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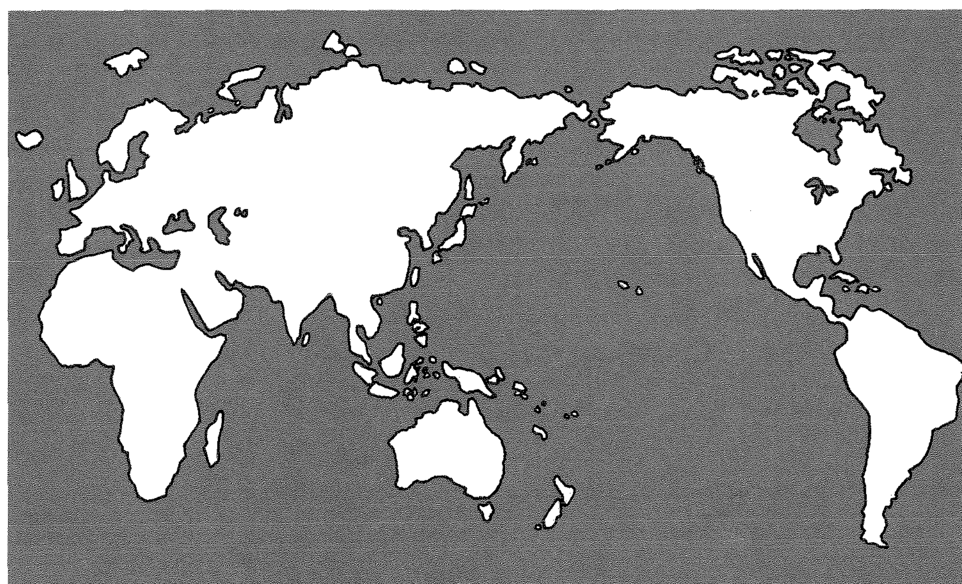

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Commercial Bank Financing of World Payment Imbalances

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In September 1977, the Senate Subcommittee on Foreign Economic Policy began hearings on the proposed $10-billion International Monetary Fund (IMF) Supplementary Credit Facility—the so-called "Witteveen Facility." The Subcommittee's concern focused on the "massive balance of payments lending that has been done by the commercial banks since the oil price hike"[1] and its impact on the stability of the U.S. banking system and the international financial system as a whole. A subcommittee staff report, prepared in advance of the hearings, described the problem created by the mounting debt of the borrowing countries as follows:

> As the debt service burden balloons for many countries toward the end of this decade, the point may come when one or several of these countries will find it more in their interest to simply default or repudiate their external debts rather than to have to continue borrowing just to repay old loans. And if this happens, a domino effect could take place in which other debtor countries follow suit: the banks panic and start calling in their international loans; the stock market drops precipitously; and the international capital market collapses. This doomsday scenario may be extreme in its pessimism, but it is being taken seriously enough by responsible officials that a concerted international effort is now underway to prevent that first domino from falling.[2]

The purpose of this paper is to analyze the grounds for this concern. Section 1 compares the conditions prevailing in world trade and finance during the 1974-76 period, with those prevailing during the 1970-73 period. This survey confirms the general impression of abrupt and large increases in world payment imbalances since 1973, rapid external-debt accumulation by non-oil developing nations, and a substantially enhanced commercial-bank role in financing the payment imbalances. Moreover, available projections suggest that world payment imbalances will continue large in the foreseeable future and that banks will continue to handle a substantial part of the payments financing.

Section 2 turns to the question: Is such a system inherently unstable, as alleged? We approach that question by examining three areas: (a) balance-of-payments adjustments of deficit countries, (b) the persistent OPEC surplus, and (c) the mounting debt of developing countries. The analysis suggests that the world economy has been more successful in approaching international financial stability than is generally realized. Although much remains to be done, there is little reason to be overly concerned over the future stability of the international financial system.

Section 3 examines two policy-related issues. First is the prudence of commercial-bank financing of world payment imbalances—in particular, the extension of medium- and long-term balance-of-payments loans for maintaining domestic consumption rather than investment financing. We find little ground for concern over such loans. The second issue concerns the roles of the IMF and national central banks in enhancing the stability and efficiency of the international financial system with respect to commercial-bank financing of world payment deficits. Although the system is found to be basically sound, appropriate national and international measures should be adopted—indeed, some already have been adopted—for improving its functioning and strengthening its safeguards. This and other conclusions are set forth in a final section.

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I. Deficits and External Debts

World payment imbalances

The world current-account payment imbalance shifted abruptly in recent years, from an annual average of $20 billion in the 1970-73 period to $87 billion in the 1974-76 period.[3] (Table 1) Incidentally, we separate "Surplus OECD" from "Deficit OECD" countries in this comparison, to underscore the different balance-of-payments performances among the OECD countries. As a result, the total world payment imbalance (total deficits) is much larger than when all OECD countries are considered as a group.[4]

The countries that suffered the largest declines (in absolute terms) from the recent shocks to the world economy were not the non-oil developing nations, as is commonly assumed, but the "Deficit OECD" countries. As a group, the latter countries recorded a shift from a current-account surplus of $3 billion per year during the 1970-73 period to an annual deficit of $29 billion during 1974-76, whereas the non-oil developing countries moved from a $15-billion average deficit to a $37-billion average deficit over the same period.

