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# STRAINS! THE EUROCURRENCY MARKET AND THE DEVELOPING COUNTRIES

TWENTY-SECOND SESSION

EXECUTIVE SEMINAR IN NATIONAL AND INTERNATIONAL AFFAIRS

DEPARTMENT OF STATE

1979-80

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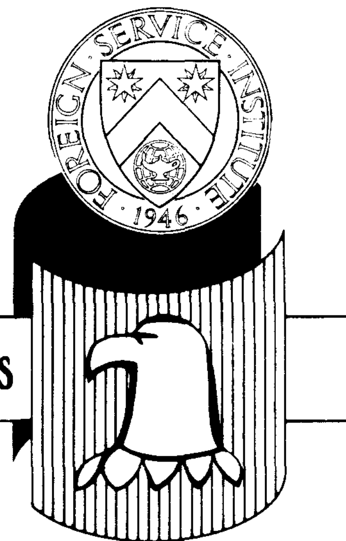
# STRAINS! THE EUROCURRENCY MARKET AND THE DEVELOPING COUNTRIES

A Case Study

MARY E. McDONNELL

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# STRAINS! THE EUROCURRENCY MARKET AND THE DEVELOPING COUNTRIES

By

Mary E. McDonnell

SUMMARY

Bank borrowing on commercial terms became the major source of financing for middle-income developing countries after the oil-price rise of 1973. Official aid to less developed countries (LDC's) did not keep pace with the rise in their deficits. The International Monetary Fund (IMF), the only multilateral organization existing to finance balance-of-payments deficits, attached to its credits tough economic-performance conditions that governments of developing countries frequently found threatening to their political survival; IMF credits and advice were little taken.

The slow pace of adjustment among many LDC's raises the question of their ability to earn enough foreign exchange to service their external debts. The danger posed to banks is compounded by some unsound practices in the Eurocurrency market.

The need of developing countries for foreign loans will be great for some time to come. Oil prices are likely to continue to rise as long as no alternatives are found to petroleum, adequate in supply and competitive in cost. It will take time for developing countries to reduce their oil consumption, adjust the volume of other imports, and increase their foreign earnings. Without new credits, LDC's would have to contract imports rudely. Growth would stop. Ability to produce for export, earn foreign exchange, and repay external debts would be impaired. Yet, if credits continue to be supplied to LDC's mainly on commercial terms, the capacity of the developing countries to repay will be under increasing strain and the international banking system in danger. The dilemma is a harsh one.

Three things are necessary for sound continued lending to LDC's: better prudential supervision of the Eurocurrency market, economic adjustment by developing countries to rising oil prices, and a greater proportion of concessional credits in total lending to LDC's than in the recent past. This paper reports prudential concerns and considers a number of measures on which the IMF, development organizations, governments, and private banks might collaborate to help the LDC's and to preserve order in international banking.

Failure to ease the financing strains on developing countries and on Eurolenders could lead to a retreat from what has been a rapid and welcome internationalization of money markets, and a return to segmented national markets of limited access and limited efficiency. It could bring severe banking losses and heightened political tensions between developing and developed countries.

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PROBLEM: DEBT SERVICE OF DEVELOPING COUNTRIES AND BANKING STABILITY

After the first big oil price rise in 1973, commercial banks operating in the Eurocurrency market provided most of the balance-of-payments financing made available to the less developed countries (LDC's). In the two years 1977-1978, for example, publicized new Eurocurrency credits made up 84 percent of new borrowings by non-oil-exporting developing countries. (Table I, Appendix)

Balance-of-payments financing was a new function for banks. Traditionally, they have supplied investment funds to expand production and finance trade. The borrowers have repaid from earnings made possible by the financing. In the past it was official lenders who provided most of the balance-of-payments assistance to deficit countries. After 1973, credits to LDC's from governments and international organizations did not go far toward filling the payments gap created by higher oil prices, inflated costs of manufactured imports, and loss of export revenues due to recession in developed countries. The developed countries themselves were hard hit. They were not in a mood to be generous. Banks, especially banks in the Eurocurrency market, assumed the balance-of-payments financing function when official lenders were slow to respond. Banks were not expected to be generous. Confronted with a sluggish demand for credit in major national financial centers, they vied with each other for what started out to be the profitable business of lending to LDC's.

In many respects, the increase in bank lending to LDC's was most fortunate. To both developing and developed countries, banks lent funds deposited with them by the oil-exporting countries; banks put these resources back into circulation -- on a loan basis -- in countries that had been forced to transfer them. In the absence of lending, whether by the Eurocurrency market or by national banking systems, developing countries would have had to cut back oil imports and imports of goods from developed countries to the level of their foreign earnings. The harsh consequences of sudden deflation would have been widespread among the LDC's: intensified physical hardship for their populations, negative economic growth, a declining ability to generate foreign exchange, and political destabilization.

There have also been negative aspects of Eurolending to developing countries. Some people hold that banks lent too easily to the developing countries, that they only made it possible for the LDC's -- especially the middle-income developing countries which were the largest LDC borrowers from the private market -- to put off the real adjustment to higher oil prices that they must eventually make. Had less bank financing been available to them, it has been argued, they would have had to introduce healthy structural changes into their economies to increase export earnings.

The U.S. Treasury Department finds evidence that, as a group, LDC's achieved a considerable degree of adjustment. Non-oil developing countries maintained higher growth rates in the aggregate than industrial countries in the years following the 1973 oil price rise. Furthermore, they slightly reduced their deficit on nonpetroleum trade and service transactions in

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nominal terms between 1973 and 1979 -- the equivalent of a substantial real reduction.[1] It might be a mistake to put too much stock in this opinion. While the apparent improvement could reflect some use of borrowed funds to increase export capacity, it also reflects, in part, lucky temporary upswings in the market prices of certain commodities exported by non-oil developing countries and probably even a decrease in the volume of manufactured imports from inflation-troubled developed countries. It seems probable that bank loans have, in fact, permitted some LDC's to spend on nonessential consumption.

To the extent that LDC's are not using their borrowed funds for investment in new productive capacity that could be used to repay their loans, international bankers, mainly those in the Eurocurrency market, have extended credits unrelated to any basis for repayment and they have done this, all the more astonishingly, for countries that were in deficit even before the first oil price rise. There has therefore been a serious general weakness in international lending to developing countries since 1973. Implications for the stability of the international banking system are profound.

After 1973, when balance-of-payments financing grew in volume, the common assumption was that it was needed only temporarily until countries could adjust to the higher price of oil. Oil price increase continue, however, and many developing countries are now in the position of having to borrow just to service their debts.

There is no reason to believe that real oil prices are going to decline after the second quantum increase of 1979-1980. Although there is temporarily a surplus of oil worldwide due to a mild winter, conservation, and an excess of production over demand, there is nothing to stop members of the Organization of Oil Exporting Countries (OPEC) from increasing their prices in the face of declining demand so long as they do not fall into competition with one another for customers.

Moreover, it is altogether logical for OPEC members to seek to compensate themselves well for the depletion of their nonrenewable resource. They can continue to make price increases as long as the present value of oil is perceived to be less than its future value -- that is, as long as no consequential alternative sources of energy are developed.

Developing countries, by definition, require foreign financing because they are net importers of resources. In addition, they are going to continue to need extra financing to cover the rising cost of oil and their growing oil-related debt service. Until alternative sources of energy can compete with oil in price and availability, developing countries, in the absence of adjustment, will face a constantly ascending debt-service curve that never peaks. In the absence of adjustment, LDC's will be unable to manage their mounting debt. International banks are likely to suffer severe losses and to stop lending to developing countries. At worst, we will see a retreat from the internationalization of money markets to national markets of limited access and limited efficiency.

The stakes are high. This paper considers several questions. How prudent is the Eurocurrency market? What must be done to reduce bank risk in developing countries? How can the adjustment of developing countries to higher oil prices be helped forward? How rapidly should that adjustment proceed?

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## II

## 1973-1978: THE FIRST OIL PRICE SHOCK: THE DEVELOPED COUNTRIES ADJUST MORE RAPIDLY THAN THE DEVELOPING COUNTRIES

In late 1973, oil prices rose abruptly. In 1974, the average nominal price for "marker" crude set by OPEC was well over three times the 1973 average. Despite a subsequent decline below the 1974 level, the real price remained well over twice what it had been in 1973 until the third quarter of 1979 when it rose again.

