 12 major borrowers
(over $5bn bank debt)

	Total BIS bank debt end-1981 ($bn) (1)	of which % short term (under 1 year) (2)	Total foreign exchange reserves end-1981 ($bn) (3)	Medium term debt service ratio – 1981 (%) (4)	Cash flow ratio – 1982 estimated (%) (5)
Latin America					
Mexico	56.9	42	2.8 (March '81)	60	129
Brazil	52.7	27	5.9	58	122
Venezuela	26.2	55	7.1	37	95
Argentina	24.8	40	3.4	27	179
Chile	10.5	34	3.1	45	116
Colombia	5.4	43	44.0	12	94
Asia					
Korea	19.9	53	2.6	16	53
Philippines	10.2	53	2.2	24	91
Indonesia	7.2	35	4.5	12	27
Thailand	5.1	55	2.5	17	48
Africa					
Algeria	8.4	8	3.4	36	39
Nigeria	6.0	30	3.6	17	20

Sources: (1) and (2) Bank for International Settlements; (3) IMF; (4) OECD; (5) Morgan Guaranty estimates.

Notes: The debt service ratio on medium term debt (4): interest and principal in relation to exports of goods and services. A ratio of over 20% is considered potentially worrying. Conventionally defined it excludes short term debt (though, on some measures, interest on short term borrowing is included).

Cash flow (5): interest and principal due on all debt in relation to exports of goods and services. Recent events have concentrated attention on the ability of borrowers to repay short term debt too, hence the relevance of this measure. The ratio needs to be used with care since it does not differentiate those cases where refinancing is a problem from those where it is not.

Net indebtedness (1) less (3): an assessment of external debt should take account also of the country's external assets. Some countries with high servicing ratios also have large external assets (eg Colombia). Some countries also have other assets which may not be so easily mobilised because they are long term investments (Venezuela).

contraction in (medium-term) new international bank lending in the third quarter of 1982. Lending to non-OPEC ldcs fell by $800m – the first absolute fall since 1977 – after an increase of $13bn in the second quarter and an annual growth of $50bn in 1981. There was a corresponding rise in new lending to OPEC and industrial countries and in inter-bank lending. Individual banks – Citibank, Lloyds – have announced a sharp reduction in the growth of future loans. The slowdown in new lending has coincided with rising amortisation so that in some cases there is a net flow of funds from ldcs to the banks.

The implication for the borrowers is clear: they cannot service debt and sustain imports, and therefore growth, at previous rates. There are implications for the banks too. One consequence of the slowdown in lending has been to precipitate a cessation of debt servicing by the borrower, as occurred in the case of Mexico. The bigger banks, and most central banks, are well aware that they are in an acute dilemma. If they try to reduce exposure they risk precipitating default. If they allow lending to grow in line with borrowers' requirements, they expose their shareholders to even greater and more concentrated risk. The dilemma is less acute for small banks whose attempts to reduce exposure are less conspicuous, and it is these (accounting for about 20% of claims) who appear to have led the slowdown in lending.

How the ldc debt crisis affects the banks

World recession has hit Western banks through a growing number of bankruptcies and bad debts, which affect their profitability and could make some insolvent. The significance for the banks of the ldc debt crisis, as opposed to more general problems of bank management in a recession, is four-fold. First, ldc debt is large and concentrated. At the end of 1980 the nine largest US banks had an exposure to Brazil equal to 43% of shareholders' capital, to Mexico of 38% and to Korea of 19% (some of which was private rather than sovereign debt). The same banks had an exposure to ldcs, overall, of 204% of capital as against 156% in 1977. Second, a sovereign debtor cannot, like a domestic corporate debtor, be treated as bankrupt and its assets liquidated. It can, in theory, repudiate its obligations (eg Cuba). The figures above show that if Brazilian, Mexican and Korean debts had to be written off, all the capital and reserves of the US banks would be wiped out; an improbable eventuality but enough to create anxiety. Third, a large part, perhaps two-thirds, of international 'eurocurrency' lending takes place through inter-bank transactions. Many of the international banks involved – 100 of the top 500 – are based outside OECD countries, in offshore centres, and have little or no supervision or protection for depositors. UK banks have a higher value of loans to banks in offshore centres than directly to non-oil ldcs and OPEC combined. Thus, there is potentially a weakness in many of the financial intermediaries heavily involved in ldc lending, with the possibility of a chain of bank collapses. Fourth, there appears to be a particularly destabilising 'knock on' effect in international lending as a result of generalised loss of confidence in particular regions. Thus the difficulties of Argentina and Mexico had serious effects on the ability of Brazil and Venezuela to raise new funds though their problems were different, and arguably less severe.