International debt accumulation

Although nearly all the deficit countries borrowed internationally during 1974-76, data on external debts are available only through 1975, and only for the 84 developing countries that regularly report such information to the World Bank.[5] The data indicate that the accumulation of public external debt accelerated sharply in the 1972-75 period (Table 2). Most notably, non-oil developing countries increased their debts to foreign *private* creditors at a 40-percent annual rate in the 1972-75 period, compared with a 17-percent growth rate in the 1970-72 period. Consequently, such debts rose from 31 to 40 percent of the non-oil LDC's total external public debts between the end of 1970 and the end of 1975. According to incomplete World Bank estimates, external public debts of the non-oil LDC's continued to rise in 1976, but at a decelerated (23-percent) rate, to a year-end total of $123 billion.[6]

Bank lending

The recent rapid growth of international lending has been a global phenomenon, with banks of

Table 1
World Current-Account Balances,[1] 1970-76
(Billions of Dollars)

	1973	1974	1975	1976	Annual Averages 1970-73	Annual Averages 1974-76
(1) OPEC[2]	3.0	63.5	35.5	44.0	1.5	47.7
(2) Surplus OECD[3]	12.8	12.0	27.4	18.6	7.9	19.3
(3) Deficit OECD[4]	−1.3	−34.0	−20.9	−32.1	3.1	−29.0
(4) Non-oil Developing[5]	−15.0	−32.5	−44.0	−34.0	−15.0	−36.8
(5) Socialist and Others[6]	−4.0	−10.5	−17.5	−13.5	−4.0	−13.8
(6) Statistical Discrepancies[7]	4.5	1.5	19.5	17.0	6.5	12.5
Total Deficits	−28.4	−85.5	−89.7	−85.7	−20.5	−86.9

1. Balance on goods, services and private transfers.
2. Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, U.A.E., and Venezuela.
3. Germany, Japan, Belgium, Netherlands, Switzerland, and United States.
4. Australia, Austria, Canada, Denmark, Finland, France, Greece, Iceland, Ireland, Italy, Luxembourg, New Zealand, Norway, Portugal, Spain, Sweden, Turkey and the United Kingdom.
5. All countries that are not included in "OPEC" or "Socialist and Others."
6. USSR, Eastern European Countries, China, North Korea, Mongolia, Laos, Cambodia, Vietnam, Malta and South Africa.
7. Attributed to asymmetries in national reportings of balance of payments data. For details, see Organization for Economic Cooperation and Development, *Economic Outlook*, July, 1977, Technical Annex, pp. 152-3.

Source: Based on data in Organization for Economic Cooperation and Development, *Economic Outlook*, July 1977, pp. 69, 72-73, 89.

many nations participating (Table 3). The data indicate that the banks' external claims increased by more than 50 percent during the 1974-76 period, and more than doubled between 1973 and 1976 when interbank credits were excluded.

For the three groups of payment-deficit countries, the banking system provided about $51 billion net lending in 1976 (Table 4), but that was offset by a reverse flow of $31 billion into the banking system, so that the *net* banking capital flow amounted to only $20 billion, or about 25 percent of their aggregate deficit in 1976 (Table 1).[7] Bank net financing of current-account deficits last year amounted to 55 percent for "Socialist and Others," 23 percent for "Deficit OECD," and only 14 percent for "Non-Oil Developing."

Despite the concern over bank lending to the non-oil LDC's, the net banking capital flow to these countries amounted to only $4.9 billion in 1976, or 25 percent of the total flow to all deficit countries. Moreover, only Latin American non-oil LDC's were net bank borrowers ($7.9 billion), and Mexico and Brazil accounted for almost that entire amount ($7.1 billion). This analysis thus suggests the need to consider

Table 2
External Public Debt[1] of 84 Developing Countries

	1970	1972	1975	Annual Average Increase 1970-72	Annual Average Increase 1972-75
	(Billions of dollars)			(percent)	
Total	**51.3**	**69.0**	**121.2**	**17.3**	**25.2**
Official Creditors	35.4	46.1	70.9	15.1	17.9
Private Creditors	15.9	22.9	50.2	22.0	39.7
Non-Oil Developing Countries	**43.8**	**56.8**	**100.3**	**14.9**	**25.5**
Official Creditors	30.1	38.4	59.4	13.8	18.2
Private Creditors	13.7	18.5	40.8	17.5	40.2

[1]Disbursed debt outstanding at end of year.
Source: *IMF Survey*, Supplement on International Lending, June 6, 1977, p. 186.

Table 3
Total External Claims of Banks[1], 1973-76
(Billions of Dollars)

	1973	1974	1975	1976
Total Claims	**n.a.**	**368**	**447**	**555**
U.S. banks[2]	n.a.	185	223	286
Other banks	n.a.	183	224	269
Claims on Non-Banks	**154**	**215**	**261**	**326**
U.S. banks[2]	56	83	98	124
Other banks	98	132	163	202

[1]Includes banks in the United States, Western Europe, Canada and Japan.
[2]Includes branches.

Source: *IMF Survey*, Supplement on International Lending, June 6, 1977, pp. 177 and 182; and Senate Subcommittee staff report, *op. cit.*, p. 44.

changes in bank liabilities as well as changes in bank claims on developing countries. The difference between the two reflects a country's net recourse to the banks during a given period.