The sharp price rise in 1973 exacted a massive transfer of resources to the oil-exporting countries. OPEC members accumulated a current account surplus of about $180 billion in the period 1974-1978. The conventional wisdom had it that the banking system would be unable to recycle the vast volume of earnings pouring into the oil-exporting countries. Soon after the initial price shock, one major bank predicted that OPEC countries would accumulate $500 billion in reserves by 1980.

The Eurocurrency market was a major instrument for recycling the OPEC surplus. OPEC members deposited some $58 billion in the market between 1974 and 1978. These funds and OPEC funds deposited elsewhere[2] helped to support economic growth in developed and developing countries.

By 1978 the surplus of the major oil-exporting countries had declined to $6 billion, the level of 1973, and OPEC reserves were only $50 billion more than they had been in 1973. The surplus of the industrial countries rose that year to more than four times the average annual level of 1974-1977.[3]

Current Account Balances, Excluding Official Transfers

(In billions of U.S. dollars)

| | 1973 | 1974-77 Net total | 1974-77 Average annual | 1978 |
|---|---|---|---|---|
| Major oil-exporting countries[4] | 6 | 175 | 44 | 6 |
| Non-oil developing countries[4] | -11 | -115 | -29 | -31 |
| More developed primary-producing countries[4] | 1 | -56 | -14 | -6 |
| Industrial countries[4] | 19 | 32 | 8 | 33 |

Source: Based on data in Annual Report 1979, International Monetary Fund, p. 15.

Surpluses and deficits do not balance because of errors, omissions, and exclusion of countries not members of the IMF.

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The relative current-account positions of the several groups of countries by 1978 were significant. They showed that developed countries had far greater success than developing countries in increasing their foreign earnings in adjustment to the higher price of oil. They also suggested heavy spending by OPEC countries on the goods and services which industrial countries were able to offer.

The buoyancy of the developed countries leads to a further conclusion: industrial countries and OPEC members, too, had the capacity to increase their lending to the LDC's. As it was, they left the job mainly to the private banking system.

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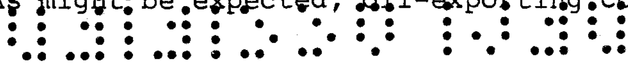
# III

## THE EUROCURRENCY MARKET: DEFINITION, HISTORY, ROLE, AND SIZE

By definition, assets and liabilities in the Eurocurrency banking market are denominated in currencies other than that of the country where the bank is located. Neither the currencies nor the location of Eurobanking operations need be "European". Dollars are the main currency of the market; Morgan Guaranty Trust Company of New York estimates that Eurodollars, i.e., dollars held outside the United States, accounted for 73 percent of gross liabilities in all "Euro"-currencies in June 1979. Other important Eurocurrencies are the yen, the mark, and the Swiss franc. Besides Continental centers of the Eurocurrency market like London, Luxembourg, Geneva, Zurich, Amsterdam, and Paris, there are a growing number of centers elsewhere, now including Panama, the Bahamas, the Cayman Islands, Hong Kong, Singapore, and Bahrain. There is, of course, another broad area of international banking -- lending to foreigners or taking deposits from foreigners in the currency of the country in which the bank is located. OPEC members deposit and borrow within national banking systems as well as in the Eurocurrency market. They are, however, attracted to the Euromarket by its anonymity, its usually advantageous interest rates, and its existence outside the jurisdiction of any country -- or so it seemed until the U.S. Treasury recently froze Iranian assets in foreign branches of American banks as well as in banks in the United States.

The Eurocurrency market began forming in the late 1950's when postwar exchange controls were relaxed, Western European currencies became convertible, and U.S. trade and direct investment abroad began to boom. But the market made a sharp burst of growth -- 31 percent a year, on the average, in the period 1966-1972 -- when big U.S. banks set up branches and subsidiaries in London to escape costly U.S. domestic banking regulations: the Interest Equalization Tax, effective in 1973, on purchases of foreign securities by U.S. residents; voluntary -- later mandatory -- controls on American direct investment abroad and American bank lending to foreigners, beginning in 1965; limits on the rate of interest that could be paid on large time deposits under Regulation Q; and long-standing reserve requirements on member banks of the Federal Reserve System. They found a haven in London. The Bank of England imposed no restrictions on non-sterling banking operations in the United Kingdom. By the 1970's when all these regulations except the reserve requirement had been lifted or liberalized, the Eurodollar business of the American banks abroad had become so profitable that they remained firmly established within the Eurocurrency market and fiercely competing for business.

Although there has been explosive growth of the Eurocurrency market since 1973, this has not been due primarily to OPEC deposits but also to the expansion of international trade and investment and the growth of foreign-exchange reserves held by governments. The major source of Eurocurrency funds, as shown in Table II of the Appendix (partially netted out to remove certain interbank transactions), is the European area reporting Eurobanking data to the Bank for International Settlements (BIS) in Basel.[5] Other big sources of Eurodeposits are the United States and even the developing countries, which often hold their foreign-exchange reserves in this form. As might be expected, oil-exporting countries are an important



source of Eurocurrency funds and the largest of the net suppliers. Other sources are the United States and the European countries within the BIS reporting area.

Major users of Eurocurrency credits are the developed countries -- those in Europe reporting to BIS; the United States; Canada and Japan; and nonreporting developed countries. Eurocurrency credits outstanding to these countries at the end of September 1979 amounted to $265 billion or 59 percent of total Eurocredits outstanding, partially netted out. Outstanding Eurocredits to non-oil developing countries were $51 billion, by BIS count[6], or only 11 percent of outstanding Eurocredits. The position of LDC's as net users of the Eurocurrency market ranks below that of Canada and Japan, developed countries not within the BIS reporting area, and Eastern Europe.

Depositors and borrowers are nonfinancial institutions like multinational corporations temporarily having surplus funds, and individual investors with large sums; official institutions such as central banks, international financial organizations and governments; and commercial banks.

The gross size of the Eurocurrency market in September 1979 has been estimated at $1,070 billion[7], compared to $200 billion at the end of 1972. However, the figure for gross liabilities or assets, or even the figure for "net" liabilities or assets, contains considerable double counting of interbank and intrabank deposits or loans. The most meaningful measures are loans to, or deposits from, private nonbanks. This measure eliminates inter- and intrabank loans which make up some two-thirds of Eurobanking activity and do not add to the total credit outstanding to end-users. In terms of the more meaningful measure of claims on nonbanks, the Eurocurrency market has grown from $45 billion in 1972 to $265 billion at the end of June 1979.[8]

At the same time, claims of foreign branches of U.S. banks on nonbank foreigners, in all currencies, were the equivalent of $82 billion; claims of those branches on "others" in the United States besides parent banks amounted to almost $7 billion, some part of which were claims on nonbank U.S. residents. Nonbank liabilities of foreign branches of U.S. banks to foreigners and to U.S. residents, in all currencies, amounted to more than $71 billion.[9]

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## IV

## DEPENDENCE OF DEVELOPING COUNTRIES ON PRIVATE CREDIT

Banks in general, and the Eurocurrency market in particular, were more responsive to the financing needs of developing countries after the 1973 oil price rise than were official lenders.

For non-oil developing countries, bank borrowing became the major source of deficit financing. In the seven years through 1979, LDC's borrowed, net, some $135 billion from banks in the Eurocurrency market and outside it. In that same period, the net borrowing of LDC's from all official sources was $65 billion.[10] According to the World Bank, 47 percent of the outstanding disbursed external public debt of 96 developing countries[11] was due to official sources at the end of 1974; 33 percent of their total external debt was on concessional terms. By the end of 1978, the dependence of developing countries on private financing was much greater. The share of debt outstanding to official sources had fallen to under 40 percent; only 26 percent of the total external debt was then on concessional terms.[12]

The increase in official aid, bilateral and multilateral, to non-oil developing countries did not keep pace with the rise in their combined deficit in the years 1974-1978. The combined average annual deficit of those countries in the five years was 259 percent higher than their deficit in 1973. But the average annual increase in bilateral aid disbursements in that period was only 165 percent above the increase in 1973 over the year before. (Table III, Appendix)

In 1978, for example, development assistance from the 17 member governments of the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) amounted to $18 billion, only 0.32 percent of their combined GNP. The DAC estimates that OPEC aid flows in 1978 amounted to an additional $7 billion, down from a peak of over $8 billion in 1975. OPEC countries have given a bigger share of their GNP in aid than the OECD countries. In 1978 that share was 2 percent. For Saudi Arabia, Kuwait, and the United Arab Emirates, individually, the record was more impressive yet: their assistance averaged 5.5, 7, and 11 percent of GNP, respectively, in recent years.

