

Commercial Bank Lending and Third-World Debt

Graham Bird

COMMERCIAL BANK LENDING AND THIRD-WORLD
DEBT

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COMMERCIAL BANK LENDING AND THIRD- WORLD DEBT

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To Jim Smyly: a good friend

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Preface

One of the main features of the international economy and of world development since the beginning of the 1970s has been the changing role of the private sector, and in particular the commercial banks, in providing balance of payments financing to developing countries. The banks have become an integral element of the Third-World debt problem. The activities of the banks, although much reported, have, however, received little direct analysis. This book sets out to make a contribution towards closing this gap. It investigates various aspects of commercial bank lending to developing countries, not only examining past behaviour but also looking at the likely future evolution of bank lending.

It is hoped that the book will be of use to all those with an interest in international development and monetary economics. Not only students and academics, but also practitioners in the field, drawn from the banks themselves and the official agencies, should find the contents of the book relevant to the problems with which they are dealing.

In the writing of the book the ideas of numerous people in the international banking community, on both sides of the Atlantic, have been drawn on freely, and a debt of gratitude is owed to all those who contributed the time to talk about the issues raised here. To acknowledge them specifically would result in a list of over thirty names and, on grounds of efficiency, as well as on the assumption that some of them might be embarrassed to be associated with the views expressed here, no such list appears. I am also grateful to the World Bank for letting me make use of material that was originally prepared for them.

Two further acknowledgements need to be made; first to Liz Blakeway and Belinda Marking for so efficiently and happily preparing the text for publication, and to Clive Pritchard for

preparing the index; and second to my family, Heather, Alan, Anne and Simon, for providing me with the first-hand experience of the problems created by the acquisition of debt and the related financing role of the commercial banks!

GRAHAM BIRD

Introduction

The role of the commercial banks in first helping to cause and then seeking to find a solution to the problem of developing country debt has received a growing amount of attention over recent years. Given the geographical location of the banks in the United States, United Kingdom, Japan, Germany, France and other centres, it is perhaps unsurprising that their involvement has represented a dimension of the problem which has been of particular concern in the major industrial countries. To read that a developing country in a distant part of the world is encountering difficulties in servicing its debt obligations may generate a certain amount of academic interest. To realise that these difficulties may, and do, translate themselves into losses for the large 'high street' banks generates rather larger amounts of anxiety in the countries in which these banks are based.

However, this book does not claim to provide a comprehensive description and analysis of the part played by the international private banks in the story of Third-World debt. Instead, it brings together various papers and articles which investigate certain aspects of commercial bank involvement. Most of the papers have been published elsewhere, although sometimes in a fairly inaccessible form, and the book does not, therefore, say much that is new. Even so, it does, it is hoped, provide a convenient source of information on topics that have been capturing the headlines, and it does have a common theme running through its pages.

The chapters have been arranged in a fashion designed to make some chronological sense. Chapter 1 examines the basic theory underlying commercial bank lending to developing countries. It seeks to explain why the banks became so heavily involved in such lending during the 1970s and why they became anxious to reduce their exposure during the 1980s. The chapter also raises the question of the proper role for the banks in providing finance for developing countries.

Having established that the banks' assessment of developing country credit-worthiness made an important input in accounting for the banks' lending decisions, Chapter 2 goes on to offer a critical analysis of the ways in which banks have carried out such risk assessment. It then suggests various ways in which risk analysis might be improved in the future.

Whatever the methodology by which they reached the conclusion, during the 1980s the commercial banks certainly came to reassess developing country credit-worthiness. One response to this was the setting aside of larger provisions against their loans to some indebted developing countries. Chapter 3 provides a detailed investigation of the provisioning that was undertaken by the banks during 1987. It shows that changing views on the risks of lending to the Third World was only one factor at work. The chapter also illustrates how provisioning creates more flexibility for the banks in the management of their balance sheets and gives them more opportunity to engage in various forms of debt swapping. Chapter 4 examines the main issues involved in debt swaps and makes some attempt to estimate the welfare effects of swapping debt. The chapter is not only relevant to the discussion of debt-equity swaps but also to that of debt buy-backs in general.

Finally, Chapter 5 offers some comments about the future, and covers, amongst others, the following questions: what might the banks do in order to help further alleviate the problem of debt: should they stick with the techniques used up to now, for example restructuring and debt swaps, or look to more adventurous schemes of debt relief; what is the bargaining position of the banks *vis-à-vis* the indebted developing countries and in what ways has this been changing; what might be done to restore developing country access to private market finance and do the banks offer an appropriate long-term channel for financing economic development; what is the appropriate division of labour between the banks and the official sector; and what is the appropriate institutional structure within which the banks might assist in resolving the Third-World debt problem?

Although the book focuses on the role of the commercial banks, this should not be interpreted as meaning that they are the most important actors in the international debt drama. The roles of the official sector institutions, of the debtor countries and their governments, as well as of other countries and their governments are clearly also of crucial importance. Indeed, the analysis here

demonstrates that many of the recent initiatives pursued by the banks have been of relatively little quantitative significance in finding a way out of global debt difficulties. Although worthy of scrutiny, the activities of the banks, and their relevance, should not, therefore, be exaggerated.

Moreover, since the banks largely by-passed the least developed countries during their surge of lending to the developing world, the position of the poorest countries tends to be ignored in this book. However this is not to argue that these countries encounter few debt problems but rather that the commercial banks have only a strictly limited role in helping to resolve them.

Finally, just as it is invalid to lump together all developing countries and treat them as if they were one group with similar problems to which similar solutions may be applied, it is also invalid to assume that all commercial banks will behave in the same way in terms of their approach to Third-World debt. Banks operate in different regulatory and tax environments and have different levels of exposure in developing countries. A small US regional bank with little developing country exposure may be expected not to have the same point of view as a major US money centre bank. Similarly, the views of these latter banks may well differ from those located outside the United States, say, for example, in Germany. Even where banks share a common location and a broadly similar level of exposure there may still remain significant variations in attitude towards the developing country debt problem, and even though there exists a quasi-formal mouthpiece, in the form of the Institute of International Finance, there may be important detractors from the banks' views as expressed by it. Throughout the pages of this book an attempt has been made to reflect these shades of opinion and to explain them, although to examine them in every context would have resulted in unnecessary repetition.

1 Private Bank Lending to Developing Countries

The general pattern of bank lending to developing countries over the last twenty years or so is fairly well known. From a situation in the 1960s in which the banks provided only a very small proportion – much less than 10 per cent – of net financial flows to developing countries, the 1970s and early 1980s saw a dramatic increase in bank lending, as well as a change in its nature away from project, trade-related or specific purpose financing towards balance of payments or general purpose financing. However, beyond the early 1980s the banks became much more reluctant to lend and often had to be coerced into doing so by monetary authorities and by the International Monetary Fund (IMF).

This chapter provides, first, a statistical background which illustrates in more detail the changes in bank lending. Second, it discusses, in fairly general terms, the basic influences lying behind the variations in bank lending which the data reveal. Finally, it identifies weaknesses associated with commercial bank lending to developing countries.

1. THE STATISTICAL BACKGROUND

Table 1.1 provides information on public or publicly guaranteed long-term debt covering outstanding debt, disbursements, total debt service, and net transfers for all developing countries broken down between subcategories of official and private creditors. Loans from financial markets include loans from private banks and other financial institutions as well as publicly issued and privately placed bonds or similar instruments, which, for most developing countries, are rather insignificant. The table reveals a number of interesting things. First, it shows the absolute and relative increase in the importance of private financial markets (dominated by the banks) as holders of

TABLE 1.1 Total long-term debt, all developing countries (US\$ millions)

| | 1975 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
|------------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
| Debt Outstanding & Disbursed (DOD) | 126,160.8 | 359,102.6 | 402,555.3 | 454,664.7 | 528,040.9 | 603,198.8 | 682,392.8 | 780,435.3 |
| Official Creditors | 71,884.9 | 162,462.9 | 180,870.9 | 199,448.8 | 222,241.3 | 256,508.1 | 295,014.0 | 343,157.9 |
| Multilateral | 18,507.3 | 52,513.3 | 61,436.4 | 72,716.9 | 83,030.9 | 112,442.7 | 129,675.0 | 126,470.9 |
| IBRD | 9,299.2 | 22,077.3 | 26,382.8 | 31,271.2 | 36,963.8 | 42,879.1 | 47,969.0 | 54,110.3 |
| IDA | 5,586.2 | 11,874.3 | 13,796.3 | 16,288.0 | 18,536.9 | 20,825.5 | 24,157.6 | 27,872.9 |
| Bilateral | 53,377.5 | 109,949.6 | 119,434.5 | 126,731.9 | 139,210.4 | 44,065.4 | 165,339.1 | 216,686.9 |
| Private Creditors | 54,275.9 | 196,639.7 | 221,684.4 | 255,215.9 | 305,799.6 | 346,690.7 | 387,378.8 | 437,277.4 |
| Suppliers | 12,760.6 | 23,177.8 | 22,382.8 | 23,574.9 | 26,718.0 | 27,230.6 | 31,684.1 | 34,417.8 |
| Financial Markets | 41,515.3 | 173,461.9 | 199,301.6 | 231,641.0 | 279,081.6 | 319,460.1 | 355,694.7 | 402,859.6 |
| Disbursements | 33,534.5 | 82,385.6 | 91,003.9 | 94,768.0 | 86,308.6 | 79,078.9 | 77,100.3 | 75,130.3 |
| Official Creditors | 15,123.6 | 28,399.8 | 32,887.6 | 32,307.9 | 32,778.5 | 33,055.4 | 30,558.8 | 36,883.6 |
| Multilateral | 4,289.7 | 11,162.6 | 11,927.6 | 14,509.9 | 15,258.2 | 16,472.2 | 16,875.4 | 20,701.8 |
| IBRD | 2,038.0 | 4,593.7 | 5,655.3 | 6,667.2 | 7,864.5 | 8,646.0 | 8,474.6 | 10,230.4 |
| IDA | 1,116.4 | 1,580.1 | 1,983.2 | 2,560.2 | 2,367.9 | 2,556.1 | 2,875.3 | 3,142.3 |
| Bilateral | 10,833.9 | 17,237.2 | 20,960.1 | 17,798.1 | 17,520.3 | 16,583.2 | 13,683.4 | 16,181.9 |
| Private Creditors | 18,410.9 | 53,985.8 | 58,116.3 | 62,460.0 | 53,530.1 | 46,023.5 | 46,541.5 | 38,246.7 |
| Suppliers | 4,108.2 | 5,839.9 | 6,078.5 | 6,565.2 | 8,080.4 | 6,693.4 | 5,987.9 | 4,854.0 |
| Financial Markets | 14,302.7 | 48,145.9 | 52,037.8 | 55,894.8 | 45,449.8 | 39,330.2 | 40,553.5 | 33,392.7 |
| Net Transfers | 18,942.2 | 26,704.2 | 25,215.3 | 22,438.7 | 14,638.2 | 2,117.0 | -11,895.3 | -20,710.2 |
| Official Creditors | 9,861.2 | 14,849.3 | 17,378.3 | 14,513.3 | 12,821.2 | 11,616.0 | 4,869.6 | 4,159.1 |
| Multilateral | 2,821.9 | 6,857.9 | 7,092.7 | 8,646.1 | 7,032.3 | 7,604.4 | 6,230.5 | 6,669.7 |
| IBRD | 962.3 | 1,730.4 | 2,427.0 | 2,694.4 | 3,030.3 | 2,692.0 | 1,546.6 | 994.8 |
| IDA | 1,066.5 | 1,470.1 | 1,831.7 | 2,395.1 | 2,166.3 | 2,302.0 | 2,571.9 | 2,770.9 |
| Bilateral | 7,039.3 | 7,991.4 | 10,285.6 | 5,867.3 | 5,789.0 | 4,011.7 | -1,360.9 | -2,510.7 |