II. Stability of the Present System

The prevailing concern over the stability of the international financial system may be summarized by three propositions which are analyzed in this section:

1. Balance-of-payments financing by banks has enabled the deficit countries to postpone adopting necessary but politically and socially difficult policy measures for correcting payments deficits. Continued reliance on foreign borrowing reflects continued inability or unwillingness to adopt necessary policy measures.[8]
2. The persistent surplus of the OPEC nations is a "structural surplus," which is not amenable to normal balance-of-payments adjustment policies.[9] Until oil-importing nations as a group adjust to reduce their dependence on oil imports and until oil-exporting countries expand their import-absorptive capacities, oil importers will

Table 4
External Positions of Banks[1] Vis-a-Vis Groups of Countries
Year-End 1975 and 1976
(Billions of Dollars)

	1975		1976		Change in	Change in	Change in
	Claims	Liabilities	Claims	Liabilities	Claims	Liabilities	Net Position
Surplus OECD[2]	128.2	154.3	149.6	189.0	21.4	34.7	13.3
Offshore Centers[3]	61.9	40.8	83.7	56.2	21.8	15.4	6.4
Oil-Exporting[4]	14.3	51.8	24.1	64.2	9.8	12.4	−2.6
Subtotal	**204.4**	**246.9**	**257.4**	**309.4**	**53.0**	**62.5**	**−9.5**
Deficit OECD[5]	134.6	138.6	158.5	155.2	23.9	16.6	7.3
Non-Oil Exporting	65.2	38.4	83.7	52.0	18.5	13.6	4.9
Latin America[6]	(43.5)	(16.3)	(57.4)	(22.3)	(13.9)	(6.0)	(7.9)
Middle East and Africa	(6.6)	(10.0)	(8.8)	(12.4)	(2.2)	(2.4)	(−0.2)
Other Asia	(12.9)	(10.4)	(14.7)	(14.7)	(1.8)	(4.3)	(−2.5)
Other Europe[7]	(2.2)	(1.7)	(2.8)	(2.6)	(0.6)	(0.9)	(−0.3)
Socialist and Others[8]	28.2	9.6	36.6	10.6	8.4	1.0	7.4
Subtotal	**228.0**	**186.6**	**278.8**	**217.8**	**50.8**	**31.2**	**19.6**
Unallocated[9]	9.3	13.6	11.4	16.4			
Total	**441.7**	**447.1**	**547.6**	**543.6**			

1. Banks in the Group-of-Ten countries and Switzerland and the foreign branches of U.S. banks in the Caribbean area and the Far East, in domestic and foreign currencies.
2. See Table 1, Footnote 3.
3. Bahamas, Barbados, Bermuds, Cayman Islands, Hong Kong, Lebanon, Liberia, Nėtherlands Antilles, New Hebrides, Panama, Singapore, West Indies.
4. Includes Bahrain and Oman, which are not members of OPEC.
5. See Table 1, Footnote 4.
6. Includes those countries in the Caribbean area which are not offshore banking centers.
7. Andorra, Cyprus, Gibralter, Liechtenstein, Monaco, Vatican, Yugoslavia.
8. See Table 1, Footnote 6.
9. Includes international institutions, residuals of Western European countries and other developed countries, and statistical discrepancies.

Source: Bank for International Settlements, *Annual Report 1976*, pp. 86-87; *Annual Report 1977*, pp. 112-114.

continue to accumulate a large aggregate payment deficit to the oil-exporting nations. So long as the oil surplus persists, there is no end in sight to this cycle of a few permanent financial surplus oil producer countries and burgeoning international indebtedness by weaker oil importing countries.[10]

3. These developments have led to mounting international debts with rising debt-service burdens for debtor countries. If this situation continues, debtor countries may start defaulting or repudiating external debts, and this could signal the collapse of the shaky international financial system.[11]

Payment adjustments

Many observers consider persistent large payment imbalances as *prima facie* evidence of lack of adjustment by the deficit countries. The blanket indictment, however, is an over-simplification which considers only the nominal magnitudes involved, in isolation from the major price and output changes that have taken place in the world economy. Moreover, the aggregate figures hide a great deal of payment adjustments that have actually taken place in recent years.

The conventional wisdom—see Proposition 1 above—has been challenged in a massive study by the International Monetary Fund,[12] the result of which is summarized in Table 5. The study compares IMF staff projections of 1977 current-account balances of four groups of countries with their average balances in 1967-72—"a period of little bias in cyclical conditions"[13]—adjusted to reflect changes in prices and real output. The results indicate that (a) the industrial countries have sustained the largest current-account deterioration ($32 billion) in comparison with their 1967-72 norm; (b) the deficits of other developed non-oil countries have doubled since 1967-72; and (c) non-oil LDC's are the only oil-importing group which has fully adjusted to the oil-price increases and other economic disturbances.

The IMF study also notes that, as a result of these changes, the oil-exporting nations have replaced the industrial countries as the major surplus group, supplying national savings for financing the net imports of goods and services required by non-oil LDC's. Only the "non-oil more-developed" countries are now incurring a substantially greater current-account deficit than they did in 1967-72.[14] Thus, aside from these shifts, the global structure of current-account balances has been largely restored to its 1967-72 pattern. If that earlier structure was a stable one, there should be no cause for alarm over the present payments structure.

Table 5
Global Current-Account Balances:
1977 Projections Compared to Rescaled 1967-72 Norms
(Billions of dollars)

	1967-72 Average			Changes
Country Groupings	Actual	Rescaled to 1977 Levels[1]	1977 Projections	Effected by 1977
	(1)	(2)	(3)	(4)=(3)−(2)
Oil Exporting[2]	0.7	3	37	34
Industrial[3]	10.2	31	−1	−32
Other Non-Oil				
More Developed[4]	−1.7	−6	−12	−6
Less Developed[5]	−8.1	−28	−25	3

1. 1967-72 average rescaled to 1977 prices and real-output levels by using (a) a general index of world trade prices for rescaling prices, and (b) average real-GNP (or GDP) growth rates of the respective country groups for adjustment for output growth.
2. OPEC countries, as listed in Table 1, Note 2, minus Ecuador and Gabon, plus Oman.
3. OECD countries, as listed in Table 1, Notes 3 and 4, excluding Australia, Finland, Greece, Iceland, Ireland, New Zealand, Portugal, Spain and Turkey.
4. OECD countries excluded in Note 3 above, plus South Africa, Malta, and Yugoslavia.
5. All other IMF member countries.