International organizations raised their lending more rapidly than bilateral aid rose, but the rate of increase in their lending was less than the rate of increase in the deficits of developing countries. The IMF, the World Bank group, and regional development banks lacked resources to finance LDC deficits of the size that were created by the first OPEC price increases and lacked a mandate that precisely fit the situation. Project assistance from the World Bank and development banks was welcome but the projects on which it was to be spent did not necessarily increase the external earning capacity of the recipient countries. Program credits supplied by the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA), the two major World Bank institutions, were more flexible but they were tied to development objectives and they were modest in comparison with financing needs. The IMF imposed conditions for its credits that governments of developing countries found difficult to accept.

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Commercial Lending Terms Weigh Upon LDC's

Paucity of official assistance has forced developing countries to accept market terms for most of their borrowing. As a result, they must make far larger debt-service payments than would have been the case if a higher proportion of their borrowing had been from official sources. Consider the data.

In 1978, the average interest rate charged by official lenders (governments and international organizations) to developing countries on loans was 5 percent per annum. The average maturity of such loans was 24.8 years and official loans had an average grant element of 37 percent.

Average terms of private loan commitments were far less generous. The average interest rate was 9.8 percent and the average maturity was 8.7 years for loans by private banks and other private financial institutions -- which make up the bulk of private lending to developing countries. Private loans from financial institutions had no grant element.[13]

Only six percent of the Eurocurrency credits extended to developing countries in the period 1976 through the first three quarters of 1979 had maturities of over 10 years, and only 11 percent of the Eurobonds floated by LDC's. Access of developed countries to extended maturities was little better (four percent and 23 percent, respectively).[14]

Table IV (Appendix) illustrates the heavy burden of debt service borne by developing countries who must rely primarily on the private market for financing. Upper-middle-income developing countries and intermediate-middle-income countries, as defined by the World Bank[15], must make debt service payments in 1980 equal to 33 and 37 percent, respectively, of their disbursed external private debt outstanding. The burden of debt service is a function not only of the level of interest charges but also of the maturities of loans.

For developing countries of all income groups, debt service payments to private lenders as a share of total debt service is larger in percentage terms than the share of private credits in total external credits outstanding. At year end 1980, private lenders will account for 54-64 percent of the external disbursed debt outstanding of upper-middle-income and intermediate-middle-income countries.[16] But these groups will have to make 75-78 percent of their total debt service payments this year to private lenders. The intermediate-middle-income countries are in the worst position as a group: 54 percent of their outstanding external debt is from private sources to which they will pay 78 percent of their total debt service this year. Put another way, their debt service due to private lenders will equal 37 percent of their outstanding disbursed external private debt.

Debt, debt service, and bank lenders are highly concentrated, a fact which makes the possibility of default by a major borrower particularly worrisome. Middle-income countries owed almost all the disbursed private debt outstanding of developing countries in 1978. Ten countries owed 68 percent of that debt and 10 paid 60 percent of all the debt service paid by LDC's.[17] Countries appearing on both lists are Algeria, Argentina, Brazil, Indonesia, Iran, Korea, Mexico, Spain, and Yugoslavia. A few major banks, among which there is heavy American representation, account for most lending to developing countries.

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Balance-of-Payments Financing from the IMF: No Thanks

After the first oil shock, as today, the IMF was the only international organization existing specifically to provide temporary balance-of-payments financing to countries in deficit. One of its stated purposes was

> to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
>
> Article I, Articles of Agreement, International Monetary Fund.

Its emphasis was not on economic assistance but on correction of the causes of a country's payments imbalance. It was not an aid agency but the guardian of international monetary stability. Temporary balance-of-payments credits from the IMF, except in minimal amounts, carried stiff requirements for economic reform.

The Fund's response to the 1973 oil price rise was limited. In 1975, it softened conditions for use of its Compensatory Financing Facility, more readily to assist countries suffering shortfalls in export income. It established new lending facilities. Among these was the Extended Facility, set up in 1974 especially for nations needing to undertake deep restructuring of their economies; the Extended Facility made help available over longer periods than under the usual standby credit arrangement -- subject to compliance with performance conditions effectively set by the IMF. In 1976, the Fund placed proceeds from the sale of gold holdings in a temporary Trust Fund to provide additional financing to low-income countries having programs for balance-of-payments adjustment. In February 1979, its new Supplementary Financing Facility -- the so-called "Witteveen Facility" -- became operational. Intended to supplement the Fund's ordinary resources for members with serious payments imbalances, who are willing to undertake extended adjustment programs subject to IMF conditions, the Supplementary Financing Facility has the equivalent of some $10 billion to lend. This was a large increase in total Fund resources but still modest compared to the financing needs of the non-oil LDC's.

But, more to the point, the funds that the IMF has had to offer have not been used much. The Communique of the Ministers of the Group of 24 /developing countries/ on International Monetary Affairs, issued after their meeting in Belgrade, September 28, 1979, observed that

> it was paradoxical that at a time of growing payments imbalances of a number of /IMF/ member countries, and of severe external difficulties for most developing countries, the net use of Fund resources should show a decline.[18]

The fact was that most governments sought a slower rate of adjustment to both their underlying deficits and their oil-related deficits than the IMF was prepared to allow them.

The IMF has been regularly criticized by borrowing countries for the severity of the conditions that it places on loans. Access of a country to upper credit tranches, to the Extended Facility and now to the Supplementary Financing Facility depends on its agreeing with the Fund on a detailed economic stabilization program, including fiscal, monetary, exchange-rate, trade, and payments policies for a specific program period. Governments of countries in need of credits usually find that the conditions are politically difficult to accept. They frequently involve contractionary measures -- lower imports, reduction in the money supply, cuts in the budget -- that spell increased unemployment, decline in consumption, and curtailment of government spending on social programs. IMF prescriptions have caused riots in Egypt and Peru.

Former Prime Minister Bülent Ecevit of Turkey once complained in connection with his government's negotiations with the IMF on a standby credit agreement that a democratic developed country can accept IMF conditions, a totalitarian developing country can accept them, but the government of a democratic developing country cannot impose harsh austerity measures without expecting a harsh reaction from its people.

This bad-tasting medicine is undoubtedly very good for reducing the external deficit of any single country, if the country can stand it. It does, however, discourage governments from going to the doctor. Deficit countries clearly by-passed the IMF in the period following the first oil shock; instead, they sought bank financing without conditions.

Morgan Guaranty Trust Company recently published some data on this point. Fund credits outstanding to non-oil LDC's at the end of August 1979 amounted to only $4.7 billion, excluding $1.9 billion outstanding under the 1974-1975 Oil Facility and $1.5 billion under the Trust Fund. Less than $1 billion of the credits outstanding entailed conditionality. The developing countries have obviously been reluctant to submit to IMF conditions.[19]

<u>What Has Been Wrong?</u>

The situation has been unhealthy. Developing countries have built up a vast debt to private banks on difficult terms. Without real adjustment to the higher price of oil, at least to the point where LDC's are no longer borrowing to service their debt, banks operating in the Eurocurrency market, including several large American banks, are in great risk.

What has been lacking?

-- First, there has been no effective way to encourage developing countries to begin real adjustment. For example, a country might have to slow the growth of its money supply that has been leading to inflation and noncompetitiveness of exports; another might have to stop inflationary subsidies tc inefficient public enterprises; and still another might have to correct overvaluation of its currency that has been causing understatement of import costs and overpricing of exports. More realistically, a single country might have to do all these things and more. The IMF is right to condition its credits on basic reforms that will reduce payments deficits.

-- The IMF has not appreciated the political necessity of giving LDC's time to put reforms into effect gradually. It has asked too much too soon. A country may have to continue to subsidize inefficient state enterprises until it can rationalize them or phase them out of existence, in either case having to provide for the retraining and relocating of

workers. If a country has not been export-minded, it will need time to dismantle bureaucratic impediments to exports, set up quality controls, increase productivity, and decide upon and develop export products and markets.

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-- Funds available to the IMF and to other official sources that might support IMF conditionality have been small. More ample funds would make acceptance of IMF reform programs politically feasible for governments. They would also permit countries to seek payments balance through expansion of their economies rather than by contraction.

-- And, finally, the resources of private banks have not been sufficiently employed to encourage the adoption of economic stabilization measures by borrowing countries. Sometimes LDC's have used bank credits to escape submission to IMF conditionality.

Chapter VII will make a number of suggestions for policymakers in these areas.