| | | | | | | | | |
|--------------------------|----------|----------|----------|----------|----------|----------|-----------|-----------|
| Private Creditors | 9,081.0 | 11,854.8 | 7,837.0 | 7,925.3 | 1,817.0 | -9,499.0 | -16,764.9 | -24,869.2 |
| Suppliers | 984.5 | -478.4 | -596.6 | -262.2 | 1,542.6 | 37.0 | -985.1 | -3,077.3 |
| Financial Markets | 8,096.5 | 12,333.2 | 8,433.6 | 8,187.6 | 274.4 | -9,536.0 | -15,779.8 | -21,791.9 |
| Total Debt Service (TDS) | 14,592.3 | 55,681.4 | 65,788.6 | 72,329.3 | 71,670.4 | 76,961.9 | 88,995.6 | 95,840.5 |
| Official Creditors | 5,262.4 | 13,550.5 | 15,509.3 | 17,794.6 | 19,957.2 | 21,439.4 | 25,689.2 | 32,724.6 |
| Multilateral | 1,467.8 | 4,304.7 | 4,834.9 | 5,863.8 | 8,225.8 | 8,867.8 | 10,644.9 | 14,032.0 |
| IBRD | 1,075.7 | 2,863.3 | 3,228.3 | 3,972.8 | 4,834.1 | 5,954.0 | 6,928.0 | 9,235.6 |
| IDA | 49.9 | 110.0 | 151.5 | 165.1 | 201.6 | 254.1 | 303.4 | 371.4 |
| Bilateral | 3,794.6 | 9,245.8 | 10,674.4 | 11,930.8 | 11,731.3 | 12,571.5 | 15,044.3 | 18,692.6 |
| Private Creditors | 9,329.9 | 42,131.0 | 50,279.3 | 54,534.7 | 51,713.1 | 55,522.5 | 63,306.4 | 63,115.9 |
| Suppliers | 3,123.7 | 6,318.3 | 6,675.1 | 6,827.5 | 6,537.8 | 6,656.3 | 6,973.1 | 7,931.2 |
| Financial Markets | 6,206.2 | 35,812.7 | 43,604.2 | 47,707.2 | 45,175.4 | 48,866.2 | 56,333.3 | 55,184.7 |

AVERAGE TERMS OF NEW COMMITMENTS

| | | | | | | | | |
|----------------------|------|-------|-------|-------|------|------|------|------|
| All Creditors | | | | | | | | |
| Interest (%) | 6.9 | 9.2 | 11.1 | 10.5 | 9.2 | 9.1 | 8.0 | 6.9 |
| Maturity (years) | 16.5 | 15.8 | 14.2 | 14.1 | 13.9 | 15.5 | 15.9 | 16.4 |
| Grace Period (years) | 5.4 | 4.9 | 4.6 | 4.4 | 4.3 | 5.0 | 5.4 | 5.0 |
| Grant Element (%) | 19.8 | 8.9 | -1.2 | 1.3 | 6.8 | 7.7 | 13.2 | 19.0 |
| Official Creditors | | | | | | | | |
| Interest (%) | 5.2 | 5.6 | 6.4 | 7.5 | 7.3 | 7.1 | 6.5 | 6.4 |
| Maturity (years) | 25.2 | 23.5 | 21.1 | 22.0 | 21.7 | 22.6 | 23.1 | 21.3 |
| Grace Period (years) | 8.0 | 6.2 | 5.4 | 5.8 | 5.6 | 5.7 | 5.8 | 5.5 |
| Grant Element (%) | 35.2 | 32.5 | 24.8 | 20.1 | 20.0 | 22.4 | 25.9 | 24.9 |
| Private Creditors | | | | | | | | |
| Interest (%) | 8.6 | 12.3 | 14.1 | 12.3 | 10.5 | 10.9 | 9.0 | 7.5 |
| Maturity (years) | 8.3 | 9.2 | 9.6 | 9.4 | 8.4 | 9.5 | 10.9 | 10.0 |
| Grace Period (years) | 3.0 | 3.8 | 4.1 | 3.7 | 3.4 | 4.5 | 5.1 | 4.4 |
| Grant Element (%) | 5.3 | -11.1 | -18.2 | -10.0 | -2.5 | -4.7 | 4.2 | 1.4 |

SOURCE: World Debt Tables: External Debt of Developing Countries, 1987-8 edn, World Bank.

developing country debt; there being an almost tenfold increase between 1975 and 1986. Second, it shows the rapid increase in disbursements from financial markets between 1975 and 1982 and the subsequent decline. Third, it shows that beyond 1983 the net transfer of funds turned negative with developing countries paying more back to the private financial markets than they were receiving from them in the form of new loans, and that this negative net transfer became increasingly marked between 1984 and 1986. Finally, the section of the Table dealing with the average terms of new commitments reveals that the terms were hardest, as measured by the grant element, in 1980–2, when private lending was at its peak.

Tables 1.2 and 1.3 provide similar data for highly indebted countries (HICs) and for low-income African countries. Broadly the same trends are shown here, although certain features are noteworthy. For the HICs, first, disbursements in 1986 had fallen below their 1975 level; the fall in commitments was in fact more dramatic with these standing at \$1.9bn in 1986, compared with \$9.6bn in 1975 (American billions are used throughout). Second, net transfer involving the financial markets turned negative in 1983. Finally, debt held by the private financial markets represents by far and away the most important component of their total debt.

For low-income African countries debt owed to the private financial markets represents a very much smaller proportion of their total debt, reflecting the fact that such countries have been unattractive loan outlets for the private banks. Having reached their peak somewhat earlier for these countries (in 1981) financial market disbursements by 1986 had again fallen below their 1975 level.

Returning to the highly indebted Baker 15 of developing countries and the 'market borrowing countries', data from the Institute of International Finance in Washington presented in a statistical appendix to this chapter confirm that commercial banks held over 60 per cent of the external debt of the latter. They also reveal the declining role of banks as a source of net external financing, while illustrating the difference from country to country in any particular year arising primarily from the state of debt restructuring.

Although it would be possible to extend this statistical review of developing country debt, and of the role of the private financial markets as well as of the private banks within them, the principle features have been established. These relate to both time series and cross-sectional variations in bank lending. It is these variations which the rest of this chapter seeks to explain. However, before moving

on to attempt such an explanation, it may be noted that the statistics provided in Tables 1.1–1.3, in an important way understate both sorts of variation. Firstly, much of the private lending beyond 1982 was involuntary or ‘concerted’. Undoubtedly the banks would have preferred to lend much less than they did. Secondly, even within the classification of developing countries used here there have been big differences. The World Bank in its *World Debt Tables*, 1987–8, for example, reports that there was a small increase in new private lending in 1987, but goes on to point out that this was entirely associated with new money packages for Argentina and Mexico and with refinancing by Korea. The most recent data available show no indication of any general revival in private lending to developing countries.

Chapter 5 offers some comments on the future outlook. Informed discussion of the future, however, requires some understanding of the past and it is to this that we now turn. The purpose of this chapter is not to provide a sophisticated model of international bank lending to developing countries. Less ambitiously it merely attempts to give some insight into the forces which influence such lending. Having discussed the underlying theory the chapter concludes by identifying weaknesses of international bank lending to developing countries.

2. EXPLAINING THE PATTERN OF BANK LENDING

There are basically two alternative approaches to explaining the pattern of private international financial flows to developing countries. The first distinguishes between the significance of demand and supply factors. The central question here is whether flows are determined largely by the demands of borrowers, with supply being relatively elastic and responding quite passively to demand; or whether flows are supply-constrained, with borrowers unable to raise additional finance and the banks rationing credit.

In the former case the concept of a foreign exchange constraint is relatively meaningless. Instead, constrained by factors other than the availability of foreign exchange, countries decide on an optimum combination of economic growth and external debt and then simply borrow what they require.

In the latter case the availability of foreign exchange is the binding constraint, with countries modifying their domestic aspirations and

TABLE 1.2 Highly indebted countries¹ (US\$ millions)

| | 1975 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
|--------------------|----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
| Debt Outstanding | 49,505.1 | 146,816.0 | 169,590.1 | 199,150.0 | 250,013.0 | 279,625.8 | 308,027.1 | 354,401.5 |
| & Disbursed (DOD) | | | | | | | | |
| Official Creditors | 19,598.8 | 37,190.4 | 42,742.4 | 47,933.2 | 56,987.2 | 62,589.1 | 73,544.0 | 91,614.2 |
| Multilateral | 7,505.1 | 16,455.8 | 18,967.3 | 22,691.2 | 25,557.8 | 29,515.1 | 34,266.2 | 41,111.3 |
| IBRD | 5,380.5 | 10,540.9 | 12,224.1 | 14,138.4 | 16,682.4 | 19,599.1 | 21,999.6 | 25,733.8 |
| IDA | 212.8 | 265.2 | 286.4 | 304.1 | 318.0 | 327.9 | 338.3 | 344.6 |
| Bilateral | 12,093.7 | 20,734.6 | 23,775.2 | 25,242.0 | 31,429.4 | 33,074.0 | 39,277.8 | 50,502.9 |
| Private Creditors | 29,906.2 | 109,625.6 | 126,847.7 | 151,216.8 | 193,025.8 | 217,036.7 | 234,483.1 | 262,787.3 |
| Suppliers | 4,376.8 | 6,594.9 | 6,102.0 | 6,595.4 | 8,397.1 | 8,342.9 | 10,186.4 | 10,952.8 |
| Financial Markets | 25,529.5 | 103,030.7 | 120,745.7 | 144,621.3 | 184,628.7 | 208,693.8 | 224,296.2 | 251,834.5 |
| Disbursements | 13,554.6 | 35,648.0 | 42,711.9 | 45,135.8 | 36,085.9 | 28,106.7 | 20,950.8 | 19,963.3 |
| Official Creditors | 3,925.0 | 7,222.8 | 9,431.1 | 9,386.5 | 10,312.3 | 10,078.1 | 9,560.3 | 12,356.2 |
| Multilateral | 1,575.6 | 3,451.9 | 3,678.7 | 5,074.9 | 5,407.1 | 6,341.2 | 6,285.3 | 8,340.8 |
| IBRD | 1,057.3 | 2,126.2 | 2,361.7 | 2,810.1 | 3,639.6 | 4,383.6 | 4,168.5 | 5,750.7 |
| IDA | 27.9 | 4.4 | 23.4 | 20.5 | 17.5 | 13.9 | 15.1 | 12.0 |
| Bilateral | 2,349.4 | 3,770.9 | 5,752.4 | 4,311.6 | 4,905.3 | 3,736.9 | 3,275.0 | 4,015.4 |
| Private Creditors | 9,629.6 | 28,425.2 | 33,280.7 | 35,749.3 | 25,773.6 | 18,028.6 | 11,390.5 | 7,607.1 |
| Suppliers | 1,181.4 | 1,519.4 | 1,323.0 | 1,971.3 | 2,303.9 | 1,155.1 | 1,258.7 | 1,106.0 |
| Financial Markets | 8,448.2 | 26,905.8 | 31,957.7 | 33,778.0 | 23,469.7 | 16,873.5 | 10,131.8 | 6,501.0 |
| Net Transfers | 5,970.1 | 6,150.0 | 9,288.9 | 8,951.3 | 2,038.3 | -463.1 | -17,907.9 | -18,384.3 |
| Official Creditors | 1,823.3 | 2,512.9 | 4,095.7 | 3,018.9 | 3,022.3 | 2,493.1 | 50.3 | 562.2 |
| Multilateral | 746.7 | 1,409.0 | 1,423.1 | 2,358.9 | 1,208.9 | 2,323.8 | 1,559.2 | 2,251.0 |
| IBRD | 455.3 | 736.5 | 773.7 | 900.8 | 1,383.1 | 1,490.1 | 860.6 | 1,400.4 |
| IDA | 25.1 | 0.8 | 19.2 | 15.6 | 11.5 | 7.7 | 7.8 | 3.7 |
| Bilateral | 1,076.6 | 1,103.9 | 2,672.5 | 660.00 | 1,813.4 | 169.2 | -1,509.0 | -1,688.8 |
| Private Creditors | 4,146.8 | 3,637.1 | 5,193.2 | 5,932.4 | -984.0 | -9,956.1 | -17,958.2 | -18,946.5 |
| Suppliers | -94.4 | -337.9 | -463.8 | 286.6 | 911.8 | -152.3 | 28.0 | -389.2 |
| Financial Markets | 4,241.2 | 3,975.0 | 5,657.0 | 5,645.7 | -1,895.8 | -9,803.9 | -17,986.2 | -18,557.3 |