In the last six months a substantial number of ldc debtors have fallen into arrears of principal repayment on their outstanding loans and in some cases a postponement has been negotiated. How banks treat arrears is a complex question of accounting which varies from one country or bank to another. But the BIS committee of supervisors (see Box) is urging banks to increase their reserve provisions against bad – or non-performing – debts and to write down the value of loans. The first will reduce bank earnings and profits since reserves are not invested; the second will reduce the value of shareholders' equity. Banks are, however, normally reluctant to do either since they weaken the bank's capacity to raise new funds from shareholders. A further consequence is that interest rates will tend to be higher as banks seek to restore their earnings position, and credit will be reduced as banks use deposits to build up reserves.

So far there have been no outright cases of default and very few cases of interest arrears, but the fear is that one or more major ldc debtor could default on all obligations. The damage to banks could be of two forms. First, the effect on earnings of some major banks could be so great as to induce insolvency. In theory a bank could increase the interest spread on its loans but weaker banks acting independently would then lose custom. Second, there could be a loss of confidence in some international banks which could find themselves liquidated and unable to meet their obligations to depositors – other banks. There would be a rapid and sizable collapse before a rescue operation could be mounted.

The banking system depends to a large degree on confidence for its stability, but the security of the system as a whole can be measured in respect of two indicators. The first is the extent of reserve provision. Banks in industrial countries have gradually allowed reserve ratios to decline over the years; in the US from 9% (equity to assets) in 1960 to 2.6% in 1980. It is only a succession of scares over the last year caused by the effect of recession on domestic and international borrowers which has heightened their importance. As a precautionary measure, reserves are now being rebuilt. The second indicator is the effect of debt servicing problems on earnings, but the banks have yet to feel the pinch fully.

The crux of the ldc debt problem for the banks is the following: prudent accounting practice requires a reduction in exposure to vulnerable debtors, relative to bank reserves, and a switch to higher quality borrowers; but if all banks cease, or sharply cut back, lending a default would ensue. So methods must be devised to make future loans to ldcs more secure.

Would a major bank be allowed to collapse? In Britain the Bank of England acts as lender of last resort to recognised banks and would act to prevent a collapse. In the USA depositors are protected while banks themselves are not, although in practice the Federal Reserve could launch a rescue operation if a major bank was at risk. Thus, the main central banks would not be passive spectators in a crisis. However, not all banks or depositors are covered either by legal statute or the likely scope of any lifeboat operation by central banks. Depending on the speed and scale of any crisis of confidence some international banks and some of the weaker banks in the US would undoubtedly go under, and there would generally be a reversion to much stricter and more cautious lending.

Remedies for the banking crisis

The immediate interests of the banks, and of the monetary authorities of industrial countries, lie in remedies which prevent ldc debtors defaulting. The interests of ldcs lie in remedies which ensure a continuing net flow of funds to sustain economic growth. These interests may coincide but they are not identical and, indeed, most of the short-term emergency measures being implemented or considered by industrial countries are more concerned with protecting the banking system than the ldc debtors (let alone other ldcs).