Before we consider those suggestions, it would be useful to look in more detail at bank risk and at the attitudes of banks after the second oil price rise.

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## V

## PRUDENCE IN THE EUROCURRENCY MARKET

The 1973 price rise occurred in a competitive period in Eurobanking business. The recession induced in the United States and in Western Europe by the event led for a time to decreased demand for funds in national financial markets. Vying with each other for business in highly liquid markets, the banks sought customers among the oil-importing developing countries. OPEC members themselves largely avoided lending directly to the LDC's, letting the banks assume that risk.

Has the Eurocurrency market been prudent in its lending to developing countries and to other borrowers? Because the market has operated outside the supervision and regulation of national authorities, there is some concern about the possibility of unsound banking practices. These could affect the orderly operation of the market and of the international financial system.

There are several practices bearing upon lending to LDC's that deserve attention:

Acceptance of an Injudicious Level of Country Exposure. Some banks have allowed loans to individual countries to make up a large share of their loan portfolios. True, banks impose country limits on their lending, but these are self-imposed limits and adjustable. The U.S. Comptroller of the Currency keeps watch over the consolidated positions of U.S. banks and their foreign branches, however; this surveillance may help to keep U.S. capital/loan ratios within prudent limits. Nevertheless, there is no regulated ceiling on this ratio in the United States. In most other countries, banking authorities do not yet exert a similar influence.

Haphazard Assessment of Country Risk. The assessment of country risk is necessarily imprecise, as banks found in the case of Iran. It should, however, always be tough-minded. It is not. The big banks approach the task through a variety of methods, ranging from the application of gut feeling to detailed quantification of the factors bearing upon risk. Smaller banks in the Eurodollar market, ones that perhaps should not be in it, may depend on the "old boy" net to supply them with judgments that they are without the resources to reach themselves. In violation of their practice anywhere else, some American banks have lent to Eastern European countries without insisting upon detailed financial data, assuming that these countries existed under a Soviet "umbrella" which would guarantee their creditworthiness. There has never been such a Soviet assurance.

Banks use a country's relationship with the IMF as an indication of its creditworthiness. A country may turn to the IMF for balance-of-payments financing when it is in such poor shape that it cannot obtain credits elsewhere. Banks will usually stand aside until the government has reached agreement with the Fund on an economic stabilization program. They will usually stop lending later if it appears that a country is not living up to its commitments to the Fund. There are relatively few countries negotiating or having negotiated currently active standby agreements with the IMF.

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Mismatching of Maturities and Interest Rates. Excessive mismatching of maturities and interest rates could affect bank solvency. It is a normal and acceptable practice for banks to borrow short and lend long, but if the maturity mismatch becomes excessive, banks risk liquidity shortages and loss of depositors' confidence. The safe degree of mismatch will vary with circumstances. A rough example will illustrate the problem. Sixty-eight percent of the liabilities of U.K. banks in foreign currencies early in 1976 had maturities of less than three months.[20] Yet, the average maturity of new Eurocurrency bank credits to governments and state enterprises in 20 countries in the fourth quarter of 1978 was 8.9 years.[21] Mismatch of interest rates is less troublesome now. In a serious mismatch banks would pay more for deposits than they would earn from loans. This situation could occur in a period of rising interest rates if banks have been lending at fixed rates. The adoption of variable interest rates for most Eurocurrency loans has reduced the interest-rate risk; rates are now often reset every three or six months.

Pyramiding of Unsecured Interbank Loans. About three-quarters of Eurocurrency liabilities are to commercial and central banks. The interbank market is the key to the liquidity of the Eurobanking system; ready access to the interbank market enables Eurobanks to minimize their voluntary reserves. But interbank loans are unsecured. The reputation of the borrowing bank is the basis for lending. Borrowed funds are relent within the banking system. The security of the system depends upon every bank in the chain being able to meet its obligations up to, and including, the final nonbank borrower.

Trust in the Existence of a Lender of Last Resort. It is possible that, in the past, banks have made high-risk loans under the assumption that governments would come to their rescue in the event of default. Until recently, lenders in the Eurocurrency market appeared to discount the possibility of sovereign risk when they lent to governments. But governments do, indeed, miss payments. Eighteen countries experienced debt-servicing problems in the years 1974-1978, according to the IMF's Annual Report for 1979. Those countries represented 12 percent of the total outstanding external debt of developing countries.[22] Central banks of major industrial countries have left ambiguous whether or not they will provide lender-of-last-resort support for overseas branches of banks under their jurisdiction. They have recognized that foreign branches are integral parts of the parent banks. They are satisfied that means exist to provide liquidity, if necessary, to prevent destabilization of the Eurobanking system itself. The Federal Reserve has stated that it is prepared to provide secured funds to a solvent parent temporarily in need of liquidity.[23] But no central bank has promised to bail out an insolvent bank.

There is agreement among central bankers on the need for increased prudential supervision of the Eurocurrency market. Over the past year, meeting under the auspices of BIS, they have approved in principle the concept of greater transparency of international banking operations and have moved to collect more Eurobanking data than ever before and to share it. Major sources of information at present are the World Debt Tables and supplements of the World Bank and its quarterly data on Borrowing in International Capital Markets. The BIS issues quarterly and annual reports on developments in the Eurocurrency market. The Bank of England Quarterly and the Federal Reserve Bulletin give data on the positions of banks in the United Kingdom and on American banks worldwide in the Eurocurrency market. There is now considerable information available about such matters as the amount of borrowing being done by a particular country, the rate of growth of the Euromarket, sources and uses of Eurocurrencies, and the average

terms of Euroloans and deposits.

Nevertheless, there are wide data gaps. One of these has to do with a bank's total exposure in a particular country. To remedy this deficiency, central bankers have shown themselves to be receptive to the consolidation of bank balance sheets on a worldwide basis. By this means, they will be able to see the total amount lent to any country not only by the home office of a bank but also by its branches and affiliates abroad. This improved information about the aggregate lending position of each bank will also give banking supervisors a better picture of the adequacy of a bank's capital to its outstanding loans. The United States is the first major financial country to require banks to report their consolidated balances; other major countries will follow shortly.

Central bankers are also looking at ways to collect maturity transformation statistics.

Further, they have agreed that parent banks should be responsible for their own branches and affiliates wherever located and that central banks should be responsible for supervising banks of their own nationality at home and throughout the world. The principle of "parental responsibility" has eased, but not erased, fears of the difficulties that one bank could inflict on others in a Eurobanking system which depends heavily on unsecured interbank loans for liquidity.

Central bankers have not effectively addressed the problem of assessment of country risk. Some suggestions are made on this subject in Chapter VII.

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## VI

## 1979-1980: THE SECOND OIL PRICE SHOCK: ATTITUDE OF BANKS TOWARD LENDING TO DEVELOPING COUNTRIES

Oil prices began to go up again, sharply, in the second half of 1979 and rose still further early in 1980. Additional increases are expected this year. The current account surplus of OPEC members rose from $6-7 billion in 1978 to an estimated $65 billion in 1979. The current account of OECD countries swung from a surplus of $11 billion in 1978 to a deficit of $32 billion in 1979. The deficit of non-oil developing countries deepened from $26 billion to $39 billion.[24] (Discrepancies between these figures and figures on page 3 are due to different estimating methods used by different sources.)

Estimates vary on the level of the OPEC surplus in 1980. The U.S. Treasury believes that it will reach $110 billion and that the current account deficit of the non-oil LDC's will rise by $20 billion this year to a total of $60 billion.[25]

The net outlook for the developing countries in the face of the second oil shock must be judged gloomy. Their mounting debt-service burden requires new credits of ever-increasing size. At the same time, their capacity to raise export earnings will be constrained by slackened demand for their goods abroad.

The second series of oil price rises is not going to be met, as the first was, by a concerted program among OECD countries to stimulate domestic demand and counter the loss of purchasing power to OPEC. The main economic objective of the industrialized countries now is to reduce inflation. The international recession that can be expected to follow the second round of price increases will be enforced by the anti-inflationary policies of the United States and other major economies. If it is politically feasible to stick to its goal of cutting inflation, the United States cannot be expected to play the same role as it did after 1973 when U.S. domestic demand was a major factor in sustaining economic activity abroad.

Moreover, the terms of trade of the non-oil developing countries may continue to deteriorate for a while. Inflation in the industrial countries is presently driving up the prices that LDC's pay for manufactured imports. Prices for their exports of primary commodities are rising more slowly.