| | | | | | | | | |
|--------------------------|---------|----------|----------|----------|----------|----------|----------|----------|
| Total Debt Service (TDS) | 7,584.6 | 29,498.0 | 33,423.0 | 36,184.5 | 34,047.6 | 35,569.8 | 38,858.8 | 38,347.6 |
| Official Creditors | 2,101.7 | 4,709.9 | 5,335.5 | 6,367.5 | 7,290.1 | 7,585.1 | 9,510.1 | 11,794.0 |
| Multilateral | 828.9 | 2,042.9 | 2,255.6 | 2,716.0 | 4,198.2 | 4,017.4 | 4,726.1 | 6,089.8 |
| IBRD | 602.1 | 1,389.7 | 1,588.0 | 1,909.2 | 2,256.5 | 2,893.4 | 3,307.9 | 4,350.3 |
| IDA | 2.8 | 3.6 | 4.2 | 4.9 | 6.0 | 6.2 | 7.3 | 8.3 |
| Bilateral | 1,272.8 | 2,667.0 | 3,079.9 | 3,651.6 | 3,091.9 | 3,567.7 | 4,784.0 | 5,704.2 |
| Private Creditors | 5,482.8 | 24,788.1 | 28,087.5 | 29,817.0 | 26,757.6 | 27,984.7 | 29,348.7 | 26,553.6 |
| Suppliers | 1,275.8 | 1,857.3 | 1,786.8 | 1,684.7 | 1,392.1 | 1,307.4 | 1,230.7 | 1,495.3 |
| Financial Markets | 4,207.0 | 22,930.7 | 26,300.7 | 28,132.3 | 25,365.5 | 26,677.3 | 28,118.0 | 25,058.3 |

AVERAGE TERMS OF NEW COMMITMENTS

| | | | | | | | | |
|----------------------|------|-------|-------|-------|------|-------|------|------|
| All Creditors | | | | | | | | |
| Interest (%) | 8.3 | 11.7 | 13.2 | 12.6 | 10.7 | 11.2 | 9.4 | 8.0 |
| Maturity (years) | 10.5 | 10.6 | 10.6 | 10.0 | 10.0 | 11.5 | 12.4 | 15.5 |
| Grace Period (years) | 3.2 | 4.1 | 4.0 | 3.6 | 3.1 | 4.3 | 3.4 | 4.1 |
| Grant Element (%) | 8.1 | -7.2 | -13.3 | -10.2 | -2.1 | -5.9 | 2.9 | 10.8 |
| Official Creditors | | | | | | | | |
| Interest (%) | 7.0 | 7.8 | 7.9 | 9.8 | 9.4 | 9.1 | 8.7 | 7.9 |
| Maturity (years) | 19.3 | 16.5 | 15.0 | 15.2 | 16.0 | 15.8 | 16.0 | 16.9 |
| Grace Period (years) | 4.9 | 4.4 | 4.0 | 4.5 | 4.2 | 4.2 | 3.9 | 4.4 |
| Grant Element (%) | 18.2 | 14.7 | 12.7 | 4.0 | 4.5 | 6.2 | 6.7 | 12.1 |
| Private Creditors | | | | | | | | |
| Interest (%) | 8.8 | 13.2 | 15.2 | 13.6 | 11.3 | 12.6 | 9.9 | 8.9 |
| Maturity (years) | 6.9 | 8.5 | 8.9 | 8.2 | 7.0 | 8.8 | 9.3 | 7.4 |
| Grace Period (years) | 2.5 | 4.0 | 3.9 | 3.3 | 2.5 | 4.3 | 2.9 | 1.9 |
| Grant Element (%) | 4.0 | -15.2 | -23.3 | -15.1 | -5.5 | -13.5 | -0.5 | 2.8 |

1. Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Côte d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, Yugoslavia.

SOURCE: World Debt Tables: External Debt of Developing Countries, 1987-8 edn, World Bank.

TABLE 1.3 *Low-income Africa*¹ (US\$ millions)

| | 1975 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
|---|---------|----------|----------|----------|----------|----------|----------|----------|
| Debt Outstanding & Disbursed (DOD) | 9,794.3 | 26,013.2 | 28,839.2 | 31,064.2 | 33,804.7 | 34,999.3 | 39,978.6 | 45,862.3 |
| Official Creditors | 6,632.5 | 19,087.8 | 21,453.3 | 23,913.8 | 27,662.0 | 29,297.1 | 34,131.7 | 39,949.2 |
| Multilateral | 1,685.5 | 6,284.6 | 7,236.4 | 8,344.3 | 9,386.2 | 10,326.7 | 12,068.3 | 14,406.7 |
| IBRD | 682.3 | 1,338.9 | 1,454.4 | 1,558.2 | 1,674.1 | 1,847.7 | 1,899.9 | 1,875.1 |
| IDA | 749.6 | 2,292.0 | 2,755.6 | 3,361.5 | 3,929.3 | 4,595.7 | 5,594.4 | 7,139.8 |
| Bilateral | 4,947.0 | 12,803.2 | 14,216.9 | 15,569.6 | 18,275.8 | 18,970.4 | 22,063.4 | 25,542.5 |
| Private Creditors | 3,161.8 | 6,925.4 | 7,385.9 | 7,150.4 | 6,142.7 | 5,702.2 | 5,846.8 | 5,913.1 |
| Suppliers | 1,212.7 | 2,283.1 | 2,137.2 | 1,996.9 | 1,679.6 | 1,443.5 | 1,539.2 | 1,364.1 |
| Financial Markets | 1,949.1 | 4,642.3 | 5,248.7 | 5,153.4 | 4,463.1 | 4,258.7 | 4,307.7 | 4,549.0 |
| Disbursements | 2,495.6 | 5,331.2 | 4,850.7 | 4,147.4 | 3,921.8 | 3,234.2 | 3,030.7 | 4,179.5 |
| Official Creditors | 1,507.2 | 3,478.3 | 3,495.4 | 3,163.7 | 3,352.3 | 2,840.6 | 2,695.3 | 3,668.3 |
| Multilateral | 450.6 | 1,553.8 | 1,376.8 | 1,409.4 | 1,456.5 | 1,406.7 | 1,515.5 | 2,236.3 |
| IBRD | 174.8 | 185.5 | 184.2 | 178.4 | 192.0 | 186.7 | 146.8 | 124.8 |
| IDA | 175.7 | 397.7 | 476.6 | 621.9 | 599.4 | 739.8 | 848.9 | 1,326.7 |
| Bilateral | 1,056.7 | 1,924.5 | 2,118.6 | 1,754.3 | 1,895.8 | 1,433.9 | 1,179.9 | 1,431.9 |
| Private Creditors | 988.3 | 1,852.9 | 1,355.3 | 983.7 | 569.4 | 393.7 | 335.3 | 511.3 |
| Suppliers | 385.2 | 631.0 | 433.7 | 187.8 | 172.6 | 101.9 | 162.6 | 104.1 |
| Financial Markets | 603.1 | 1,221.9 | 921.7 | 795.9 | 396.8 | 291.8 | 172.8 | 407.2 |
| Net Transfers | 1,755.8 | 3,470.6 | 3,053.6 | 2,594.9 | 2,363.5 | 1,378.5 | 983.6 | 1,681.8 |
| Official Creditors | 1,192.8 | 2,614.9 | 2,648.4 | 2,315.7 | 2,420.6 | 1,632.8 | 1,295.8 | 1,891.9 |
| Multilateral | 358.0 | 1,267.3 | 1,069.1 | 1,055.5 | 1,030.1 | 880.2 | 879.0 | 1,386.7 |
| IBRD | 100.9 | 9.6 | 11.6 | -6.6 | -19.4 | -53.7 | -120.2 | -201.5 |
| IDA | 168.0 | 379.3 | 447.1 | 587.7 | 562.3 | 689.7 | 781.1 | 1,241.9 |
| Bilateral | 834.7 | 1,347.6 | 1,579.3 | 1,260.2 | 1,390.5 | 752.6 | 416.8 | 505.2 |
| Private Creditors | 563.1 | 855.8 | 405.2 | 278.3 | -57.2 | -254.3 | -312.2 | -210.1 |
| Suppliers | 219.6 | 319.1 | 152.7 | 24.9 | 5.4 | -70.4 | 42.9 | -33.5 |
| Financial Markets | 343.5 | 536.5 | 252.5 | 253.4 | -62.6 | -183.9 | -355.1 | -176.5 |

| | | | | | | | | |
|---|-------|---------|---------|---------|---------|---------|---------|---------|
| Total Debt Service (TDS) | 739.7 | 1,860.6 | 1,797.1 | 1,553.4 | 1,558.3 | 1,855.7 | 2,047.1 | 2,497.8 |
| Official Creditors | 314.5 | 863.4 | 847.0 | 848.0 | 931.7 | 1,207.7 | 1,399.6 | 1,776.4 |
| Multilateral | 92.5 | 286.5 | 307.7 | 353.9 | 426.4 | 526.4 | 636.5 | 849.7 |
| IBRD | 73.9 | 175.9 | 172.6 | 184.9 | 211.3 | 240.4 | 266.9 | 326.3 |
| IDA | 7.7 | 18.4 | 29.5 | 34.2 | 37.1 | 50.1 | 67.9 | 84.9 |
| Bilateral | 221.9 | 576.9 | 539.3 | 494.1 | 505.3 | 681.3 | 763.1 | 926.7 |
| Private Creditors | 425.3 | 997.1 | 950.1 | 705.4 | 626.6 | 648.0 | 647.5 | 721.4 |
| Suppliers | 165.6 | 312.0 | 281.0 | 162.9 | 167.2 | 172.4 | 119.6 | 137.6 |
| Financial Markets | 259.6 | 685.2 | 669.1 | 542.5 | 459.4 | 475.6 | 527.9 | 583.8 |
| AVERAGE TERMS OF NEW COMMITMENTS | | | | | | | | |
| All Creditors | | | | | | | | |
| Interest (%) | 4.8 | 4.9 | 5.3 | 4.5 | 3.6 | 4.1 | 3.0 | 2.8 |
| Maturity (years) | 22.0 | 21.5 | 23.2 | 27.6 | 27.7 | 29.2 | 33.0 | 33.0 |
| Grace Period (years) | 6.6 | 5.7 | 5.9 | 6.7 | 6.6 | 6.8 | 7.7 | 7.8 |
| Grant Element (%) | 37.7 | 36.3 | 36.1 | 42.4 | 48.2 | 46.8 | 56.6 | 57.0 |
| Official Creditors | | | | | | | | |
| Interest (%) | 3.3 | 3.2 | 3.8 | 3.5 | 3.1 | 3.4 | 2.3 | 2.3 |
| Maturity (years) | 27.6 | 26.8 | 27.3 | 30.9 | 29.5 | 31.6 | 36.0 | 35.1 |
| Grace Period (years) | 8.1 | 7.0 | 6.9 | 7.5 | 7.0 | 7.4 | 8.4 | 8.2 |
| Grant Element (%) | 50.9 | 49.7 | 46.2 | 50.5 | 52.3 | 52.7 | 63.0 | 61.5 |
| Private Creditors | | | | | | | | |
| Interest (%) | 8.2 | 9.1 | 11.0 | 10.3 | 8.3 | 9.8 | 8.2 | 8.4 |
| Maturity (years) | 8.7 | 8.6 | 7.5 | 8.8 | 9.3 | 10.1 | 10.1 | 11.0 |
| Grace Period (years) | 3.0 | 2.3 | 1.8 | 2.6 | 2.4 | 2.1 | 2.3 | 3.9 |
| Grant Element (%) | 6.9 | 3.7 | -2.1 | -2.4 | 7.5 | -0.3 | 6.6 | 8.5 |

1. Benin, Burkina Faso, Burundi, Central African Republic, Chad, Comoros, Equatorial Guinea, Ethiopia, Gambia, The, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Madagascar, Malawi, Mali, Mauritania, Niger, Rwanda, São Tomé and Príncipe, Senegal, Sierra Leone, Somalia, Sudan, Tanzania, Togo, Uganda, Zaire, Zambia.