Events are moving rapidly, but with the immediate debt problems of Mexico, Brazil and Argentina still partially unresolved, let alone those of numerous smaller borrowers, it is too soon to speak of 'remedies' or 'solutions'. Nonetheless, it is clear that in the period since the Toronto IMF meeting in September 1982 there have been several major changes. First, the emphasis of the monetary authorities in the main industrial countries has shifted away from urging banks to reduce exposure by observing country limits. Banks are now being urged to lend more to problem countries in order to prevent their defaulting, and to facilitate rescheduling. Second, there is recognition of the need for more active intervention by authorities in industrial countries. Market forces could 'resolve' the banking crisis by forcing 'overlent' banks into bankruptcy and 'overborrowed' countries to drastic adjustment measures, but it is recognised that the first could lead to a widespread collapse of banks and loss of confidence in the financial system and that the second could reinforce world recession as well as have incalculable political and social consequences in the countries concerned. Third, opinion in the USA is that the IMF should be allowed to play a central role in financing the balance of payments of countries with debt problems; there is also a greater willingness by debtor countries to accept IMF terms and conditions. The immediate action being taken or proposed concerns three interlocking problems: commercial debt rescheduling; emergency large scale financing for countries with servicing problems; the role of the IMF.

Rescheduling

Rescheduling will inevitably look different to borrowers and lenders. For the borrower rescheduling negotiations can be seen as humiliating, hence some countries, like Yugoslavia, try to postpone the issue until long after banks accept debt postponement as inevitable. Yet, pride apart, rescheduling helps the borrower by restructuring the repayment periods in such a way as to avoid acute liquidity problems. Rescheduling eliminates, through negotiations, the imbalance between short- and long-term debt which countries with more room for manoeuvre have been trying to handle through commercial refinancing of short-term debt. From the banks' point of view rescheduling is preferable to default and writing off loans. The outcome of any individual rescheduling exercise will however depend on the relative bargaining power of the banks and the debtor, and also on the magnitude of the problem. In some cases banks have had to accept interest postponement and an element of debt relief. With Brazil, the debtor endeavoured to impose, unilaterally, the terms of debt postponement. However, research done on past bank debt rescheduling by Peru, Turkey, Zaire, Nicaragua, Sudan and Jamaica indicates that eventually lenders gain a higher rate of return than they would have on the original debt.

Many countries and banks are now involved in rescheduling exercises; it is estimated that at least 22 countries rescheduled bank debt in 1982 and the combined figure of rescheduled loans (over $5bn) was larger than the total for the previous 25 years. From the experience of the countries concerned various generalisations can be made. Rescheduling is enormously complex and difficult because of the number of banks: 1400 for Mexico, and over 100 even for Nicaragua – and it is a considerable feat for the big banks to get the small ones (as well as each other) quickly to agree terms. There is a continuous threat during any negotiation that one bank can precipitate default by demanding repayment, triggering off cross-default clauses and setting in chain a scramble for the debtor's assets – such as are realisable. Rescheduling is usually a short-term, stop-gap, measure only, dealing with immediately maturing debt. The exercise then has to be repeated at intervals and bad cases may involve the rescheduling of rescheduled debt. There is, as yet, no clear definition of the relationship between rescheduling negotiations for commercial bank debt and the system evolved through the Paris Club for dealing with *official* debt (owed to the main OECD governments); that is, government loans and insured commercial credit (ECGD in the UK). Until the end of 1981, the Paris Club rescheduled the official debt of 34 countries in 60 negotiations, involving $14bn. The terms of rescheduling one kind of debt inevitably affect the other, and Western governments are particularly concerned not to be accused of using taxpayers' money for debt relief on official debt which makes private commercial lending easier. Perhaps most seriously of all, bankers are reluctant to discuss a rescheduling arrangement unless the debtor country has IMF approval. But until very recently the IMF has been anxious not to become directly involved in bank debt rescheduling; it certainly does not want to underwrite bank debts; and it has had limited resources.