There are, however, some factors that will help the developing countries now. Large current account surpluses in Japan and Germany, amounting to over $25 billion in 1978, are no longer compounding the recycling problem. Oil import bills as a proportion of the GNP of all borrowing countries will be no greater than in 1971.[26] Developing countries have steadily built up their foreign exchange reserves through "over-borrowing", as protection against reverses in their current accounts. Many have refinanced debt acquired after 1973 as a means of stretching out maturities. The new Supplementary Financing Facility within the IMF has somewhat augmented official credits available to deficit countries.

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Are banks willing to continue, at something like their previous rate of lending, to extend credits to deficit developing countries? The question is important since we have little reason to expect that official lending to LDC's will expand greatly in the near term. Yet financing is essential if LDC's are to import oil and other goods needed to achieve some economic growth.

When you ask bankers how willing the system will be, you get a wide range of answers.

The optimists see no reason why the Eurocurrency market should not work as well in the future as it has in the past. It is, after all, a borrowers' market, they say. OPEC members are going to have to deposit their money, the Eurocurrency market will therefore be liquid, and borrowers, even LDC borrowers, will obtain funds. This situation does not mean that the cost of borrowing for LDC's may not increase to reflect their rising debt and its associated risk. But, optimists point out, the risk of lending even to developing countries is now widely shared through the syndication of loans.

Others, perhaps more numerous, sense reluctance now on the part of banks to step up lending to the LDC's. Conditions, they say, are different from what they were at the time of the first oil shock and these differences are almost certain to make banks proceed more cautiously than they did in the mid-1970's:

-- Banks are concerned about the future ability and willingness of Third-World borrowers to repay or even to service their debt;

-- Banks are now approaching their self-imposed limits on lending to individual countries;

-- Spreads between deposit and loan rates have narrowed; the profitability of Eurolending has declined;

-- In this low-profit situation, banks find it difficult to attract the new capital that would permit them to expand their total lending while preserving prudent capital/loan ratios.

The economic risks of lending to LDC's are seen to be higher now than after 1973. Their debts have accumulated. For a few individual countries, the debt burden has approached unprecedented levels. Banks worry about debt reschedulings that could involve losses, and they fear repudiation of debt by governments that may see no alternative to repudiation.

New political risks are also darkening the outlook. Events in Afghanistan, Iran, Iraq, and Saudi Arabia have raised fears about the security of Middle East oil supplies, the interruption of financial ties, and the outbreak of war.

The Eurocurrency market is, therefore, likely to display greater caution than in the past. Although there should be ample liquidity, the market will probably differentiate more sharply between preferred and riskier borrowers. Banks should not find that difficult to do. There will be no shortage of top-quality customers; all major industrialized countries are expected to be in deficit in 1980, even West Germany and Japan, once in wide surplus. Banks will slow the growth of their exposure in many developing countries. An informal consensus is forming among Eurocurrency lenders on the need for more caution and for higher interest rates on loans to LDC's to compensate for risk.

VII

SUGGESTIONS FOR POLICYMAKERS

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We have seen that many banks are cautious about supplying balance-of-payments financing to LDC's following the latest round of oil price increases. The full effect of the second round has by no means worked itself out. If we assume that oil prices will continue to rise in real terms, we must be concerned, further, that oil-related deficits will not improve and may worsen cumulatively for a long time to come. The developing countries, as before, will be hardest hit.

This chapter outlines a number of suggestions for easing the debt-service burden on developing countries and reducing bank risk in lending to them. These proposals would raise the share of governments and international financial organizations in total lending to LDC's, provide for coordination between private banks and the International Monetary Fund, and discourage governments of industrial countries from policies leading to large and persistent current-account surpluses.

There are perhaps objections to all of these suggestions but there is strong reason to find ways to minimize their drawbacks and to make them contribute to a flow of funds to LDC's on terms that will assist real adjustment, support growth, lessen strains on the international banking system, and promote political stability.

Expanded Role for the IMF

Below are some suggestions on what the IMF might do to increase use of its resources and assist banks and other lenders to provide funds to LDC's under informed circumstances and on conditions that could contribute to reducing the debt service of deficit countries and the strain on the international banking system.

Consultation Between IMF and Banks. The common interest of the IMF and banks in the maintenance of international financial order would seem to justify a formal channel of communication between them. Consultations would help coordinate Fund and private bank activities in a borrowing country. Communication would seem particularly important between lead banks of a syndicate and the Fund in connection with large loans to LDC's.

Consultations would serve several purposes:

-- increase the likelihood that bank lending policies will support the Fund's efforts to lead a country toward adjustment;

-- enlist the help of banks in urging countries to seek the advice of the Fund when they may be reluctant to do so;

-- provide the Fund with information about proposed private bank financing for deficit countries;

-- inform banks of country credit programs under development by the Fund;

-- as a contribution to prudent banking practice, provide banks with

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basic data, perhaps nowhere else available, for use in assessing country risk.

There are dangers in such consultations. Countries might refuse to give the IMF detailed data on their economic performance if they felt that the Fund were not guarding the confidentiality of this information. Data would have to be provided with the full knowledge of the government concerned, possibly even with its consent to details. The IMF must not give out information concerning its policy disagreements with governments or reveal measures that a government might have under consideration or be planning to take. Banks might be tempted to press IMF officials for their opinions about country risk or IMF officials might be tempted to provide them. Governments might pressure the IMF to persuade banks to lend to them. On both matters, IMF policy would have to be clearly announced: the Fund would have no part in the decisions of banks and would scrupulously avoid making recommendations to banks on whether or not to lend.

Co-financing. Consultations between the Fund and the banks might provide the added benefit of encouraging co-financing. Informally, co-financing exists now; banks usually -- but not always -- release new credits to a country in severe balance-of-payments difficulty only when the Fund does -- that is, only after the Fund has approved the government's stabilization program.

There would be several important advantages to a more formal arrangement:

-- the possibility of a combined credit, probably much larger than what the IMF alone could offer, would strengthen the hand of the Fund in its negotiations with a borrowing country;

-- the larger total credit would make it politically more acceptable for a government to agree to IMF conditions than would a small tranche drawing from the Fund;

-- the Fund, the banks, and the borrowing government could work out together a logical, purposeful credit package that would meet a foreseen portion of the country's total credit need;

-- the government would know how much credit it could expect upon signing an agreement with the IMF;

-- by knowing more clearly than otherwise how much credit might be available to a country, the IMF would be able to judge the adequacy of proposed stabilization measures;

-- the lending risk of participating banks would be minimized by the fact that the borrowing country had undertaken serious economic reforms.

The banks' share in such a credit package would not have to be guaranteed by the IMF.

Relaxation of IMF Conditionality. The IMF was a net recipient of resources in 1979. The reluctance of many developing countries to borrow from the IMF more than what is their automatic due without conditions argues strongly for a moderation of the conditionality which the Fund attaches to its loans.

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The IMF has not been altogether insensitive to the fact that LDC's are making relatively little use of its resources and its expert assistance in correcting payments imbalances. Its guidelines on conditionality have been lately amended and now promise:

> In helping members to devise adjustment programs, the Fund will pay due regard to the domestic social and political objectives, the economic priorities, and the circumstances of members, including the causes of their balance of payments problems.[27]

The practical effect of this statement is not yet clear, however.

LDC's are deficit countries by definition; they are net importers of resources because they are developing. But, if we assume, as we must, that there will continue to be real increases in the price of oil -- perhaps intermittent shocks rather than steady moderate price rises -- they could be said to be in "double deficit" for as long ahead as can be foreseen. Under these circumstances, it is all the more important that the mismanagement that characterizes so many developing economies be straightened out. IMF conditions are certainly not to be waived.

It would seem to make sense to ease the expected rate of adjustment of the double-deficit developing countries to induce more of them to submit to IMF advice. If you can't achieve a lot of adjustment in a given period, at least you can achieve a little; and, over time, countries can make substantial progress.

This means, among other things, that the mix of adjustment and external financing needed to manage a deficit would be tilted somewhat more toward external borrowing than the IMF has condoned in the past. The addition to borrowing, however, should come from the IMF or other concessional sources in order to ease the debt-service payments of LDC's and hold down the rate of growth of their commercial borrowing. The purpose of borrowing would be to assure the expansion of production for exports and for essential imports. It would not increase imports of frivolous consumption goods.