SOURCE: World Debt Tables: External Debt of Developing Countries, 1987-8 edn, World Bank.

policies to be consistent with the quantity of funds that they can attract. Here it is the banks that are active participants, with the borrowers adjusting to whatever volume of finance is provided.

The second approach is closely related to the first, though it differs in emphasis. It focuses instead on whether the flow of funds is rationed through price or in some other way. Is the rate of interest at which countries borrow from the banks the market clearing rate, or is there excess demand at the prevailing interest rate? If loans are not rationed by price, how are they rationed? Moreover is it rational for banks to ration credit by means other than price? Why should banks be reluctant to do more business at a higher price?

The issues raised above may be illustrated schematically by using a series of diagrams. In Figure 1.1 the banks' supply of funds is shown as being infinitely elastic (S), and they are prepared to supply as much finance at a given interest rate as borrowers are prepared to borrow. In these circumstances it is clearly the demand side of the market (D) that determines the level of business.

Similarly, in Figure 1.2, demand is again the active determinant although now it is assumed that the supply of funds is no longer infinitely elastic. The result is that an increase in the demand for funds leads to an increase both in the rate of interest and in the flow of funds. The rate of interest is here performing a rationing role.

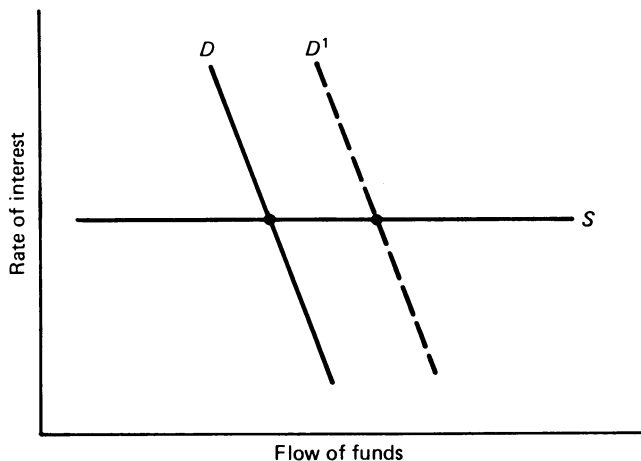


FIGURE 1.1

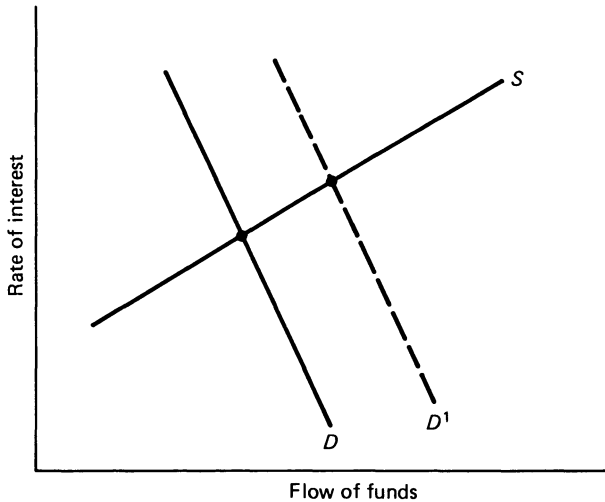


FIGURE 1.2

Figure 1.3 illustrates a situation where the supply of funds schedule first becomes completely inelastic and then bends backwards, with the banks supplying less finance as the rate of interest rises.

This Figure has some interesting properties. Depending on the location of demand and supply schedules, it can generate a stable local equilibrium (in the sense that, if disturbed, market forces will encourage the system to return to the initial equilibrium) such as point *A*, or an unstable one (in the sense that, once disturbed, the system moves away from the initial equilibrium) such as point *B*. But is it anything other than a diagrammatic quirk that the supply schedule is infinitely inelastic or backward bending, or can this possibility be defended in terms of economic logic? A number of explanations may be offered.

First, let us assume that banks set out to maximise their *expected* profits. This is not an unreasonable assumption, although legitimate questions may be raised about the objectives of banks; are they maximisers or satisficers and, if the former, what will they set out to maximise? After all, banks have many features of the large multinational companies, for which alternative theories of the firm have been developed. However, on the assumption of profit maximisation, the lending process will be affected not just by the unit profit on each deal struck and the level of business but also by

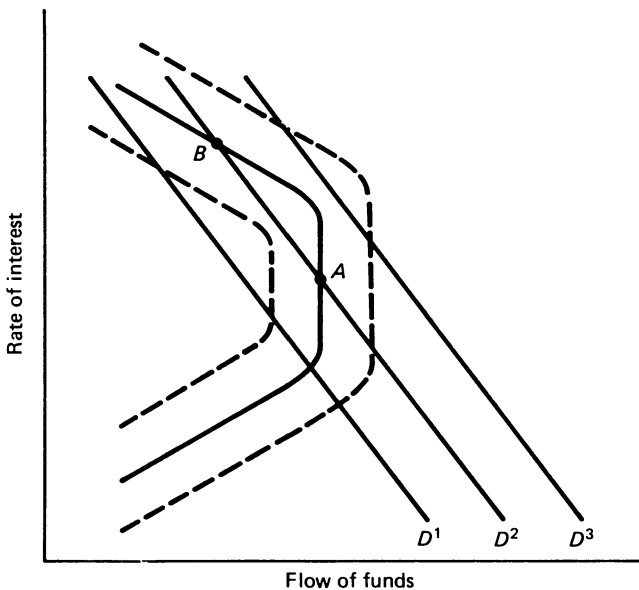


FIGURE 1.3

the probability of the borrower repaying the loan – or, in other words, by the risk of default. If this risk increases significantly as the rate of interest rises, it will be quite rational and quite consistent with their objectives for the banks to *reduce* their supply of loans to this category of borrowers. Given the possibility of default, there is likely to be an interest rate which uniquely maximises the banks' expected returns. If, at this rate, the demand for funds by potential borrowers exceeds the supply of funds made available by the banks, credit will have to be rationed by a non-price means. The interest rate will be a pseudo-equilibrium one in the sense that no market forces would encourage the banks to lend more. Increasing the rate of interest merely raises the banks' perception of the probability of default by increasing the benefits of default to the borrower.¹ The supply of funds will also change if the banks' assessment of the default risk changes for other reasons. Thus, the supply schedule will shift to the right as the perceived risk declines and to the left as it increases.

A second explanation of supply inelasticity follows on from the fact that it is not the rate of interest as such that determines the banks' rate of profit. An increasing interest rate raises what the

banks have to pay on their deposits as well as raising what they receive for their loans. The banks' unit profits depend instead on the spread between the price they pay and the price they charge. If the spread narrows as the rate of interest rises, it may again seem logical for the banks to reduce their supply of loans. There is some evidence to support this relationship.²

These two explanations may of course be combined. While the banks may be primarily concerned about the spread, borrowers will be concerned about the level of the rate of interest as well, since they are unlikely to be protected from a rising rate by having equivalent assets. An increase in the rate of interest may then both narrow the spread and raise the risk of default. It emerges as being quite possible that the supply of bank loans schedule will become inelastic with respect to the rate of interest or even bend backwards above some specific rate of interest.

Up to now we have concentrated on the shape of the supply schedule and have assumed that the demand schedule has a 'normal' shape. This assumption may be unwarranted, since, although an increasing interest rate may be expected to encourage risk-averting borrowers to reduce their borrowing and to put more emphasis on correcting their balance of payments deficits, it will increase the size of repayments (interest plus amortisation) on existing debt. Borrowers may need to borrow more in order to finance these payments. In this case the two forces will pull in opposite directions and it may end up that the demand for loans at some point would increase along with the rate of interest. The demand schedule will then have the shape shown in Figure 1.4, and it again becomes possible to encounter an equilibrium that is unstable (point A in Figure 1.4).

2.1 Applying the analysis: a supply and demand interpretation of recent bank lending to developing countries

The interesting question is whether simple demand and supply analysis may be applied to help explain observed flows of private capital to developing countries in the late 1970s and the early 1980s. Different answers emerge, depending on the way in which interest rates are defined.

For the period 1978–82 there was generally a positive correlation between nominal interest rates and the flow of private bank loans

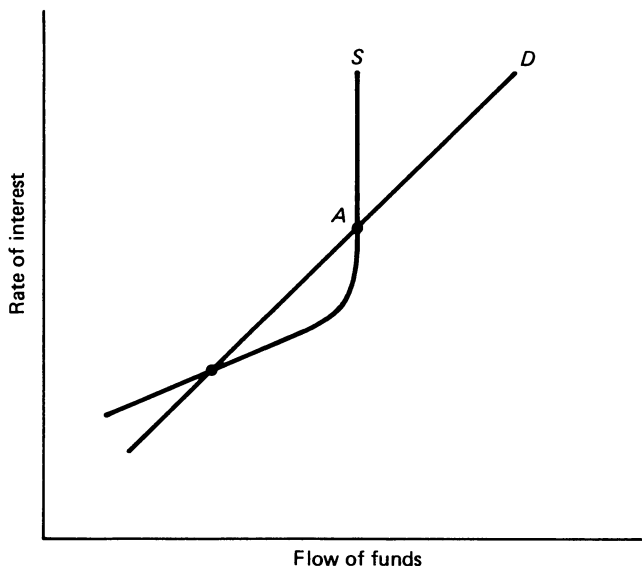


FIGURE 1.4

(apart from 1980–1)³ and this in turn suggests that demand side factors had the dominant influence in determining international bank lending.⁴

However care has to be exercised in reaching such a conclusion. What if, as discussed above, the supply of bank lending is more appropriately related to the spread than to the interest rate? If the absolute value of the spread falls as nominal interest rates rise, then the positive correlation noted above may be interpreted as revealing a negative correlation between the 'price' (that is spread) and 'quantity' variables, and this would suggest that supply side factors are more important.

Furthermore it needs to be recognised that, as already stated, the international banks are intermediaries, the volume of funds they can lend is constrained by what they can attract from ultimate lenders, and the supply of deposits is likely to respond positively to the rate of interest. Indeed this may provide an explanation of why spreads narrow as rates rise, since, following an inflow of deposits, banks compete to make loans and are willing to cut their profit margins in order to increase total profits. Again, in these circumstances, there would seem to be supply domination.

But what if it is the *real* rather than the nominal rate of interest which is the more relevant concept? For a time in the early 1980s the correlation between real rates and bank loans was negative or zero. During this period, yet again, it seems that it was the supply of funds through the banks that was the dominant factor in explaining lending to developing countries rather than the borrowers' demand for funds, though this may have had a significant secondary effect and, indeed, seems to have been of primary importance in the late 1970s when real interest rates and lending rose together.

If the inverse relationship between spreads and the rate of interest relates to nominal rates, and if real rates have increased as nominal rates have fallen, it follows that real rates and spreads are positively related. This would provide further evidence of supply side domination in the determination of international capital flows to developing countries.