Emergency financing and 'safety nets'

Widespread arrears in debt servicing and the threat of large scale defaults has persuaded the major Western governments of the need for large scale, immediate, emergency financing for governments with debt servicing problems to provide 'bridging finance' until longer term remedies are agreed. Various facilities are involved: proposed or actual.

(i) At present, the main form of emergency financing is a 'safety net' provided by central banks meeting at the *Bank for International Settlements*. Their pooled reserves are advanced on an emergency and short-term (one year) basis to a country with serious liquidity problems. In some cases the emergency financing has been bilateral (from the USA in Mexico's case), rather than a joint exercise.

(ii) The US proposal made at Toronto in September 1982 (the Sprinkel system) involved enlarging and setting aside specific sums for emergency financing. It did not find wider favour at the time since it appeared to by-pass the IMF (or, at least, severely limit the

A brief guide to the jargon

Default. Tightly defined – and the definition used here – as a formal termination of debt obligations. It can be triggered by a sovereign (country) debtor repudiating its debts or by a creditor taking legal action over arrears in payment. More loosely defined, it can refer to any arrears on debt servicing, and particularly any failure of interest payment. Banking conventions are such that prolonged arrears of interest have to be treated as if default had occurred.

Rescheduling. An agreement between debtors and creditors to rearrange (in fact, to postpone) debt repayment. For private, and most public, creditors, the agreement invariably involves delays in principal repayment rather than interest.

Eurodollar loans. Lending in foreign currencies. Originally referred to dollar lending by US-owned banks in Europe; now has much wider application to all forms of expatriate money. Eurodollar markets provide both loans and bond finance.

Libor. London inter-bank offered rate. The rate of interest at which eurodollar deposits are traded in the main international money market. Loans tied to the libor rate are usually revised every six months. The *spread* is the difference between the libor rate and the actual interest rate on a loan.

Banks' capital. Banks are owned by their shareholders, not their depositors. Bank shareholders' capital, or equity, provides the banks with a reserve against losses and, of course, the investors with profits. To be distinguished from the banks' much larger cash or liquidity reserve which is to enable them to meet a liquidity crisis arising from withdrawals by depositors.

Lender of last resort. These days national central banks, in most countries, stand ready automatically to protect 'High Street' clearing banks from a large-scale withdrawal of deposits. Techniques vary from central bank advances to banks (UK) to insurance cover for depositors (USA).

The Paris Club has no formal rules or legal status but is an ad hoc group of officials from creditor governments who meet to discuss specific requests for rescheduling debt to official agencies (not commercial bank debt).

The Bank for International Settlements in Basle provides an information service on bank business and, more importantly, a forum for monthly meetings of the central banks of major industrial countries (The Group of 10). Has become a main vehicle for larger scale emergency financing when debt crises have arisen.

The Basle Committee (or Cooke Committee, after the Bank of England official who chairs it) co-ordinates surveillance of international banking by national central bank supervisors.

Fund's freedom of manoeuvre) and since it was not clear that additional resources would be involved.

(iii) Although the Sprinkel system was not adopted, a variant of it has been. In January 1983, there was an agreement in principle to set up a SDR 17bn emergency fund – an SDR 10.6bn expansion – under the IMF's General Agreement to Borrow. Hitherto reserved for and controlled by 10 major industrial countries, the GAB will now be available for lending to all IMF members, and is augmented in membership by Saudi Arabia and Switzerland. But even if this proposal is implemented it would not come into effect immediately and its implications for individual IMF borrowers' ceilings are, as yet, unclear.

(iv) In the meantime the main debtors are being offered *ad hoc three-way financing arrangements*, involving emergency central bank loans from the main industrialised countries, IMF Stand-by credits and some additional bank lending. No firm agreement has been reached with these countries, but it is already clear that commercial banks are contributing to the co-financing arrangements reluctantly, partly because they are receiving conflicting signals from their national authorities (eg the US Federal Reserve urging US banks to lend; the US Security and Exchange Commission stressing the need for observing supervision rules on high risk lending). Also the co-operation of the debtor countries – especially those with a strong hand to play, like Brazil – is not fully guaranteed until it is clear that the emergency measures involve additional resources for them as well as first aid for the Western banking system.