It would also mean that other performance criteria would be somewhat less demanding than economic considerations alone would suggest to be desirable. Budget cuts would not be so deep; slowdown in the growth of the money supply would not be so rapid. The cost of relaxation would be the persistence of inflation and of the underlying external deficit. But the benefit would outweigh the cost: the enlistment of more countries than now in paced programs to raise their external revenues to a level more appropriate to the size of their basic import needs.

Surveillance Over Surplus Countries. The IMF should examine the economic policies of surplus countries more critically than it has in the past as a means of reducing balancing deficits. A persistent deficit -- an inability to make ends meet without borrowing -- can raise fears that a country will ultimately be unable to obtain new credits to pay for its current expenditures. This concern, understandably, has been greater than worry about surpluses. But in the closed bookkeeping system of the world economy, one country's surplus accumulation of foreign exchange will deprive other countries.

A new symmetrical surveillance procedure under Article IV of the Articles of Agreement requires the Managing Director of the IMF to

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initiate a discussion with a member country whenever he considers that its exchange-rate arrangements or policies may have important effects on other members. There is an opportunity, then, for the Director to open talks when a country's policies result in an exceptionally large and persistent surplus.[28]

It is too early to tell how aggressively the IMF will implement this new procedure. One hopes that it will be active in the area, but there are two strikes against its success. First, attitudes are slow to change; industrial countries now in deficit are likely to aim for surplus over the medium and long term. And, second, the IMF has no real leverage over surplus countries; these have no need for its credits or its imprimatur and, hence, no need to agree with it on an adjustment program. Success depends on the ability of the Fund to mobilize political acceptance of the principle that surpluses are as disequilibrating to the international monetary system as deficits and to foster the will to create, through official grants and credits, an appropriate correspondence between imbalances and external capital movements.

Broadened Intermediation by the IMF. Broadened intermediation by the IMF would help to reduce the share of private bank lending and risk in total lending to developing countries and slow the growth of the LDC debt service.

The IMF itself might go to the financial markets to borrow funds to lend to LDC's. In the event of a default by a borrowing country, the IMF would have to make good the loss. Member governments might have to increase IMF capital as a safeguard against such a possibility. The IBRD provides a precedent for using the private markets as a source of funds. In fiscal year 1979 (ending June 30), the World Bank group raised the equivalent of $3.4 billion, or 68 percent of its total gross borrowings that year, in capital markets.[29] The IMF would, of course, have to pay the market rate for such funds. The cost, passed on to LDC borrowers, would not be advantageous to them unless the IMF subsidized interest rates.

Governments would be a cheaper source of funds for the IMF. An increase in quotas is now under consideration; for most members it would amount to 50 percent. Even this adjustment will not be sufficient as oil prices rise. Furthermore, OPEC members might lend to the IMF. The OPEC group provided most of the funds for the 1975 Oil Facility: Saudi Arabia lent the Fund SDR 2.3 billion for this purpose, while Abu Dhabi, Iran, Kuwait, Nigeria, Oman, and Venezuela together provided another SDR 2.7 billion (total: $5.9 billion). Further OPEC loans to the IMF of at least equal magnitude would make an important contribution to recycling.

A suggestion that the IMF borrow relatively short-term funds from OPEC and transform these into longer-term credits to LDC's is discussed below.

Interest Subsidies and Longer-Term Lending by the IMF. The IMF could subsidize interest charges and lengthen maturities on its new and outstanding loans to selected countries. It might also subsidize interest charges of private lenders that are associated with it in co-financing arrangements. In some instances, its interest subsidies might enable LDC's to obtain longer maturities from banks than are usual on private loans.

IMF interest charges are, by contrast, normally low -- for example, 4.375 percent per annum during financial year 1979 for the first 12 months

that a credit-tranche purchase was outstanding and 9.45 percent for purchases made under the Supplementary Financing Facility during the six months ending June 30, 1979 (0.20 percent above the rate of interest paid by the IMF on amounts borrowed from members to set up that Facility).[30]

Currently IMF loan maturities are 3-5 years for credit tranches and 4-8 years for the Extended Facility. The Supplementary Financing Facility provides a grace period of no more than 3 1/2 years with full repayment due in seven years. With respect to maturities, the IMF offers no advantages to LDC's over the Eurocurrency and Eurobond markets.

Not all developing countries should automatically qualify for subsidized, long-term IMF credits; eligibility criteria would have to be established and each case examined individually.

More concessional terms for IMF loans would only be significant to the extent that the Fund was able to increase the volume of its lending to LDC's and replace some portion of commercial lending to those countries.

People will argue that lending on such easy terms puts the IMF in the aid business. It does, but not for the first time. Subsidized interest charges are not a new idea for the Fund: a Subsidy Account was established in 1975 to help the Fund's most seriously affected members meet the cost of using the 1975 Oil Facility. The Subsidy Account is still in operation but disbursements from it are declining as countries repay drawings under the Oil Facility. It would be useful to enlarge the Subsidy Account in size and scope, obtaining contributions by IMF members and extending its application to IMF loans beyond those made through the Oil Facility. Under extraordinary circumstances, extraordinary measures may be necessary to help the more burdened countries.

OPEC Lending to LDC's

It would be desirable if OPEC governments could be persuaded to adjust their surpluses directly with LDC's. Presently banks, especially American banks both in the United States and abroad, receive a major portion of the OPEC surplus and lend these funds to LDC's and other borrowers. Short-term deposits give the oil countries the liquidity they prefer for much of their investment. The banks, not the OPEC members, assume the risk of lending to the deficit developing countries. Obviously, the banks have found this intermediation profitable but they are aware that the debt of developing countries will tower precariously as real oil prices rise. Conversations with bankers indicate that many would welcome direct OPEC lending to LDC's.

The question is how to step up movement of OPEC funds to the developing countries outside the channel of private banks. Direct loans to LDC's are unlikely to provide OPEC members with the liquidity they want or the low risk they have enjoyed in bank deposits. But there may be ways of satisfying OPEC's preferences while routing some of its funds outside the banks.

One course would be to spread the risk. The IMF or the World Bank might insure and guarantee eligible direct loans to LDC's by governments and government agencies. This new insurance/guaranty facility would have to be capitalized by member governments. The scheme would be open to all lending governments or government agencies, with the particular intention of encouraging direct loans to LDC's from OPEC countries. Its success would be measured by the extent to which it increased the share of official

lending in total lending to LDC's.

If there should be a growing reluctance on the part of banks to continue lending to LDC's, they could be invited to participate in the facility. However, their participation would reduce the incentive for direct OPEC lending. It might be better not to open the facility immediately to banks but to impress on oil-exporting countries a political sense of their direct responsibilities for helping to finance that part of LDC deficits attributable to higher oil prices.

Whether it is established under the IMF or another international organization, the insurance/guaranty facility should judge the quality of loans that it is asked to insure and establish general criteria regarding the uses of loan funds, taking into account a country's IMF-approved stabilization program or the Fund's observations at the time of its regular consultations with the member. The facility would therefore contribute to coordination between lenders and the IMF to the benefit of the borrower.

Another course would be for the IMF (or the World Bank) to relieve banks of some of the task of transforming short-term OPEC deposits into long-term loans to LDC's. The IMF, which has substantial permanent resources, might be able to provide longer maturities than are available to developing countries from the Eurocurrency market.

Neither of these suggestions solves the problem of getting OPEC members to assume full financing responsibilities. Both only relieve the banks of some of their current intermediation role and transfer it to an official institution. It is possible, however, that major financial countries could prevail upon the larger surplus countries within OPEC, over time, to take a direct role. The reasons are persuasive: the need to avoid overloading the international banking system with high-risk credits to LDC's, the need to maintain growth in the LDC's to permit their eventual adjustment to higher oil prices, and the need to avoid deflation in an important segment of the world's economy. It is probably unrealistic to expect the non-oil LDC's to urge upon OPEC a more direct part in their relief. Until a number of them are facing default and the banks are frightened off, the dependence of non-oil LDC's on OPEC for oil and their political solidarity as the Third World make it unlikely that they will speak out loudly for themselves on this point.

Program Loans and LDC Bonds:
Further Roles for Official Lending Institutions

First, the IBRD, the IDA, and other development banks could expand their program lending. The World Bank group has already started. The IBRD and the IDA approved $401.5 million in nonproject financing for Bangladesh, Guyana, Jamaica, Peru, and Turkey in 1979. An increase in this form of balance-of-payments assistance, in consultation with the IMF, could ease liquidity problems for LDC's in financing imports needed for growth and exports.

Second, borrowing countries might offer bond issues to official developing banks and institutional investors, including, for example, investment funds.