Source: IMF, *Annual Report 1977*, p. 13.

Persistent OPEC surplus

If the above IMF analysis is correct, then the persistent OPEC surplus should not be a threat to the stability of the international financial system. As stated, the OPEC countries have now displaced the industrial countries as the surplus group in the world economy. Of course, a persistent OPEC surplus implies a persistent deficit on the part of the oil-importing nations, but that is no more a "structural imbalance" than was the former surplus. The latter represented national savings that helped to finance the rest of the world's economic-development expenditures. Now, the OPEC countries have assumed the role of supplying such savings—the players have changed, but the game is the same.

Some worry about the reliability of the new players. What if for political considerations, they employ their enormous financial resources as a weapon and threaten to withdraw funds from the financial institutions of the major industrial nations? Would that not unsettle the market and, in particular, the affected institutions?[15] The concern perhaps stems from a faulty perception of how banks compete for funds. A sudden withdrawal of any large deposit always poses a threat to an individual bank's profit margin, as the bank has to scurry for funds that may be more costly than the original deposit. But such an occurrence does not threaten the stability of the market as a whole nor the viability of the bank as an institution. The withdrawn funds have to go somewhere, and can be recycled back to the original bank if the bank is willing to bid for them.

In addition, as Thomas Willett has pointed out, there are strong economic incentives against irresponsible behavior by OPEC (in fact, any) investors.[16] In today's highly competitive foreign-exchange and financial markets, large sudden shifts of funds will turn prices and exchange rates against the one making the transfer. Thus, the market place exercises its own discipline against erratic behavior on the part of individual participants. Indeed, to date, there has been no evidence to suggest that OPEC investors have behaved irresponsibly.

Mounting debt

Concerns over the so-called "mounting debt" problem are often expressed in terms of the nominal value of the accumulated debt, in isolation from other factors in world economic growth. That is hardly a meaningful way of looking at the problem. The magnitude of the problem also depends critically on price changes, income and export growth, and similar factors.

From 1970 to 1975, the nominal debt of developing nations increased steadily by 145 percent, while their real debt (adjusted for export-price changes) rose by only 40 percent—and actually declined from 1972 to 1974 as a result of steep increases in primary-commodity prices (Chart 1, upper panel). Various debt ratios, despite increases in recent years, still remain below their 1972 peaks, and the situation is not expected to change much in 1977 (Chart 1, lower panel). These measures include the ratio of outstanding debt to exports, the debt-service ratio (ratio of interest plus amortization to exports), and the ratio of interest payments to exports. Thus, after allowing for price changes and export growth, international indebtedness has not increased disproportionately in recent years.

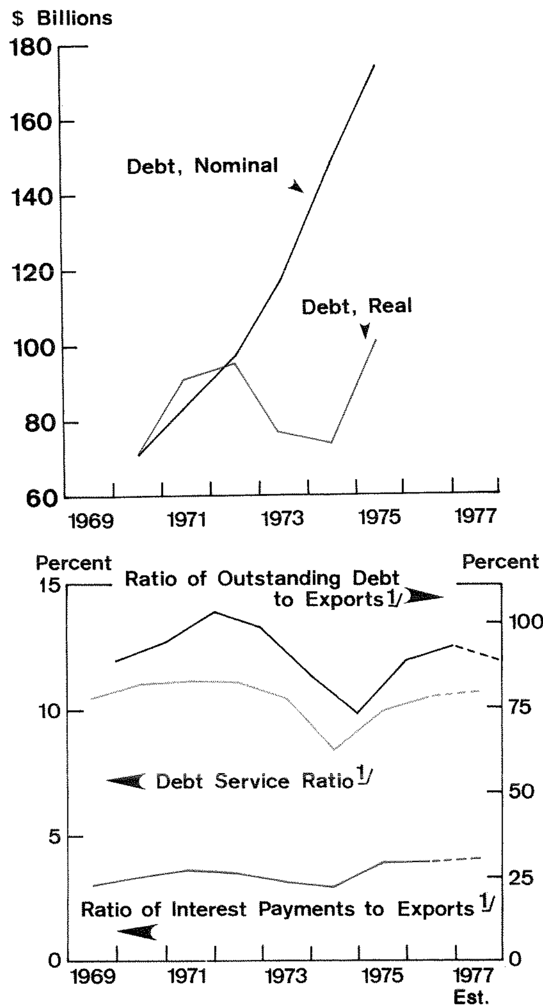
The current concern over the external-debt problem is reminiscent of the fears expressed over consumer-credit accumulation in this country in an earlier era. During the 1950's, the public became alarmed by the fact that in the first postwar decade, consumer credit had risen at a 26-percent average annual rate compared with only a 6-percent growth rate of personal income. What would happen to the economy if the debt burden became unbearable and debt accumulation had to stop? In a classical analysis of the subject, Alain Enthoven used a simple debt-growth model to show the unwarranted nature of this concern.[17] His model assumed a constant income growth rate, and new borrowings as a constant proportion of income. Over time, both the debt-growth rate and the debt-income ratio would asymptotically approach their respective limits, which are determined by the income-growth rate and the new borrowing/income ratio. Moreover, if the initial stock of debt is small, both the debt-accumulation rate and the debt-income ratio would rise steeply at the beginning and then asymptotically approach their respective long-run limits. The Enthoven prediction has been borne out by subsequent developments. The debt-income ratio rose only from 10 percent to