A demand and supply configuration which is consistent with a negative relationship between the flows of loans and real interest rates is presented in Figures 1.5 and 1.6. Here it is suggested that during the 1970s and early 1980s both the demand for loans schedule and the supply schedule shifted to the right, but that the supply shift was greater, since, in addition to borrowing, deficit countries decumulated reserves and adjusted to deal with their payments

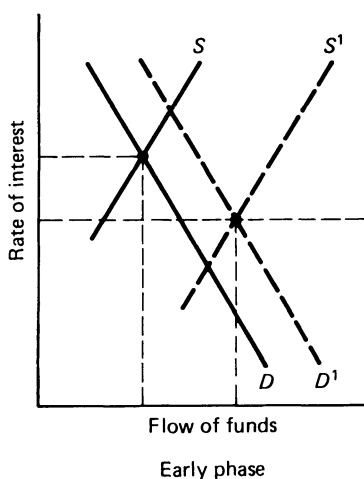


FIGURE 1.5

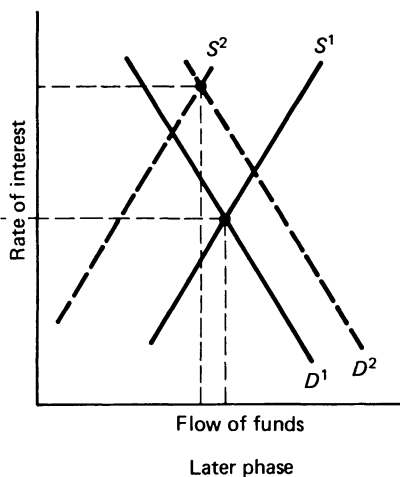


FIGURE 1.6

problems. During the later phase after 1981–2, while the demand schedule shifted to the right more gradually, the supply schedule shifted significantly to the left.

Hypothesising of this type raises a number of questions. Let us examine two in particular. First, what determines the demand for and supply of loans; is the real interest rate more relevant than the nominal rate; and what factors will cause demand and supply schedules to shift? Second, what about the credit rationing approach, which denies the existence of a conventional market equilibrium solution as an explanation of events in the late 1970s and 1980s? Does this have anything to contribute to our understanding?

The real *ex post* price of borrowing, reflecting the real resource costs of repayments, depends not only on the nominal rate of interest but also on what happens to the price of a borrower's exports and to exchange rates. Where borrowing is to finance future imports, it will also depend on future import prices or more generally on expected movements in the terms of trade.

Having implied that the real rate of interest may be relevant, we must face the problem of choosing the appropriate price index with which to deflate nominal rates. For individual borrowers there is a case, as suggested above, for using export prices. For developing countries as a group the argument that their exports are highly concentrated on primary products would suggest that commodity prices might be used. Yet for the major developing country borrowers the degree of export concentration on primary products is less marked than for other developing countries, and this deflator may therefore be less appropriate.

In addition to the real interest rate, the demand for loans depends on the size of current account deficits in borrowing countries, or the excess of national investment over saving, the willingness of monetary authorities to run down international reserves, the scope for and cost of domestic adjustment designed to eliminate deficits, and the rate of time preference between current and future absorption. Given the size of payments deficits encountered by non-oil developing countries after 1973, it seems reasonable to assume that the demand schedule has shifted persistently, though latterly less rapidly, to the right.

As noted earlier, the supply of loans from the banks depends not only on the expected return on lending but also on the supply of funds deposited with the banks. This in turn depends on the size and location of balance of payments surpluses and the rate of

interest on offer. Lenders are also likely to base their lending decisions on real rates and these will be influenced by movements in their import prices and exchange rates. By using flexible nominal rates, the banks do of course protect the real rate they receive against unanticipated movements in global inflation, while, by syndicating loans, they spread the risks associated with individual loans.

Following the oil price rise in 1973–4 surpluses were concentrated in OPEC countries, which had a strong preference for placing excess revenues on the Eurocurrency market. At the same time the banks were more than willing to lend; this was the era of 'loan push'.

Certainly, looking back at the 1970s, it appears now that the banks overlent. With the benefit of hindsight, such overlending can be explained in a number of ways. With little recent evidence of country default, the banks probably underestimated the risks of lending. They probably lacked the information necessary to calculate such risks and may have misinterpreted what evidence they did have. They certainly seem to have miscalculated the impact of world recession and rising interest rates on the position of debtors. Beyond this, a belief that short-term lending would enable them to extricate themselves if necessary and a confidence generated by the fact that other banks were also lending, as well as a belief that banks would not be allowed to go bust by national and international regulatory authorities, all had the effect of reducing their perceived risks.

At the time, however, it was less easy to see that the banks were overlending. Many of the conventional debt indicators did not show any significant deterioration during the 1970s. Indeed it can be argued quite strongly that, had the world economy not moved into recession in the early 1980s, the debt problem might never have arisen, and bank lending to developing countries on the scale at which it occurred would have seemed appropriate *ex post* as well as *ex ante*. In either event it is difficult to blame the banks for a lack of perfect foresight, when nobody else possessed it.

By the early 1980s the OPEC surplus had fallen dramatically and the banks had become more sensitive to risk; indeed they were probably by now overstating the probability of default on the basis of the debt crisis in 1982. Furthermore many of the other causes of previous confidence had evaporated. The banks accepted that mistakes could be made, and recognised that their ability to get out of lending to LDCs was constrained largely because implicit guarantees turned out to be only partial. Meanwhile increasing bank

regulation and supervision as well as growing opportunities elsewhere also served to limit bank lending to developing countries. On the basis of these factors it is not unreasonable to suppose that the supply schedule of bank loans to developing countries shifted leftwards.

2.2 Credit rationing and credit-worthiness

If we turn to the credit-rationing approach, this might also suggest that in the period since the end of the 1970s the banks have become more aware of the risks of lending to developing countries, with the result that the supply schedule of loans has not only shifted to the left but has become increasingly inelastic. According to this approach, however, events in the late 1970s and 1980s are more appropriately illustrated by Figure 1.7, with the rate of interest being set at a maximum level where the demand for loans exceeds their supply and with the banks rationing loans on the basis of their assessment of credit-worthiness.

The course of events in the 1980s is consistent with just such a credit-rationing interpretation. Indeed, with the real rate of interest levelling off and the volume of loans declining during 1982–3, reality is perhaps more consistent with this explanation than with a market model under which interest rates would continue to rise as the level of business fell.

Many factors will affect credit-worthiness. These include a country's natural endowments, the degree of export and import diversification, export and import growth, the level of reserves, the volume and structure of debt and the past conduct of debt servicing, the scope for balance of payments correction and the willingness of the government to exploit it, the size of the domestic savings ratio, and the productivity of investment.

Essentially what the banks are trying to do is to estimate their chances of being repaid, and this depends both on the *ability* and *willingness* of borrowers to repay. A borrower's ability to repay depends on how productively loans are used and on whether the necessary foreign exchange can be earned. It also depends on the time profile of repayments as compared with foreign exchange earnings. Even where a borrower is basically solvent, liquidity problems may still be encountered, and banks may be even more concerned about this aspect of a borrower's position. Banks will search for variables which provide an early warning of liquidity crises, such as changes in the borrower's net foreign asset position, and the rate of domestic credit creation.

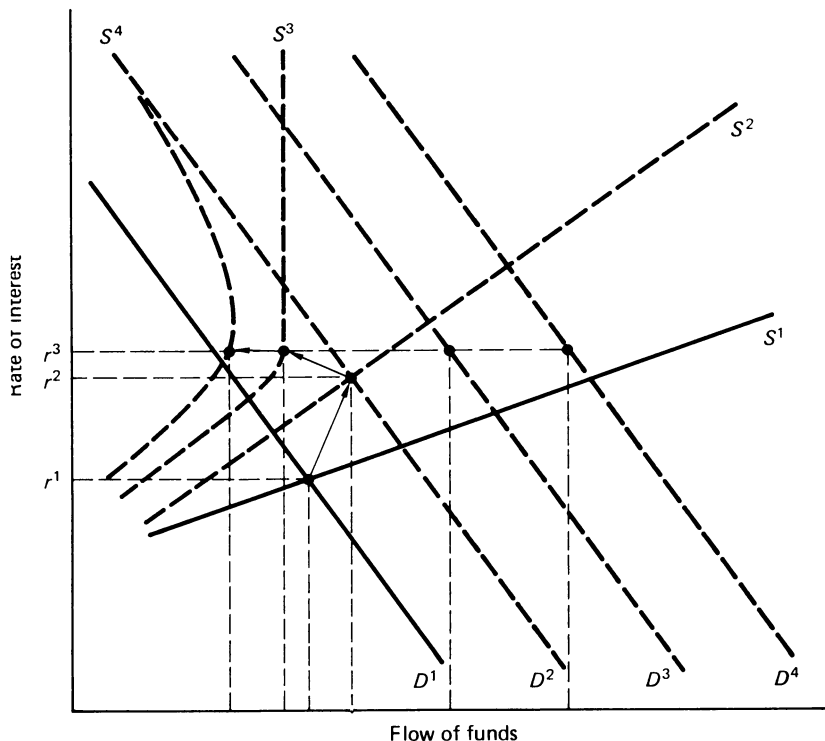


FIGURE 1.7

Note: This figure illustrates the credit-rationing approach described in the text, with the interest rate not rising above r^3 even under conditions of excess demand. At r^3 the banks are maximising their expected profit, bearing in mind the risks of default. Other ways of credit rationing are then used.

The willingness to repay depends on the borrower's assessment of the costs and benefits of defaulting. Banks may in general be less keen to lend to countries where the benefits from default are large, although usually if the benefits are large, the costs will be as well, with the result that the risks of default do not rise. In general, borrowers have shown a strong revealed preference to avoid default if at all possible. This suggests that borrowers as well as banks may be risk-averters.

3. THE SHORTCOMINGS OF BANK LENDING

Although it must be conceded that bank lending made a vital contribution to balance of payments financing after 1973, experience

has also revealed a number of shortcomings associated with it. These relate both to efficiency and equity.

However a prior question is whether the banks themselves will decide to remain in the business of balance of payments financing or whether, subject to the constraints imposed on them by the IMF and their desire to protect previous loans, they will try to pull out. A number of related factors are at work here. The first is the country risk.

The question is how the banks will assess risk in the future and whether the system may be modified so as to reduce risk. The IMF may have a role to play here. The second relates to banks' own risk and is affected by their degree of exposure in developing countries and their own capital-asset ratios. Commercial bank shareholders have become increasingly concerned that the banks have overlent to developing countries in general and to specific developing countries in particular.

Almost certainly the falling capital-asset ratios of the banks that occurred during the 1970s and early 1980s were seen by their shareholders and the various regulatory agencies as a weakening in their balance sheets. The banks therefore began to regard it as imprudent to allow the ratio to fall further if they were to retain confidence.

While the net exposure of the banks in developing countries has been small overall, net claims have been high in relation to developing country exports. Furthermore the growth in net exposure was rapid at the turn of the decade, rising by more than 600 per cent between 1977 and 1982. Moreover aggregation can be misleading. Most international lending has been concentrated in a relatively small number of banks and has been made to relatively few countries; for some American banks their loans to Brazil and Mexico alone have exceeded their total equity, and this has clearly made them reluctant to extend additional loans. For as long as other banks were prepared to enter the business of lending to developing countries, bank lending in aggregate was able to increase, but when such opportunities for expansion had been exploited, further growth relied on the elasticity of supply, and, as noted above, this may be low or negative.⁵

Considerations such as these lead back to the question of the efficiency of bank lending. World economic inefficiency will result if bank lending is unstable, if it is unrelated to the underlying productivity of resources throughout the world, and if there are external costs associated with it.

It is certainly unstable. The banks moved rapidly into balance of payments financing following the rise in the price of oil in 1973–4 and then endeavoured to extricate themselves in the 1980s. In general terms they were quick to lend to developing countries following the (temporary) upsurge in commodity prices, and anxious to reduce their lending as borrowers encountered declining terms of trade and debt difficulties. Such instability is enhanced by the tendency towards ‘herd behaviour’ that characterises the banking community. Withdrawal by one bank can quickly encourage other banks to follow suit rather than to offset the withdrawal by lending more themselves, or at least to maintain the level of their involvement. Indeed there is a problem in the sense that all banks will have an incentive to reduce exposure at the first whiff of repayment problems, yet not all of them will be able to do so, since such behaviour would certainly induce default.