The role of the IMF

Until the recent announcement of an emergency (GAB) fund and increased quotas the IMF has kept a low profile in the debt crisis and there are still arguments as to how central its role should be. At first sight the IMF seems admirably suited to leading and co-ordinating the response to an international debt crisis. It has, however, been restrained by lack of resources and by delays in mobilising new Fund resources. A difficult balance has had to be struck between the views of contributors and borrowers. Contributors, notably the USA, have been reluctant to concede, through subscriptions, greater resources to the IMF which they see as augmenting world liquidity and which are subject to inadequately severe conditions. Ldcs, for their part, have been very reluctant to approach the Fund at all, mainly for fear of domestic reaction to the preconditions and performance criteria attached to conditional lending.

In the last few months there has been a convergence of views on the necessity for an enhanced IMF role. At the Toronto meeting, proposals for a big increase in Fund resources (eg by a 100% quota increase) were firmly quashed by the USA. It now appears that the main parties have agreed a compromise increase of 40-50%. This increase in subscriptions will, moreover, be accelerated to come into effect early in 1984. This increase is over and above the GAB emergency fund, and assuming a 50% quota increase the Fund's resources would rise to around $120bn.

There remains, however, an awkward hiatus in the coming year and, if the Fund is to play a central role in any crisis in 1983, further measures may have to be taken. One proposal advocated by a committee of top bankers (the Group of 30) is for the IMF to borrow from banks who are hesitant to lend directly, and to re-lend the money in its own name. This would radically change the IMF's role, to one of carrying the risks of international commercial lending, and the Fund has so far resisted. A further worry, aired by the Brandt Commission's latest report, is that the additional resources are simply inadequate. Even with a doubling of IMF quotas, the Fund's role in relation to world activity is much below historic levels: 5% of world imports by 1983/84 as against 9% in 1970 and 12% in 1965.

A continuing role for the bankers

Even if new Fund and GAB resources were committed now, they could contribute only $22bn in new lending, whereas ldcs have lost $85bn in reserves in the last two years. Consequently a key element in emergency financing and in IMF lending generally has been to create confidence for banks to engage in lending over and above rescheduled loans. There are two proposed mechanisms for reducing bankers' risk and enhancing confidence. The first is the establishment of an information exchange to disseminate knowledge about country conditions. First steps to set up an institute have been taken by 35 banks but the initial enthusiasm has given way to suspicion by some banks in Europe that American banks will use it to protect their position in what is still a competitive lending market. The second is in the field of international bank regulation. The Basle Committee (see Box) is endeavouring to ensure greater consistency in national practices and to monitor 'grey areas' such as the operation of branches in offshore centres. While prudential regulation protects banking interests in the main Western countries, it also underpins confidence and helps maintain flows of funds.

A more fundamental issue, not at present actively on the agenda, is whether Western governments should assume (eg by rediscounting bank loans) a significantly higher share of commercial bank risk, either to provide confidence in the banking system, or to persuade banks to increase lending to debtor countries, or both simultaneously.

New sources of finance

Even if existing bank lending is stabilised, one fundamental economic problem remains: who will be responsible for recycling surpluses in future – ie making resource transfers – to deficit economies? The banks are bound to play a much reduced role especially when repayment is set alongside new lending. On one projection, by Amex, even on the relatively optimistic assumption that banks will resume large scale lending after 1983, there will be a net flow of over $10bn a year from ldcs to banks in industrial countries over the next five years. Since a net capital transfer would require ldcs to run a current account surplus the implications for growth are profound. One bank, Morgan Guaranty, has estimated the wider economic effects of a lending slowdown; on optimistic assumptions (new bank lending rises by 10% p.a. instead of 20%, more in line with bank capital) the real annual growth rate of non-OPEC ldcs would be cut by 1.5%, and 3% in Latin America. On pessimistic assumptions (no growth of lending overall) the growth reductions would be 3% and 5.5% respectively. The implicit reduction in imports by ldcs could cut OECD growth by ½-1% on the two scenarios, and deepen recession in the West.