13 percent between 1956 and 1976, and the average annual growth rate of consumer instalment credit dropped from 22 percent in the first postwar decade (1946-56) to 9 percent during the decade ended 1976.[18]

The moral of the Enthoven model is very simple: Debt and economic growth are closely related. Since debt must be serviced out of current income, the debt-income ratio is a key factor to consider. In the short run, because of transitory factors, the ratio may rise very sharply for a time. But in the long run, the ratio depends on two factors—the rate of growth of income, as well as the ratio of debt accumulation to income. In other words, a growing economy can service a growing volume of debt, and short-run fluctuations in the debt-income ratio provide little guidance to the analysis of debt-accumulation problems.

Chart 1

DEBT OUTSTANDING AND DEBT SERVICE RATIOS OF DEVELOPING COUNTRIES, 1969-77



[1] The debt and debt service figures relate only to medium-term and long-term external public, or publicly guaranteed debt, as defined in the Debt Reporting Statistics of the IBRD.

Source: International Monetary Fund, *Annual Report 1977,* p. 22; *IMF Survey,* Supplement on International Lending, June 6, 1977, p. 185.

III. Policy Issues

Bank lending

Four separate issues have arisen with respect to bank financing of world payment deficits: (a) the risks in extending medium-term (1-7 year) balance of payments loans when bank liabilities are predominantly short-term;[19] (b) the risks in making balance-of-payments loans for maintaining consumption rather than for expanding investment in productive projects;[20] (c) the relationship between profit and risk in foreign lending; and (d) economic efficiency in worldwide allocation of capital through the private market system.

Balance-of-payments loans present the usual problem of matching long-term assets against short-term liabilities.[21] In order to cope with interest-rate fluctuations, banks apply floating rates to most of their Eurocurrency medium-to-long term loans, with the loan rate adjusted every six months or so to reflect movements in the London interbank offer rate on deposits (the LIBOR rate). Thus despite being technically committed to fairly lengthy loans, banks essentially renegotiate their loans on every roll-over date.[22] In this way, they have demonstrated the ability to develop successful techniques for managing the liquidity problem in the areas of both domestic and international banking.

The concern over the use of balance-of-payment loans for domestic consumption rather than investment ignores the fungibility of capital. This means that once loan proceeds are received, the funds can no longer be distinguished from those obtained from other sources, and are thus completely substitutable with each other. For instance, a loan purportedly for the financing of an investment project could enable the borrower to release his own resources for other "non-productive" purposes. On the other hand, a loan purportedly for the importation of consumer goods could free a country's domestic resources for "productive" investments. In short, the true test of the soundness of a loan is not its stated purpose, but the anticipated income stream of the borrower—which in the case of a foreign nation is its expected rate of economic growth.

On the question of profitability, banks have achieved a considerably higher level of profits on international banking than on domestic banking in recent years. In 1976, international operations accounted for 57 percent of Citicorp's assets but for 72 percent of its after-tax earnings, and for 48 percent of Chase's total assets but for 78 percent of its earnings.[23] However, critics have asked whether banks have become so attracted by the profitability of international lending as to have imprudently incurred an unacceptable level of country risk.[24] Yet recent surveys on banks' internal control over foreign lending—conducted by the Federal Reserve System and the U.S. Eximbank—have yielded no evidence to support that conclusion.[25] Moreover, gross domestic loan charge-offs rose from 0.42 percent in 1974 to 0.94 percent in 1976, while international loan charge-offs rose from 0.11 percent to 0.20 percent over the same period.[26] Thus, international banking to date has been at least as successful as domestic banking in balancing profitability and risks.

A final consideration relates to the economic function of bank lending, in terms of the efficiency of allocation of capital on a world-wide scale. Most analysts recognize that banks perform an important task of international financial intermediation in recycling oil-surplus funds, but few explicitly recognize that the banking role goes much farther than that. The extensive banking network that has been built up during the last 15 years is now gathering savings from all parts of the world and redistributing them on a worldwide basis in response to market forces. In particular, the flows of funds are not uni-directional from surplus countries to deficit countries, but are rather *two-way* flows with respect to each region and indeed to each country as well (Table 4). Access to the banking network offers savers all over the world an opportunity for international portfolio diversification, so as banking capital flows into relatively high-return countries, savers in these countries also put funds in the banks for risk diversification.[27] Again, because of economies of scale and scope of risk diversification, multinational banks can operate world-wide on a lower overall spread between deposit and lending rates, than can local financial institutions. In ei-

ther case, the development of the international banking network means a gain in economic welfare for the world as a whole.

Role of the IMF

Several recent proposals have called for the International Monetary Fund to play a more active role in helping member countries cope with their payments financing and adjustment problems. The proposals fall into two categories: (a) enlargement of IMF resources to provide more effective assistance to member countries, and (b) increased coordination with commercial banks to reduce risks of private lending.[28]

(a) *Enlargement of IMF resources.* The two proposals of this type include the so-called "Witteveen facility" (described below) and the authorization for the IMF to borrow directly in the private capital market.[29] Both recognize the fact that IMF resources have become woefully inadequate in relation to its responsibilities as a result of the substantial growth of world payments deficits. During the 1974-76 period, IMF lending rose to record levels but still financed only about six percent of aggregate payments deficits.[30]

The Witteveen Facility is designed as a Supplementary Credit Facility at the IMF, consisting of funds borrowed from source countries at 7-percent interest and re-lent to deficit countries at market-related interest rates. About $10 billion has been pledged, including $2.5 billion from Saudi Arabia, $1.7 billion from the United States, $1.2 billion from Germany, and $1.0 billion from Japan. The Facility is viewed as a stopgap until the IMF's regular quota resources are substantially increased in about two years' time.