And third -- a variation of the second suggestion -- commercial banks could swap some of their outstanding loans to a developing country in return for longer-term, and perhaps lower-interest bonds of that country; international financial institutions could also participate in the bond

issues by investing new funds.

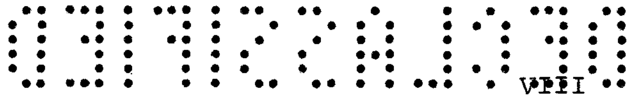
In both the second and third suggestions, individual borrowers would retain risk on their share of the investment. International financial institutions would assume only their proportional share. The conversion would relieve the debt service of the borrowing country, reduce the exposure of banks in LDC's, and provide banks with a marketable investment, the value of which is enhanced by official participation.

Increased Bilateral Aid

If OPEC members and industrial countries do not step up the flow of funds to LDC's through international financial institutions, they must increase bilateral aid. Developed countries must contribute even though they may be in deficit themselves, individually or as a group. They demonstrated after the 1973 oil price rise that they have the resources and resilience to adjust.

Higher oil costs, deeper deficits, and the mounting debt service of LDC's will, in time, make this effort unavoidable. It will be unavoidable, that is, if the richer countries are to act responsibly to support the economic development of poor countries and the proper functioning of the international monetary system.

It is folly to pretend that the task can be left to banks. It is not the business of banks to provide the steady, low-interest, long-maturity credits that LDC's should have. Nor should banks be expected to continue to lend under conditions of rising risk. It is the place of governments to assume such risk and to assure a flow of funds to developing countries in a period when banks may be reluctant to lend at their earlier pace.



VIII

## A FEW LAST WORDS

Foreign financing is not a permanent alternative to real adjustment to higher oil prices. Developing countries cannot continue indefinitely to add to their debt unless they are also increasing the foreign earnings that will permit them to service that debt. Without real adjustment by borrowing countries, lenders are assuming high risk.

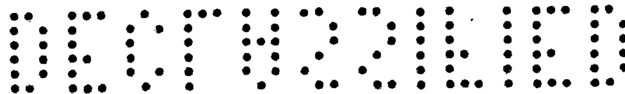
Yet, lending to the developing countries must continue while they undertake adjustment. This means that LDC's will not use borrowed funds in an optimal manner while adjustment remains incomplete. But credits will keep economic activity up in those countries far beyond the level of what it would be if lending were sharply reduced and LDC's tried to bring their foreign accounts into balance primarily by cutting foreign spending. Since growth is essential to developing countries if they are to cope with rising import costs, their borrowing should be directed to the greatest extent possible to the expansion of production, particularly export production.

In short, borrowing must be related to adjustment. There should be an effort by governments of developed countries, OPEC members, international organizations, and private banks to move LDC's toward necessary reforms. But for each country, adjustment must proceed at a pace that does not upset civil order or threaten political stability. The IMF may now be in the process of realizing that a slower rate of economic reform from what it has urged upon countries in the past may actually speed their rate of adjustment; LDC's rejecting IMF austerity proposals may well accept more moderate rates of adjustment as targets.

Governments are certainly aware of the implications of LDC defaults for the international banking system. Nevertheless, the job of financing the LDC oil deficit is still left largely to the banks -- with danger for the developing countries, the banks, and, certainly, the developed countries themselves. It is understandable that industrial countries, also hard hit by higher oil prices and by recession, can spare no thought now about increased aid.

But it is inevitable that they will have to think about it. Otherwise, one can only see ahead a dark prospect of discontent among LDC's unable to cope with the massive tax that OPEC has levied on them. The only adjustment that the LDC's will know in the absence of substantial aid is the cruel adjustment of economic failure. The economic and political costs of this failure will not be limited to the LDC's.

For policymakers it is now time to seize the problem -- to look boldly at what can be done to relieve strains on the international banking system and to speed the growth and adjustment of developing countries.



PUBLICIZED EUROCURRENCY CREDITS
AS A SHARE OF TOTAL BORROWING, 1977-1978

(Billions of U.S. Dollars)

| | A<br>Total<br>Borrowing | B<br>Publicized<br>Eurocurrency Credits | B/A<br>(Percentage) |
|---|---|---|---|
| Industrialized countries | 87 | 42 | 48 |
| Developing Countries | 69 | 58 | 84 |
| (Oil exporters) | (3) | (3) | (97) |
| (Others) | (66) | (55) | (83) |
| Other borrowers[a] | 24 | 7 | 29 |

a Centrally planned economies and their organizations; international organizations; unallocated.

Source: Borrowing in International Capital Markets, Third Quarter 1979, Foreign and International Bond Issues, Publicized Eurocurrency Credits, World Bank, January 1980, pp. 1, 7.

TABLE II APPENDIX

ESTIMATED SOURCES AND USES OF EUROCURRENCY FUNDS OUTSTANDING
END OF SEPTEMBER 1979
(Partially Netted Out)[a]

| | Billions of U.S. Dollars or Equivalent | Percent of Total | Billions of U.S. Dollars or Equivalent | Percent of Total | Net Source or Use (-) |
|---|---|---|---|---|---|
| BIS European reporting area [b] | 167.5 | 37 | 160.0 | 36 | 7.5 |
| (Nonbank) | (87.0) | (19) | (105.2) | (23) | (-18.2) |
| United States | 50.0 | 11 | 34.0 | 8 | 16 |
| Canada and Japan | 15.2 | 3 | 32.4 | 7 | -17.2 |
| Other developed countries | 30.9 | 7 | 38.2 | 8 | -7.3 |
| Eastern Europe | 10.4 | 2 | 34.5 | 8 | -24.1 |
| Offshore banking centers [c] | 49.0 | 11 | 66.1 | 15 | -17.1 |
| Oil-exporting countries [d] | 73.2 | 16 | 29.4 | 7 | 43.8 |
| Developing countries | 46.3 | 10 | 51.1 | 11 | -4.8 |
| Unallocated [e] | 7.5 | 2 | 4.3 | 1 | 3.2 |
| TOTAL | 450.0 | 100 | 450.0 | 100 | |

a Outstanding foreign-currency assets and liabilities, netting out interbank assets and liabilities within the European reporting area (Footnote b), the United States, Canada, Japan, and the offshore centers but not netting out interbank assets and liabilities elsewhere.

b Austria, Belgium-Luxembourg, Denmark, France, Germany, Ireland, Italy, Netherlands, Sweden, Switzerland, United Kingdom.

c Bahamas, Barbados, Bermuda, Cayman Islands, Hong Kong, Lebanon, Liberia, Netherlands Antilles, New Hebrides, Panama, Singapore, other British West Indies.

d Algeria, Bahrain, Brunei, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Oman, Qatar, Saudi Arabia, Trinidad and Tobago, United Arab Emirates, Venezuela.

e Including positions vis-a-vis international organizations other than BIS.

Percentages may not add to 100 because of rounding.

Source: Adapted from International Banking Developments - Third Quarter 1979, Bank for International Settlements, Table 5.

TABLE III

APPENDIX

## DEFICIT OF 87 NON-OIL DEVELOPING COUNTRIES, 1974-1978 COMPARED WITH ANNUAL INCREMENTS IN EXTERNAL DEBT OUTSTANDING (DISBURSED ONLY) DUE TO OFFICIAL AND CERTAIN PRIVATE LENDERS

(In Billions of U.S. Dollars Except Where Otherwise Indicated)

| | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 |
|---|---|---|---|---|---|---|
| A. Trend in Current Account Deficit | | | | | | |
| Current account deficit | 11.3 | 30.4 | 38.0 | 25.5 | 21.2 | 31.3 |

Average annual deficit 1974-1978: 29.3

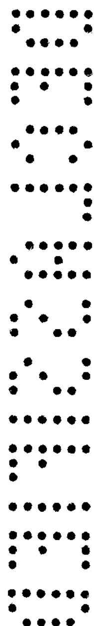
Average annual deficit 1974-1978 as percent of deficit in 1973: 259%

| | 1973/72 | 1974/73 | 1975/74 | 1976/75 | 1977/76 | 1978/77 |
|---|---|---|---|---|---|---|
| B. Increase in Official Debt Outstanding | | | | | | |
| 1. Due to Governments | 4.8 | 6.2 | 6.3 | 7.4 | 8.6 | 10.8 |
| Average annual increase 1974-1978: 7.9 | | | | | | |
| Average annual increase 1974-1978 as percent of increase 1973/72: 165% | | | | | | |
| 2. Due to International Organizations | 2.0 | 2.6 | 3.3 | 3.7 | 5.7 | 6.4 |
| Average annual increase 1974-1978: 4.3 | | | | | | |
| Average annual increase 1974-1978 as percent of increase 1973/72: 215% | | | | | | |
| C. Increase in Private Debt Outstanding | | | | | | |
| 1. Due to All Private Creditors [a] | 5.3 | 9.6 | 10.5 | 14.5 | 17.4 | 22.9 |
| Average annual increase 1974-1978: 15.0 | | | | | | |
| Average annual increase 1974-1978 as percent of increase 1973/72: 283% | | | | | | |
| 2. Due to Financial Institutions [b] | 4.3 | 8.0 | 9.6 | 12.1 | 12.1 | 16.1 |
| Average annual increase 1974-1978: 11.6 | | | | | | |
| Average annual increase 1974-1978 as percent of increase 1973/72: 270% | | | | | | |

a Suppliers' credits, credits from financial markets (loans from banks and other private financial institutions and publicly-issued and privately-placed bonds), and other obligations to private lenders (debt on account of nationalized properties and unclassified debt).

b Private banks and other private financial institutions.