As the above discussion implies, lending may be only loosely related to the underlying strength of an economy or the marginal productivity of resources. Banks may have imperfect information and may misinterpret what information they do have: they may be unduly influenced by transient and often largely cosmetic factors or, in syndicated loans, by the views and prestige of the ‘lead’ bank. This can of course work both ways. On some occasions banks may overlend, yet on others they may underlend. Either way, they are unlikely to allocate capital efficiently.

Furthermore factors which alter the credit-worthiness of one developing country can have an influence on the willingness of banks to lend to other countries, which is quite unrelated to their economic performance and prospects – the so-called contagion effect. For example, a fall in the price of oil will create debt problems for oil producers such as Mexico and Venezuela and will damage their credit rating with the banks. But as a result of debt problems in these countries the banks may become more risk-averse and less prepared to lend to other countries whose economic prospects actually improve as oil prices fall, because the price of a major import has fallen and because a falling oil price tends to increase world aggregate demand and therefore the demand for their exports. The lack of simultaneity in the debt-servicing capacity of borrowers suggests that such a response is irrational, though to the extent that the withdrawal of funds itself creates a liquidity, and perhaps with rising interest rates, even a solvency problem in the affected countries, it may seem rational after the event. Of course, some causes of debt difficulties, such as rising interest rates, may

affect all debtors simultaneously and, in these circumstances, a more uniform cross-country response would seem more logical; although, even here, the ability of borrowers to deal with rising interest rates may well vary.

Another externality associated with bank lending relates to its global consequences. If banks pull out from providing balance of payments finance and nobody else steps in to take their place, the result will be that borrowers will have to correct their deficits more rapidly. Rapid correction can be brought about by deflating domestic aggregate demand, and thus the demand for imports, or by introducing import controls. Either way, the countries that provide the imports will experience a reduction in their exports and a deterioration in their balance of payments, which they, in turn, may have to correct. A vicious circle of deflation, recession, protectionism and falling world trade can become entrenched, from which most countries stand to lose. Furthermore the mere uncertainty of bank lending may give rise to external costs.

At the same time, is it really the banks' responsibility to ensure that things do not go wrong in this way? They will undoubtedly see their principal responsibility as being to their shareholders, and they are likely to take the view that these interests are best served in an uncertain world environment by trying to maximise short-run private profits: it may be unreasonable to expect them to assume the global role of maximising world economic welfare.

The concept of welfare moves us on to the question of the distribution of bank lending. In aggregate terms this is heavily skewed, being concentrated in industrial countries and a narrow range of middle- and high-income developing countries. The banks have usually deemed low-income countries uncredit-worthy.

Again, however, it is unreasonable to criticise the banks for the inequitable distribution of their lending. After all, they are not charitable institutions. Indeed, on the contrary, they would be more open to criticism were they to lend to countries that seemed to have little chance of repaying the loans. At the same time, the elements of market failure remain, not only with respect to equity but also in terms of efficiency. If bank lending fails to meet the requirements of an efficient and equitable market solution, should so much of the recycling of world capital be left in their hands or should international agencies be more heavily involved?

4. CONCLUDING REMARKS

The policy implications of the discussion in this chapter may now be spelled out. Bank lending has been an important source of finance to some developing countries but has involved a number of problems. Factors influencing the size of banks' lending come from both the demand side and the supply side, although there is evidence to suggest that, particularly over recent years, supply-side factors have been more important. Policies need to be directed towards dealing with the problems associated with bank lending and need to address both the demand for and the supply of loans. Both efficiency and equity need to be taken into account. Because of market failure it may be appropriate to reduce the significance of bank lending to developing countries in the long term, although this poses the question of who takes over the financing role vacated by the banks.

STATISTICAL APPENDIX

TABLE A.1 *Baker 15 countries*¹: Net external financing flows (billions of dollars)

| | 1985 | 1986 ^e | 1987 ^f |
|-----------------------------------|------------|-------------------|-------------------|
| Current account balance | 0.7 | -12.7 | -15.9 |
| Non-debt-creating flows | 4.4 | 3.8 | 3.5 |
| External borrowing, net | <u>3.5</u> | <u>4.3</u> | <u>17.4</u> |
| IMF | 1.7 | 0.0 | -0.4 |
| Multilateral organisations | 4.4 | 4.8 | 6.1 |
| Official bilateral creditors | 2.1 | 2.2 | 4.2 |
| Commercial banks ² | -3.5 | -1.4 | 9.2 |
| (Interest, arrears, net) | (-1.4) | (0.5) | (5.0) |
| Other private creditors | -1.2 | -1.2 | -1.6 |
| Resident lending abroad | -3.6 | -1.7 | -1.1 |
| Errors and omissions | -3.0 | 0.1 | 0.0 |
| Change in reserves (- = increase) | -2.1 | 6.1 | -4.0 |

e = estimate, *f* = forecast

1. Includes Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia.

2. Excludes financing officially guaranteed by creditor countries.

SOURCE: The Institute of International Finance.

TABLE A.2 *Baker 15 countries: total external debt and international reserves (billions of dollars)*

| | 1985 | 1986 ^e | 1987 ^f |
|---|-------|-------------------|-------------------|
| Total external debt | 444.1 | 464.8 | 497.0 |
| Commercial banks ¹ | 283.1 | 287.8 | 302.5 |
| IMF | 17.4 | 19.5 | 20.8 |
| Multilateral Organisations | 34.5 | 39.4 | 45.5 |
| Official bilateral creditors | 72.4 | 80.9 | 90.8 |
| Other private creditors | 36.6 | 37.2 | 37.4 |
| % total debt: | | | |
| Commercial banks | 63.7 | 61.9 | 60.9 |
| IMF | 3.9 | 4.2 | 4.2 |
| Multilateral organisations | 7.8 | 8.5 | 9.2 |
| Official bilateral creditors | 16.3 | 17.4 | 18.3 |
| Other private creditors | 8.2 | 8.0 | 7.5 |
| International reserves (excluding gold) | 38.5 | 32.4 | 36.8 |

e = estimate. *f* = forecast

1. Excludes debt officially guaranteed by creditor countries.

SOURCE: The Institute of International Finance.

TABLE A.3 *Net debt flows: countries with IMF conditional programmes in 1986 (millions of dollars)*

| | Total | IMF | MDBs | Official Bilateral | Banks | Other Private |
|---------------------|-------|------|------|-----------------------|-------|------------------|
| Argentina | 689 | 163 | 417 | 172 | 709 | -772 |
| Bolivia | 544 | 139 | 152 | 139 | 114 | 0 |
| Chile ¹ | -15 | 119 | 436 | -448 | -265 | 143 |
| Colombia | 504 | 0 | 358 | 240 | 104 | -198 |
| Côte d'Ivoire | 58 | -52 | 175 | -70 | -20 | 25 |
| Ecuador | 796 | 83 | 445 | 58 | 253 | -43 |
| Mexico ² | 1242 | 753 | 893 | 1039 | -787 | -656 |
| Morocco | 191 | -300 | 270 | 95 | 126 | 0 |
| Philippines | 683 | 1 | 83 | 518 | 261 | -180 |
| Uruguay | 212 | 6 | 52 | 0 | -50 | 204 |
| Total | 4904 | 912 | 3281 | 1743 | 445 | -1477 |

1. Commercial bank financing includes \$969 million outflows in debt to equity conversions.

2. Commercial bank financing includes \$620 million outflows in debt to equity conversions.

SOURCE: The Institute of International Finance.

TABLE A.4 *Net debt flows: countries without IMF conditional programmes in 1986 (millions of dollars)*

| | <i>Total</i> | <i>IMF</i> | <i>MDBs</i> | <i>Official Bilateral</i> | <i>Banks</i> | <i>Other Private</i> |
|------------|--------------|-------------|-------------|-------------------------------|--------------|--------------------------|
| Brazil | -528 | -624 | 1138 | -575 | -300 | -167 |
| Nigeria | 1155 | 0 | 380 | 1402 | -710 | 83 |
| Peru | 520 | -14 | 42 | 207 | 251 | 34 |
| Venezuela | -676 | 0 | -44 | -207 | -567 | 142 |
| Yugoslavia | <u>-1023</u> | <u>-268</u> | <u>-12</u> | <u>-384</u> | <u>-549</u> | <u>190</u> |
| Total | -552 | -906 | 1504 | 443 | -1875 | 282 |

SOURCE: The Institute of International Finance.

TABLE A.5 *Market borrowing countries¹: net external financing flows (billions of dollars)*

| | <i>1985</i> | <i>1986^e</i> | <i>1987^f</i> |
|-----------------------------------|-------------|-------------------------|-------------------------|
| Current account balance | -15.3 | -14.0 | -13.1 |
| Non-debt-creating flows | 6.3 | 7.4 | 8.2 |
| External borrowing, net | <u>17.1</u> | <u>8.2</u> | <u>9.0</u> |
| IMF | -1.3 | -1.3 | -2.1 |
| Multilateral organisations | 4.1 | 5.0 | 5.8 |
| Official bilateral creditors | 1.2 | 0.6 | 2.2 |
| Commercial banks ² | 12.0 | 1.8 | 0.2 |
| Other private creditors | 1.1 | 2.1 | 2.9 |
| Resident lending abroad | -3.5 | -2.8 | -4.4 |
| Errors and omissions | 0.0 | 1.2 | 0.3 |
| Change in reserves (- = increase) | -4.7 | -0.1 | 0.0 |

e = estimate, *f* = forecast

1. Includes Algeria, Cameroon, GDR, Greece, Hungary, India, Indonesia, Korea, Malaysia, Pakistan, Portugal, Singapore, Thailand, Tunisia and Turkey.

2. Excludes financing officially guaranteed by creditor countries.

SOURCE: The Institute of International Finance.

TABLE A.6 *Market borrowing countries: total external debt and international reserves (billions of dollars)*

| | 1985 | 1986 ^e | 1987 ^f |
|---|--------------|-------------------|-------------------|
| Total external debt | <u>304.5</u> | <u>335.0</u> | <u>360.4</u> |
| Commercial banks ¹ | 141.2 | 151.5 | 157.9 |
| IMF | 11.1 | 11.1 | 9.9 |
| Multilateral organisations | 39.7 | 45.6 | 52.0 |
| Official bilateral creditors | 91.3 | 102.3 | 112.1 |
| Other private creditors | 21.2 | 24.6 | 28.5 |
| % total debt: | | | |
| Commercial banks ¹ | 46.4 | 45.2 | 43.8 |
| IMF | 3.6 | 3.3 | 2.7 |
| Multilateral organisations | 13.0 | 13.6 | 14.4 |
| Official bilateral creditors | 30.0 | 30.5 | 31.1 |
| Other private creditors | 7.0 | 7.3 | 7.9 |
| International reserves (excluding gold) | <u>51.1</u> | <u>52.7</u> | <u>53.6</u> |

e = estimate. *f* = forecast

1. Excludes debt officially guaranteed by creditor countries.

SOURCE: The Institute of International Finance.