Several misgivings have been raised about the proposed Facility. One criticism, raised by Senator Frank Church, concerns its size in relation to the magnitude of the aggregate payment deficits. "The amount contemplated—approximately $10 billion—is nowhere near the magnitude necessary to cover the balance-of-payments deficits of the oil-importing countries. Consequently, it is anticipated that there will be future requests for additional Congressional appropriations."[31] Another criticism concerns the use of the Facility "for bailing out the commercial banks or taking over risky loans injudiciously contracted by the banks."[32] Another possibility is that the banks, with such a "safety net" under them, might lower their standards for controlling risk and further expand their foreign lending, thus aggravating the external-debt problem.[33]

In response, it might be noted that the Facility's purpose is not so much to permit the IMF to engage in a larger volume of lending, as to strengthen its hands in urging member countries to adopt appropriate policies to cure payment imbalances. In the words of Federal Reserve Chairman Burns: "One reason why countries often are unwilling to submit to conditions imposed by the IMF is that the amount of credit available to them—as determined by established quotas—is in many instances small relative to their structural payment imbalance.[34]

The key words about the proposed Facility—indeed, about the use of all IMF credits—are "conditionality" and "payment-adjustment policies." Thus, the intent of the Facility is neither to "bail out banks" nor to "bail out countries," but to offer a viable avenue—a financially sound package—for countries in payment difficulties to adopt in order to return to health. The outcome would be reduced payment imbalances and a healthier world financial climate. The resultant reduction in risk might induce banks to expand their foreign lending beyond what they would otherwise do, but that does not necessarily imply any lowering of standards of risk-assessment. If the Facility were administered as intended, banks could not reasonably expect to be bailed out from loans to countries that do not accept policy conditions attached to IMF credits. Thus, bad loans would still be bad loans, but the Witteveen Facility, by encouraging debtor countries to adopt payment-adjustment policies, would help improve the chances of turning potentially bad loans into good loans.

(b) *Coordination with banks.* Enhanced IMF-bank coordination could take the form of greater consultation to prevent misunderstandings, greater flows of information to assist evaluation of borrowers' creditworthiness, and co-financing packages involving a blend of IMF and private funds. All these proposals raise fundamental questions about the operations of the IMF and its relationship with sovereign members and private banks. It is, therefore, not surprising that the IMF thus far has reacted cautiously to the various proposals.

Difficulties could arise, for example, over the proper handling of information flows. There can be no disagreement that a larger and freer information flow would aid risk assessment and thus improve the efficiency of the market. Specifically, more information—and more systematic and timely information—is needed on the magnitudes, maturity structures, external guarantee provisions, and types of borrowers of both the public and private external debts of individual borrowing countries. A multinational project is now underway, under the auspices of the Bank for International Settlements, to collect such information from banks of major industrial countries and make it available to banks engaged in foreign lending.[35] More difficult is the development of thorough analytical reports concerning not only the economic conditions in borrowing countries, but also the willingness and ability of their governments to carry out appropriate stabilization policies. The IMF already prepares material of this type, but it is generally not available to the public because of the confidential nature of IMF recommendations.

The need for information, however, should not be overstated, because the market mechanism can help adjust for the volume and quality of the information available at any point of time. For instance, if a government is either unable or unwilling to supply information which a potential creditor deems critical, this should affect the loan rate or lending terms—or even the decision to lend. On the other hand, if the availability of such information in fact makes little difference to loan terms, it may be a good indication that the information is not so critical after all.

Lastly, several leading commercial bankers have addressed the question of co-financing packages and coordination in lending policy. John Haley of Chase Manhattan has noted that informal consultation already exists between banks and the IMF, and asks to what extent the cooperation should be formalized. He argues against formalizing the situation to the point where the IMF would become the arbitrator of both official and private lending.[36] Gabriel Hauge of Manufacturers Hanover points to the complications arising from parallel-financing plans, where the loan agreement between the IMF and the borrowing country contains clauses that are confidential between the two parties. He suggests as a solution "cross default" clauses in parallel-loan agreements, so that default against any one loan would mean default against all the loans in the package. Thus protected, bank participants in the package would not need to know the terms of agreement between the IMF and the individual borrowing country.[37]

Role of Central Banks

In the area of international banking, as in domestic banking, a central bank's responsibility encompasses both a regulatory/supervisory function and a lender-of-last-resort function for supporting the liquidity of a particular institution or of the economy as a whole. The former is the subject of another article in this issue.[38] A few comments may be added regarding the central bank's second responsibility—the lender-of-last-resort function.[39]

The concern over foreign lending arises over the tendency for banks to jump on the bandwagon when things are going well and to stop lending when things go sour. This tendency creates great swings in lending activities, and at worst a general banking crisis.[40] That, of course, is precisely what central banks are supposed to forestall through their lender-of-last-resort function, by providing ample liquidity to the banking system through liberal discount policy. The Penn Central episode of June 1970 provides a vivid example of how the default of a major borrower can affect financial markets, and how a central bank's decisive actions can restore liquidity and market confidence.[41]