Are there alternative mechanisms?

(i) *Government aid.* Most of the middle-income heavy borrowers are not considered aid-worthy, but many poor countries which are eligible have experienced growing difficulties in financing external deficits and debt arrears when aid is declining in real terms. Some have borrowed from banks, usually on a short-term basis, and their bank debt problems can be large in terms of their ability to service debt if not in terms of the international banking system. Other countries (eg India) have responded to the fall in aid by drawing heavily on the scarce funds of the IMF and also by entering eurodollar markets on a scale which may pose problems in the medium-term. Politically, however, more aid is viewed unfavourably in the West.

(ii) *Private investment.* Long term direct investment fell from 40% of ldc capital inflows in 1973 to 10% in 1981. Many ldcs are now revising their previous negative perception of private investment, since debt service has to be paid regardless of what is produced, and profits depend on performance. But regulations and attitudes die hard and it is doubtful if foreign investors will rush in where banks now fear to tread.

(iii) *New types of private flows.* One idea being canvassed is that ldcs could switch from loan to bond financing. Ldcs have traditionally had difficulty in penetrating bond markets and confidence has not been helped by some bond-holders' rescheduling operations (eg Costa Rica). Proponents argue, however, that indexation and international guarantees could create a new form of long-term private finance for ldcs which does not involve the banking system. This problem merges into the wider issue of how long-term corporate – as well as country – financing can be expanded relative to bank lending in order to take the pressure off both the banks and monetary control mechanisms.

The future

The problems associated with international bank debt are not constant or easily predictable. In the mid-1970s the main fear was a crisis of liquidity caused by a sudden withdrawal of OPEC deposits. This fear has receded, to be replaced by that of insolvency induced by debtor default. Taking into account the importance of uncertainty, various scenarios can be sketched out. The first is the most dramatic but now looks the least likely; this is that major debtors would deliberately default, possibly in unison, precipitating a major banking crisis. The willingness of Communist and major Latin American debtors to seek an orderly rescheduling indicates the absence of sufficient political resolution to follow this dangerous route. It is possible, however, that an unpopular government with little to lose politically could repudiate its debts and try to trade on a cash or barter basis, with lesser, though serious, effects on creditor banks. It is more likely that the attempts to put together major loans for Mexico, Argentina and Brazil could fail or that subsequent rescheduling negotiations might fail, triggering a banking crisis. Even if immediate repayment problems are resolved a crisis could recur if the balance of payments position of the countries remains precarious next year and real interest rates remain high.

The most likely outcome is that a serious banking crisis will be avoided by emergency lending and rescheduling – though some banks will, no doubt, suffer losses. However there is a real danger that the banks will reduce their future growth of new lending to such an extent that economic growth in non-OPEC ldcs will be sharply cut – even beyond the cutbacks imposed following stabilisation measures – further promoting serious and prolonged depression in the world economy. A crisis results; but not a banking crisis. To avoid it there must be an alternative vehicle for resource transfers to the banks. In practice this almost certainly involves the Bretton Woods institutions, the IMF and the World Bank, but on a scale scarcely envisaged hitherto, for long-term lending on commercial terms to middle-income countries and aid to the poorest.

© Overseas Development Institute, London 1983.

ISSN 0140-8682

For further information contact Vincent Cable at the Overseas Development Institute.

Briefing Papers present objective information on important development issues. Readers are encouraged to quote or reproduce material from them for their own publications, but as copyright holder, ODI requests due acknowledgement and a copy of the publication.