TABLE A.7 Baker 15 countries: net external financing flows, 1986^e (\$ million)

| Country | Current Account | Non-Debt | IMF | MOBs | Govts | Banks | Other Private | Resident Lending | E & O | Reserve Change ¹ |
|---------------|-----------------|----------|------|------|-------|-------|---------------|------------------|-------|-----------------------------|
| Argentina | -2661 | 574 | 163 | 417 | 172 | 709 | -772 | -194 | 770 | 822 |
| Bolivia | -540 | 85 | 139 | 152 | 139 | 114 | 0 | -10 | -17 | -61 |
| Brazil | -2849 | -115 | -624 | 1138 | -575 | -300 | -167 | -102 | -242 | 3836 |
| Chile | -1106 | 334 | 119 | 436 | -448 | -265 | 143 | 743 | -64 | 109 |
| Colombia | 504 | 714 | 0 | 358 | 240 | 104 | -198 | -365 | -312 | -1046 |
| Côte d'Ivoire | -40 | 18 | -52 | 175 | -70 | -20 | 25 | 0 | 0 | -35 |
| Ecuador | -730 | 115 | 83 | 445 | 58 | 253 | -43 | 0 | -255 | 74 |
| Mexico | -1430 | 1066 | 753 | 893 | 1039 | -787 | -656 | 594 | -683 | -790 |
| Morocco | -270 | 90 | -300 | 270 | 95 | 126 | 0 | 0 | 0 | -10 |
| Nigeria | -1795 | 370 | 0 | 380 | 1402 | -710 | 83 | -111 | -200 | 580 |
| Peru | -1175 | 153 | -14 | 42 | 207 | 251 | 34 | 160 | -143 | 485 |
| Philippines | 816 | 320 | 1 | 83 | 518 | 261 | -180 | -550 | -101 | -1168 |
| Uruguay | 20 | 10 | 6 | 52 | 0 | -50 | 204 | 0 | 0 | -242 |
| Venezuela | -1628 | 19 | 0 | -44 | -207 | -567 | 142 | -1558 | 40 | 3803 |
| Yugoslavia | 226 | 0 | -268 | -12 | -384 | -549 | 190 | -271 | 1283 | -215 |
| Total | -12659 | 3753 | 7 | 4784 | 2186 | -1430 | -1194 | -1664 | 76 | 6141 |

^e = estimate

1. (- = increase in reserves)

SOURCE: The Institute of International Finance.

TABLE A.8 Baker 15 countries: total external debt and international reserves, 1986^e (\$ billion)

| Country | Total Debt | IMF | MOBs | Govts | Banks | Other Private | Official Reserves ¹ |
|---------------|------------|------|------|-------|-------|---------------|--------------------------------|
| Argentina | 53.0 | 2.7 | 2.5 | 7.2 | 33.6 | 7.0 | 2.4 |
| Bolivia | 4.5 | 0.2 | 1.0 | 1.7 | 1.4 | 0.1 | 0.3 |
| Brazil | 109.2 | 4.5 | 8.4 | 12.8 | 76.2 | 7.3 | 5.6 |
| Chile | 21.6 | 1.3 | 1.9 | 1.6 | 15.2 | 1.5 | 2.4 |
| Colombia | 15.0 | 0.0 | 3.9 | 2.4 | 7.7 | 1.1 | 2.8 |
| Côte d'Ivoire | 7.6 | 0.7 | 1.5 | 2.5 | 2.7 | 0.3 | 0.0 |
| Ecuador | 9.0 | 0.5 | 1.4 | 1.4 | 5.4 | 0.4 | 0.6 |
| Mexico | 100.4 | 4.1 | 6.8 | 9.5 | 73.5 | 6.4 | 5.7 |
| Morocco | 15.9 | 1.0 | 2.0 | 8.9 | 3.7 | 0.2 | 0.1 |
| Nigeria | 25.2 | 0.0 | 1.8 | 13.2 | 7.4 | 2.9 | 1.1 |
| Peru | 14.6 | 0.8 | 1.4 | 5.3 | 5.7 | 1.5 | 1.3 |
| Philippines | 28.3 | 1.2 | 3.5 | 7.0 | 15.2 | 1.3 | 1.7 |
| Uruguay | 5.2 | 0.4 | 0.3 | 0.3 | 2.2 | 2.0 | 0.4 |
| Venezuela | 34.1 | 0.0 | 0.2 | 1.0 | 29.4 | 3.6 | 6.4 |
| Yugoslavia | 21.1 | 2.1 | 2.7 | 6.2 | 8.6 | 1.6 | 1.5 |
| Total | 464.8 | 19.5 | 39.4 | 80.9 | 287.8 | 37.2 | 32.4 |

^e = estimate

1. Official international reserves excluding gold.
SOURCE: The Institute of International Finance.

TABLE A.9 Market borrowing countries: net external financing flows, 1986^a (\$ million)

| Country | Current Account | Non-Debt | IMF | MOBs | Govts | Banks | Other Private | Resident Lending | E & O | Reserve Change ¹ |
|-----------|-----------------|----------|-------|------|-------|-------|---------------|------------------|-------|-----------------------------|
| Algeria | -2185 | 0 | 0 | 50 | 150 | 675 | -25 | 0 | 0 | 1335 |
| Cameroon | -300 | 40 | 0 | 50 | -50 | 0 | 0 | 300 | 0 | -41 |
| GDR | 250 | 0 | 0 | 0 | -30 | 0 | -220 | 0 | 0 | 0 |
| Greece | -3100 | 1920 | 0 | 1143 | -143 | 268 | -6 | 348 | 0 | -430 |
| Hungary | -1400 | 0 | -13 | 177 | 300 | 1186 | 100 | -750 | 0 | 400 |
| India | -4480 | 320 | -399 | 1463 | 321 | 1200 | 1325 | 0 | 0 | 250 |
| Indonesia | -4610 | 310 | -49 | 846 | 1142 | 949 | -183 | 400 | 0 | 1195 |
| Korea | 4624 | 480 | -125 | 137 | -477 | -3505 | -140 | -450 | -240 | -303 |
| Malaysia | -481 | 578 | -105 | 39 | 429 | -140 | 280 | 500 | 0 | -1100 |
| Pakistan | -1145 | 640 | -266 | 234 | -16 | 654 | 100 | -30 | 85 | -255 |
| Portugal | 936 | 334 | 0 | 122 | -554 | -1309 | 246 | 0 | 224 | 0 |
| Singapore | 462 | 1788 | 0 | -14 | -60 | 761 | -86 | -2850 | 550 | -551 |
| Thailand | 27 | 457 | -143 | 146 | 46 | -723 | -178 | -50 | 594 | -276 |
| Tunisia | -795 | 200 | 175 | 95 | 75 | 130 | 0 | 0 | 0 | 121 |
| Turkey | -1840 | 360 | -386 | 550 | -525 | 1618 | 923 | -300 | 0 | -400 |
| Total | -14039 | 7427 | -1311 | 5038 | 608 | 1763 | 2138 | -2782 | 1213 | -55 |

e = estimate

1. (- = increase in reserves)

Source: The Institute of International Finance.

TABLE A.10 *Market borrowing countries: total external debt and international reserves, 1986^e*
 (\$ billion)

| Country | Total Debt | IMF | MOBs | Govts | Banks | Other Private | Official Reserves ¹ |
|----------------------|---------------|------|------|-------|-------|------------------|-----------------------------------|
| Algeria | 21.1 | 0.0 | 0.5 | 14.0 | 6.4 | 0.2 | 1.7 |
| Cameroon | 3.6 | 0.0 | 0.8 | 1.9 | 0.9 | 0.0 | 0.2 |
| GDR | 15.4 | 0.0 | 0.0 | 4.5 | 10.2 | 0.6 | 6.9 |
| Greece | 18.0 | 0.0 | 3.3 | 2.5 | 11.2 | 1.0 | 1.5 |
| Hungary ² | 14.6 | 1.1 | 0.5 | 1.6 | 10.7 | 0.8 | 2.5 |
| India | 47.0 | 4.4 | 13.9 | 12.5 | 10.1 | 6.1 | 6.8 |
| Indonesia | 43.9 | 0.0 | 5.9 | 20.8 | 15.7 | 1.4 | 4.1 |
| Korea | 44.7 | 1.5 | 4.6 | 10.2 | 27.7 | 0.7 | 3.3 |
| Malaysia | 22.4 | 0.0 | 1.2 | 5.1 | 13.0 | 3.0 | 6.0 |
| Pakistan | 15.2 | 1.2 | 3.2 | 7.9 | 2.2 | 0.8 | 0.9 |
| Portugal | 16.0 | 0.7 | 1.6 | 2.9 | 9.5 | 1.3 | 1.4 |
| Singapore | 17.2 | 0.0 | 0.1 | 1.3 | 14.1 | 1.7 | 12.9 |
| Thailand | 18.3 | 1.0 | 3.3 | 4.1 | 8.6 | 1.3 | 2.8 |
| Tunisia | 7.1 | 0.2 | 0.9 | 4.5 | 1.4 | 0.1 | 0.1 |
| Turkey | 30.4 | 1.1 | 5.8 | 8.3 | 9.7 | 5.6 | 1.5 |
| Total | 335.0 | 11.1 | 45.6 | 102.3 | 151.5 | 24.6 | 52.7 |

e = estimate

1. Official international reserves excluding gold.

2. Convertible currency external debt.

SOURCE: The Institute of International Finance.

TABLE A.11 Total external debt owed to commercial banks (\$ million)

| Country | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 ^c | 1987 ^t |
|---------------|--------|--------|--------|--------|--------|--------|-------------------|-------------------|
| Algeria | 6 860 | 6 180 | 5 239 | 4 715 | 4 728 | 5 335 | 6 378 | 7 108 |
| Argentina | 18 084 | 23 706 | 30 327 | 30 840 | 31 438 | 32 485 | 33 594 | 35 470 |
| Bolivia | 1 112 | 1 405 | 1 483 | 1 179 | 1 176 | 1 286 | 1 378 | 1 502 |
| Brazil | 48 354 | 57 406 | 66 530 | 71 946 | 76 975 | 74 829 | 76 210 | 82 683 |
| Cameroon | 854 | 770 | 886 | 773 | 731 | 835 | 920 | 1 082 |
| Chile | 8 289 | 12 737 | 13 805 | 13 981 | 15 323 | 15 444 | 15 240 | 14 874 |
| Colombia | 4 091 | 5 522 | 6 600 | 7 107 | 7 419 | 7 366 | 7 681 | 7 331 |
| Costa Rica | 1 203 | 1 363 | 1 531 | 1 675 | 1 736 | 1 732 | 1 772 | 1 705 |
| Dominican Rep | 831 | 993 | 872 | 874 | 869 | 914 | 872 | 859 |
| Ecuador | 3 477 | 4 293 | 4 551 | 4 896 | 4 902 | 5 127 | 5 394 | 5 756 |
| Egypt | 4 106 | 4 896 | 5 594 | 6 217 | 6 573 | 6 491 | 6 190 | 6 279 |
| GDR* | 9 030 | 9 830 | 7 721 | 7 188 | 6 748 | 9 003 | 10 234 | 11 167 |
| Greece | 3 650 | 4 342 | 5 683 | 6 548 | 8 095 | 10 459 | 11 203 | 10 911 |
| Hungary* | 8 721 | 8 228 | 6 319 | 6 621 | 6 758 | 8 826 | 10 658 | 12 272 |
| India | 313 | 1 134 | 1 973 | 4 104 | 5 903 | 8 348 | 10 088 | 11 799 |
| Indonesia | 6 433 | 7 211 | 10 098 | 12 721 | 13 116 | 13 874 | 15 673 | 16 316 |
| Ivory Coast | 2 543 | 2 739 | 2 802 | 2 735 | 2 202 | 2 439 | 2 682 | 2 872 |
| Jamaica | 525 | 486 | 513 | 482 | 489 | 508 | 513 | 518 |
| Kenya | 746 | 687 | 545 | 557 | 461 | 446 | 469 | 485 |
| Korea | 15 122 | 18 688 | 22 146 | 25 469 | 27 246 | 30 224 | 27 721 | 24 437 |
| Malaysia | 3 135 | 4 848 | 7 282 | 9 293 | 11 016 | 12 068 | 13 046 | 13 878 |
| Mexico | 42 004 | 58 057 | 67 252 | 71 023 | 72 930 | 73 131 | 73 492 | 78 642 |