In the international context, cooperation among national central banks is clearly necessary in carrying out this lender-of-last-resort role. In fact, major central banks already cooperate in this fashion through their regular monthly meetings at Basle under the auspices of the Bank for International Settlement. At one such meeting, they reached an agreement concerning ways of extending emergency credits to banks within their individual jurisdictions and to branches and subsidiaries of multinational banks. Under this agreement, parent banks are expected to back up their foreign branches and wholly-owned subsidiaries. Moreover, in accordance with a 1976 Federal Reserve interpretation, U.S. banks are

expected to support more than their own share in cases of difficulty with joint ventures—that is, arrangements involving minority participation where some management interest exists.[42]

The central banks participating in the agreement deliberately left unclarified the exact procedures for providing temporary liquidity. Instead, they merely stated that they were "satisfied that means are available for that purpose and will be used if and when necessary."[43] This is in line with the tradition of not defining and publicizing specific rules for emergency assistance to troubled banks, to discourage banks from relaxing their bankerly caution and relying instead on such emergency facilities.

Thus, the present international financial system is cushioned against untoward shocks, first by banks which have access to a vast international money market with considerable depth, breadth, and resiliency; then by central banks acting as joint lenders of last resort; and also by the IMF with its active surveillance over adjustment policies in borrowing countries. International cooperation in this fashion promotes a basic condition of confidence, under which banks can safely and efficiently perform their function of international financial intermediation.

IV. Summary and Conclusions

1. As a result of the post-1973 international crises—the OPEC oil price increase plus the ensuing world-wide inflation and recession—total world current-account imbalances more than quadrupled from an annual average of $20 billion in 1970-73 to $87 billion in 1974-76. Net bank lending (changes in claims minus changes in liabilities) financed about one-fourth of the aggregate deficits in 1976.

2. Considerable balance-of-payments adjustments have now been made—especially by the majority of non-oil developing countries—given the price changes and output growth that have occurred since the 1967-72 period. While continued improvements are needed, the payment imbalances and growing debt are not as unmanageable as sometimes alleged. When the same factors are taken into account, the external debt burden of non-oil developing countries (as a group) does not appear to be any larger now than in the early 1970's.

3. The continuing OPEC surplus has replaced the pre-1973 current-account surplus of the industrial nations as the principal source of world savings for financing deficit countries' development needs. Being risk averters, the OPEC countries have chosen to place the bulk of their surplus funds in world financial markets, including banks. They are thus subject to the same kind of market discipline as other investors and, in fact, have behaved as responsible investors in their investment activities.

4. In principle, there is no reason why commercial banks should not extend medium- or even long-term loans for financing payment deficits, even though the loans may be intended for maintaining domestic consumption rather than for investment financing. There is also no evidence that banks have been any more lax in controlling risks in their foreign lending than in their domestic lending. On the positive side, international financial intermediation through multinational banks means enhanced efficiency in gathering and allocating capital in the world economy.

5. Although the world financial system is basically sound, there is much that the IMF and national central banks can do—and in fact have done—to improve the system's functioning (e.g. assurance of lender-of-last-resort facilities). The proposed Witteveen Facility is a needed step in this direction.