Sources: Data on deficits 1973-1978 are from Annual Report 1979, International Monetary Fund, p. 25. Debt figures are derived from World Debt Tables, External Public Financing of 96 Developing Countries, Volume I, December 28, 1979, World Bank, pp. 22, 24, 30, 32.



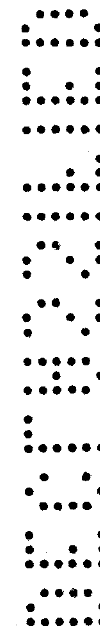


TABLE IV APPENDIX

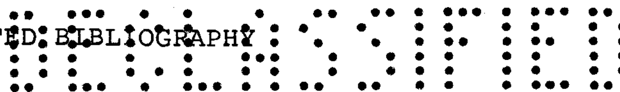
## RELATION OF DEBT SERVICE OF DEVELOPING COUNTRIES BY INCOME GROUPS[a] TO DISBURSED EXTERNAL PUBLIC DEBT OUTSTANDING FROM OFFICIAL AND PRIVATE LENDERS, END OF 1980 (ESTIMATED)

(In Billions of U.S. Dollars; Percentages)

| | | Higher Income, W/O Oil | Upper Middle Income, W/O Oil | Intermediate Middle Income, W/O Oil | Low Middle Income, W/O Oil | Lower Income, W/O Oil |
|---|---|---|---|---|---|---|
| A. | Debt Outstanding to All Lenders | $25.4 | $46.0 | $85.5 | $27.6 | $68.5 |
| B. | Official Lenders | 9.3 | 16.7 | 39.2 | 16.8 | 60.4 |
| C. | Private Lenders | 16.1 | 29.3 | 46.3 | 10.8 | 8.0 |
| D. | B divided by A | 37% | 36% | 46% | 61% | 88% |
| E. | C divided by A | 63 | 64 | 54 | 39 | 12 |
| F. | Total Debt Service | 5.9 | 12.5 | 21.6 | 4.0 | 6.2 |
| G. | Debt Service to Official Lenders | 1.5 | 2.7 | 4.7 | 1.5 | 3.8 |
| H. | Debt Service to Private Lenders | 4.4 | 9.7 | 16.9 | 2.5 | 2.4 |
| I. | G divided by F | 25 | 22 | 22 | 38 | 61 |
| J. | H divided by F | 75 | 78 | 78 | 63 | 39 |
| K. | F divided by A | 23 | 27 | 25 | 14 | 9 |
| L. | G divided by B | 16 | 16 | 12 | 9 | 6 |
| M. | H divided by C | 27 | 33 | 37 | 23 | 30 |

a Country groups are as defined in World Debt Tables, Volume I, December 28, 1979, pp. 13-16. See Note 15, p. 36.

Source: Developed from data in World Debt Tables, op. cit., Table 10, pp. 181-193.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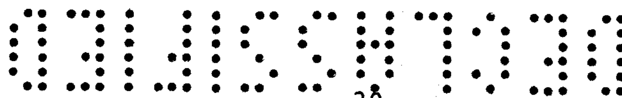
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NOTES

1 Volcker, p. 17.

2 Ibid., Table 5. In the same period, about $44 billion of the OPEC surplus was invested directly in the United States; $8 billion in the United Kingdom outside the Eurocurrency market; and $10 billion went to international financial institutions. OPEC investments of about $55 billion more remain unidentified.

3 The magnitudes of the unadjusted 1978 deficits and surpluses are, of course, exaggerated when compared to 1973 data. Inflation, the decline in the value of the dollar, and the real increase in GNP of both non-OPEC developing countries (25 percent since 1973) and members of the OECD (13 percent) are factors in the overstatement.

4 Major oil-exporting countries: Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Oman, Qatar, Saudi Arabia, United Arab Emirates, Venezuela.

Non-oil developing countries: All members of the IMF not mentioned elsewhere in this footnote, plus certain essentially autonomous dependent territories (Hong Kong and the Netherlands Antilles) for which adequate statistics are available.

More-developed primary-producing countries: Finland, Greece, Iceland, Ireland, Malta, Portugal, Romania, Spain, Turkey, Yugoslavia.

Industrial countries: Canada, United States, Japan, France, Federal Republic of Germany, Italy, United Kingdom, Austria, Belgium, Denmark, the Netherlands, Norway, Sweden, Switzerland.

5 See Footnote b, Table II, Appendix, for definition of the European reporting area.

6 The reader should keep in mind the difficulty of estimating claims and liabilities in the largely unregulated Eurocurrency market. Estimates from different sources are made on the basis of differing assumptions, not always fully explained. Some are gross estimates and others may attempt, partially or fully, to net out inter- and intrabank transactions. The Bank for International Settlements is the primary authority on measurement of the Eurocurrency market. For countries not contributing to its data bank, it must resort to estimates. The reader may regret, but should not be surprised, to find some inconsistency in the figures used in this paper.

7 World Financial Markets, February 1980, p. 13.

8 Ibid.

9 Figure is derived from Federal Reserve Bulletin, February 1980, Table 3.13.

10 Volcker, Tables 3, 6.

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11 Includes 9 oil-exporting countries: Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Nigeria, Trinidad and Tobago, and Venezuela.

12 World Debt Tables, December 28, 1979, Volume I, p. 2.

13 Ibid., p. 194.

14 Based on data in Borrowing in International Capital Markets, Third Quarter 1979, January 1980, pp. 132-133, 138-139.

15 Country groups are defined by the World Bank in its World Debt Tables, December 28, 1979, pp. 13-16. Based on 1976 per capita income in 1976 dollars, they are:

Higher income: over $2,500.
Upper-middle income: $1,136 - 2,500.
Intermediate-middle income: $551 - 1,135.
Lower-middle income: $281 - 550.
Low income: $280 or less.

Oil-exporting countries are included in the appropriate groups.

16 Banks lend little to the poorest countries. Official concessional sources lend little to the more well-to-do LDC's. In general, the lower the per capita income of a country, the higher the share of official credits in the composition of its total external public debt outstanding.

17 World Debt Tables, December 28, 1979, pp. 5-6.

18 "Group of 24 Sees Paradox in Smaller Net Use of Fund Resources", IMF Survey, International Monetary Fund, Washington, D. C., October 15, 1979, p. 319.

19 "In Quest of International Monetary Stability", World Financial Markets, October 1979, p. 11.

20 Dufey and Giddy, The International Money Market, p. 28. Most of these were interbank loans which are normally short-term loans. The example is therefore a bit unfair, but even nonbank Eurodeposits tend to be short term.

21 World Financial Markets, January 1980, Table 6, p. 10.

22 Annual Report 1979, International Monetary Fund, p. 24.

23 Frydll, pp. 17, 18; Richardson, Speech to Overseas Bankers' Club, Bank of England Quarterly, March 1979, p. 50.

24 Volcker, Table 1.

25 Ibid., p. 1

26 Ibid., p. 22.

27 Decision No. 6050 - (79/38), March 2, 1979: Use of Fund's General Resources and Standby Arrangements, Annual Report 1979, International Monetary Fund, Appendix II, pp. 136-138.

28 Decision No. 6026 - (79/13), January 22, 1979: Surveillance: Procedures, Annual Report 1979, International Monetary Fund, Appendix II, p. 136.

29 1979 Annual Report, World Bank, p. 117.

30 Annual Report 1979, International Monetary Fund, pp. 81-82.

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