FOOTNOTES

1. **International Debt, the Banks, and U.S. Foreign Policy,** a staff report, Subcommittee on Foreign Economic Policy, Committee on Foreign Relations, U.S. Senate, 95th Congress 1st Congress 1st Session, U.S. Government Printing Office, August 1977, p. 5.
2. **Ibid.**
3. According to IMF and OECD estimates, world payment imbalances will continue to be nearly as large in 1977 as in 1976, and prospects are rather dim for significant reductions in the future. For details, see International Monetary Fund, **Annual Report, 1977,** p. 13, and OECD, **Economic Outlook,** July 1977, p. 69.
4. Some arbitrariness was necessary in separating "Surplus OECD" from "Deficit OECD," particularly with respect to Japan and the United States, which changed from deficit to surplus (or vice versa) during the 1974-76 period. The criterion used was whether the sum of the annual current-account balances during the period was positive or negative for each country in question.
5. Disbursed debt only. The selection of 1972 was dictated by the fact that debt accumulation began to accelerate in 1973, even before the oil-price increases went into effect.
6. World Bank, **World Debt Tables, 1977,** Vol. 1, p. 42.
7. Changes in banks' external claims indicate banks' net foreign lending (loans minus amortizations). But, since banks also accept deposits from foreign nationals, the "net banking capital flow" to or from a foreign country is obtained by subtracting the changes in banking liabilities from those in banking claims vis-a-vis that country. Because of interbanking capital flows and of difficulties in identifying sources of funds in certain cases, the data pertaining to "Surplus OECD," "Offshore Centers," and "Oil-Exporting Countries" should be considered together.
8. Senate Subcommittee staff report, **op. cit.,** pp. 50-51.
9. Robert Solomon, "IMF Urged to Borrow in Financial Markets," **The Journal of Commerce,** September 26, 1977, pp. 4.
10. Statement by Senator Frank Church, Preface to the Senate Subcommittee staff report, **op. cit.,** p. vi.
11. See, e.g., the passage cited on the first page of this article.
12. IMF, **Annual Report 1977,** pp. 12-24.
13. **Ibid.,** p. 12.
14. Since these findings are contrary to common impressions, some elaboration may be needed. In the first place, the sharp deterioration in the industrial countries' current-account balance can be explained by the $21 billion aggregate 1976 deficit of eight countries (Austria, Canada, Denmark, France, Italy, Norway, Sweden, and the United Kingdom), which was nearly offset by the aggregate $20-billion surplus of the other members of the group (Belgium, Germany, Japan, the Netherlands, Switzerland, and the United States). The common impression of "strong" industrial countries pertains to the latter subgroup only. Secondly, the IMF study notes that an upsurge of current-account deficits among non-oil LDC's in 1974-75 was sharply reduced in 1976, especially by Asian and Latin American countries. The common impression of the adjustment problems of this group was probably based only on those 1974-75 developments.
15. For an articulation of this concern, see Senate Subcommittee staff report, **op. cit.,** p. 68.
16. Thomas D. Willett, **The Oil Transfer Problem and International Economic Stability,** Princeton Essay in International Finance, No. 113 (December 1975), p. 13.
17. Alain Enthoven, "The Growth of Installment Credit and the Future of Prosperity," **American Economic Review,** December 1957, pp. 913-929.
18. Board of Governors of the Federal Reserve System, **Banking and Monetary Statistics, 1941-1970,** September 1976; **Annual Statistical Digest, 1971-1975,** October 1976; and **Federal Reserve Bulletin,** September 1977.
19. For an expression of this concern, see Gerald A. Pollack, **Are the Oil-Payments Deficits Manageable?,** Princeton Essay in International Finance, No. III (June 1975), p. 5.
20. The Senate Subcommittee staff report comments: "Presumably, a corporate loan will be self-liquidating once the investment for which the money was borrowed begins yielding a return. But many of the loans to governments have been used not for investment, but to maintain a given level of consumption. This does nothing to increase the future earning power of the borrower, and funds to service the loan have to be found elsewhere, perhaps through additional borrowing." Subcommittee staff report, **op. cit.,** p. 5.
21. Jack Beebe, "A Perspective on Liability Management and Bank Risk," **Economic Review,** Federal Reserve Bank of San Francisco, Winter 1977, pp. 12-25.
22. John Hewson and Eisuke Sakahibara, **The Eurocurrency Markets and Their Implications,** 1975, pp. 147-152.
23. Senate Subcommittee staff report, **op. cit.,** p. 47.
24. "Has the profitability of this activity blinded them to the underlying risks?" Senate Subcommittee staff report, **op. cit.,** p. 67.
25. See statement by Chairman Arthur F. Burns, Federal Reserve Board, before the Senate Banking Committee on March 10, 1977; and also Stephen Goodman, "How the Big U.S. Banks Really Evaluate Sovereign Risks," **Euromoney,** February 1977, pp. 105-110.
26. Robert Morris Associates, **Domestic and International Commercial Loan Charge-Offs,** various issues. For a study of loan-loss experiences of the 1962-74 period, see Fred B. Ruckdeschel, "Risk in Foreign and Domestic Lending Activities of U.S. Banks," Board of Governors of the Federal Reserve System, International Finance Discussion Papers, No. 66, July 1975.
27. Herbert G. Grubel, "Internationally Diversified Portfolios: Welfare Gains and Capital Flows," **American Economic Review,** December 1968.
28. See, for instance, Arthur F. Burns, "The Need for Order in International Finance," speech at Columbia University Graduate School of Business, New York, April 12, 1977; W. Michael Blumenthal, "Toward International Equilibrium: a Strategy for the Longer Pull," speech at International Monetary Conference, Tokyo, May 25, 1977; Senate Subcommittee staff report, pp. 62-67; statements by Richard D. Hill, Frederick Heldering, John C. Haley, and Irving S. Friedman before the Senate Banking Subcommittee on International Finance, August 30, 1977; Robert Solomon, "IMF Urged to Borrow in Financial Markets," **Journal of Commerce,** September 26, 1977, pp. 5 and 10; Gabriel Hauge, "How the Banks Should Work with the Fund," **Euromoney,** October 1977, pp. 57, 59-60.
29. Robert Solomon, **op. cit.**
30. W. Michael Blumenthal, **op. cit.,** p. 7.
31. Foreword to the Senate Subcommittee staff report, **op. cit.,** p.v.
32. Cited in Michael Blumenthal's speech, **op. cit.,** p. 6.
33. "Has the banks' willingness to lend to foreign countries for balance of payments purposes been premised on the unstated assumption that in the event of a real debt repayment crisis, the governments of the wealthy industrial countries will come to the rescue because they cannot afford to see either the debtor countries or their own large banking institutions go under?" Senate Subcommittee staff report, **op. cit.,** pp. 67-68.
34. Arthur F. Burns, **op. cit.,** p. 12.
35. Participating in the project are banks from the Group of Ten countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, the United States)—plus banks from Denmark, Ireland, and Switzerland—and the affiliates of those banks in offshore centers. The global data for end-1976 were released by Bank for International Settlements on June 6, 1977; those collected from U.S. banks were released on June 3

by the Board of Governors of the U.S. Federal Reserve System.

36. "Neither the Fund nor any other official body should be asked, or allowed, to become an international credit-rating body with effective control over the allocation of foreign credit." See his statement before the Senate Banking Subcommittee on International Finance, **op. cit.**

37. Gabriel Hauge, **op. cit.**, pp. 59-60.

38. See Robert Johnston's article in this issue.

39. For a discussion of this subject, see Henry C. Wallich, "Central Banks As Regulators and Lenders of Last Resort in an International Context," remarks at the Federal Reserve Bank of Boston Conference on International Banking, October 6, 1977; and "Discussion" by Donald Hodgman.

40. See Senate Subcommittee report citation on the first page of this article.

41. For a description of the Penn Central episode, see Evelyn M. Hurley, "The Commercial Paper Market," **Federal Reserve Bulletin**, June 1977, pp. 532-533.

42. Henry Wallich, "Central Banks as Regulators," **op. cit.**, pp. 14-15.

43. **Ibid.**, p. 11.

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