TABLE A.11—continued

| Country | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 ^c | 1987 ^f |
|--------------|---------|---------|---------|---------|---------|---------|-------------------|-------------------|
| Morocco | 3 121 | 3 230 | 3 317 | 3 357 | 3 445 | 3 521 | 3 704 | 3 625 |
| Nigeria | 3 446 | 4 487 | 6 387 | 7 849 | 8 542 | 7 979 | 7 397 | 8 021 |
| Pakistan | 698 | 625 | 912 | 1 000 | 1 002 | 1 446 | 2 181 | 2 452 |
| Paraguay | 270 | 431 | 492 | 541 | 572 | 508 | 553 | 586 |
| Peru | 3 828 | 4 027 | 5 336 | 5 145 | 5 265 | 5 279 | 5 702 | 6 182 |
| Philippines | 10 122 | 12 929 | 16 141 | 14 860 | 14 983 | 14 211 | 15 231 | 15 689 |
| Portugal | 4 917 | 6 872 | 9 230 | 8 932 | 9 451 | 10 395 | 9 500 | 9 145 |
| Singapore | 3 992 | 6 881 | 7 216 | 9 118 | 11 542 | 13 012 | 14 099 | 15 338 |
| South Africa | 4 445 | 8 839 | 11 966 | 16 068 | 16 841 | 15 006 | 14 399 | 13 804 |
| Taiwan | 6 306 | 6 127 | 6 183 | 6 507 | 5 623 | 5 207 | 8 254 | 8 040 |
| Thailand | 4 263 | 5 972 | 6 325 | 6 861 | 8 098 | 8 937 | 8 644 | 9 162 |
| Tunisia | 1 267 | 1 123 | 1 079 | 1 002 | 965 | 1 181 | 1 447 | 1 696 |
| Turkey | 4 189 | 3 886 | 3 752 | 4 063 | 5 573 | 7 300 | 9 685 | 11 156 |
| Uruguay | 615 | 968 | 1 962 | 2 246 | 2 389 | 2 230 | 2 180 | 2 225 |
| Venezuela | 24 948 | 26 930 | 30 849 | 30 885 | 29 942 | 29 357 | 29 355 | 28 853 |
| Yugoslavia* | 7 727 | 7 699 | 7 620 | 8 057 | 7 578 | 8 417 | 8 596 | 8 739 |
| Zaire | 631 | 532 | 590 | 517 | 521 | 694 | 936 | 1 065 |
| Zambia | 449 | 413 | 422 | 357 | 426 | 533 | 426 | 383 |
| Total | 274 719 | 337 495 | 389 530 | 418 309 | 439 592 | 456 383 | 473 697 | 494 104 |

e = estimate *f* = forecast * Convertible currency

SOURCE: The Institute of International Finance.

2 New Approaches to Country Risk Assessment

During the 1970s and 1980s private banks made a very significant contribution to financing the balance of payments deficits of certain developing and other countries. However, as the figures in Table 2.1 reveal, following the debt difficulties of 1982 the banks have been endeavouring to extricate themselves from such lending.

Their unwillingness to lend creates problems if other lenders are not prepared, or able, to take their place, and if the financing needs of developing countries remain substantial, as indeed most projections suggest. Should these needs not be met the implications are clear. Developing countries will have to reduce their demand for foreign exchange by compressing imports, either through controls or through the contraction of domestic demand. Such policies mean not only sacrifices in living standards in the countries pursuing them, but also knock-on adverse effects in other countries which supply the imports and therefore now experience a decline in their export demand. The global effect is therefore deflationary.

Against such a background this chapter examines the lending policies of the banks and asks whether the ways in which country risks have been assessed have been satisfactory. Since the conclusion reached is that they have not, the chapter goes on to propose reforms to risk analysis; the argument being that the adoption of such reforms would result in a more stable, sustainable and predictable flow of bank finance to developing countries.

1. THE OUTLOOK FOR BANK LENDING

The prospects for any increase in voluntary lending by the banks must, at present, be regarded with some doubt. While this doubt is

TABLE 2.1 *Net financing flows to developing countries in selected years*

| <i>Type of flow</i> | <i>Amount (billions of dollars at constant prices)</i> | | |
|--|--|-------------|-------------|
| | <i>1980</i> | <i>1984</i> | <i>1985</i> |
| Official development assistance | 23.4 | 21.6 | 22.4 |
| Non-concessional loans | 47.1 | 33.4 | 28.9 |
| Official | 8.7 | 13.9 | 14.0 |
| Private ¹ | 38.4 | 19.5 | 15.0 |
| Direct investment | 10.6 | 10.8 | 11.0 |
| Total | 81.1 | 65.9 | 62.3 |
| Memo items | | | |
| Net export of goods and nonfactor services | -92.8 | -61.9 | -66.5 |
| Current account balance ² | -67.8 | -35.3 | -41.3 |

1. Mainly commercial banks.

2. Exclude official transfers.

SOURCE: *World Development Report 1986. Table 3.5*

partly based on the current perception of the risks associated with such lending in an environment of fluctuating interest rates and exchange rates, there are other influences at work as well.

First, if industrial countries move out of recession the opportunities for many lenders to expand their domestic lending will rise. With an acceptable risk-adjusted rate of return available on such loans, developing country borrowers will have to offer higher rates in order to appear competitive.

Second, many banks are looking to cut back their exposures in developing countries, feeling that they became too heavily engaged in such long-term lending in the 1970s. In combination with this, banks are concerned about their capital-asset ratios and, in any case, banking regulation in relation to overseas lending has become more constraining. While there may be scope for short-term trade-related finance where the fees and spreads may currently be more attractive, banks are looking to shift the maturity distribution of their loans away from the longer end of the spectrum.¹

Third, lenders are apprehensive about what will happen when IMF programmes in the borrowing countries have run their course. The worry is that the period of externally imposed discipline

characterising the period since 1982 will be superseded by a period of indiscipline.

Finally, lenders have become much more sensitive to the implications for developing country borrowers of global economic developments. Although these may have differential effects on different countries, the chances of a further fall in oil prices, or of increasing protectionism, or of high interest rates all militate against extra lending.

Many bankers remain unperturbed by this outlook since they argue that the failure of supply to expand will be marked by an equivalent lack of growth in demand. Forecasting the future demand for cross-border loans is itself an uncertain exercise. One suspects, however, that it would be a mistake to put too much emphasis on the balance of payments improvements achieved by many of the major borrowers in 1984. Continued export expansion cannot be relied upon, and there are limits to the compression of imports. Furthermore it needs to be recognised that the balance of payments is an *ex post* concept. To say that it is possible to pursue policy in such a way that there is no foreign exchange gap is not to say that there is no demand for foreign loans. A more reasonable claim would be that the ability of many developing country governments to realise the aspirations of their peoples will remain constrained by their impaired ability to attract private capital.

Against this somewhat bleak outlook, however, it should be remembered that banks and other lenders are anxious to make profitable loans. If developing countries can offer lenders high expected returns, the flow of funds is likely to be forthcoming. The issue comes back to the question of risk analysis.

2. COUNTRY RISK ANALYSIS

Although most commonly discussed in the context of bank lending to developing countries, country risk analysis is relevant to many other forms of lending as well. However, in this section, attention will be focused on the activities of the banks. Furthermore while, for simplicity, much of the discussion will imply that banks have a common approach, it needs to be recognised that, in practice, there are significant differences in terms of the range of variables considered when assessing risk, the way in which they are interpreted,

and the weighting or 'scores' allocated to them in reaching final decisions.

In addition to there being differences across banks, there have been discernible differences over time. Having received relatively little attention during the 1970s, methods of risk analysis have become more refined since 1982 when banks began to devote more resources to the evaluation of country risk. (Although to some extent involuntary lending has effectively replaced credit assessment.) Perhaps not surprisingly, banks are reluctant to provide precise information about their methods of assessment, but a survey of published information about banks' risk analysis undertaken for the Group of Thirty in 1982 is instructive, and is summarised in Table 2.2.

A number of comments concerning this table are in order. First, as noted above, 1982 was something of a watershed in the practice of risk assessment and things may well have changed since the research upon which this table is based was undertaken – more on this later. Second, not all banks will consult all the factors identified, some certainly work on the basis of a much shorter list. Third, the list of factors is not comprehensive. Even casual conversations with bankers reveal that other variables, not included in the table, have been examined in some cases.

However, even accepting these reservations, certain insights may be gained from an examination of Table 2.2. Broadly speaking, variables may be subdivided into economic and political categories. The most commonly used economic indicators include the level of debt in relation to exports or GNP, the debt service ratio, the current account of the balance of payments, the level of reserves in relation to imports, and economic growth. Political indicators tend to be rather judgemental, although some banks employ political risk analysts and approach the question in a more objective and structured fashion. Whatever the exact mechanism used, most bankers feel that risk analysis is an 'art' rather than a 'science', and this has important implications in an environment where it is hoped to alter lenders' attitudes and perceptions.

On the basis of interviews with bankers it would seem that, in general, there have been few changes in the range of variables consulted since the list in Table 2.2 was compiled. The principal changes reported are a greater emphasis on co-variance amongst debtors and a growing tendency to group countries together on the basis of geography, and a more sophisticated approach to risk which

now interprets it as the probability of losing a certain proportion of a loan rather than all of it. There would appear to be a growing emphasis on the return/risk trade-off, and on the fact that different lines of business involve different return/risk combinations.

3. CRITICISMS OF BANK TECHNIQUES

Although it should be conceded that the discussion above is a somewhat superficial caricature of the risk analysis undertaken by bankers, a number of criticisms may be made of it.

First, its theoretical and statistical foundations are difficult to define. One might charitably call the approach eclectic, but there seems to have been little attempt to test the methods used in any rigorous fashion. Having said this, much of the theoretical analysis of debt is seen by bankers as being of little practical relevance to them, and what statistical research has been carried out has had very limited success in predicting which countries are likely to encounter debt difficulties.² There does, however, seem to be a vacuum to be filled in providing a more scientific approach to risk analysis.

Second, many of the economic indicators which banks focus on are either essentially static (such as debt ratios) or seem to bear only a somewhat loose or tenuous connection to risk (such as GNP or reserve level). Furthermore, given the perception of 'crisis' and the banks' preferences for short-term lending, the emphasis seems to be placed on countries' liquidity positions rather than on their longer-term solvency.

Third, the distinction between the *ability* to service debt and the *willingness* to do so may be largely illusory. Although economic theorists have made much of the separation between them, willingness and ability might be more realistically seen as being positively related.³ This, in turn, has implications for the distinction between economic and political factors. Is very much to be gained by examining political factors separately? Not only is it exceedingly difficult to evaluate them in any scientific way, but also it may be argued that political factors are in any case usually proxied by economic variables.

Finally, claims that the banks overlent in the 1970s and have been underlending in the period since 1982 imply that the methods of risk assessment used by them are unsatisfactory. Although this begs

TABLE 2.2—continued

| Measure ¹ | Systems Reviewed | | | | | | | | | | | |
|--------------------------------------|------------------|---|---|---|---|---|---|----|----|----|---|---|
| | A | B | C | D | E | F | G | H* | I | J* | K | L |
| Ability of government officers | | × | | | | × | × | × | | | × | × |
| Flexibility of the political systems | | × | | | | | | × | | | | |
| External relations | | × | | | | × | | × | × | | × | |
| Minority groups | | × | × | | × | | × | | × | | × | × |
| Religious problems | | × | | | × | | × | | × | × | | |
| Unemployment | | × | × | | | | × | | | | × | |
| External ethnic problems | | × | | × | | | × | | × | | × | |
| Government support | | | × | | | | × | | | | | × |
| Type of system | | | × | | | | × | × | NA | | × | |
| Opposition groups | | | | | | × | × | | × | | × | |
| Wealth disparity | | | × | | | | × | | × | | × | |

1. In some cases similar measures from two or more systems are grouped together under one heading. For example, 'Income per capita and Income growth' are taken in terms of either GNP or GDP.

* Systems *H* and *J* allude to a comprehensive political analysis but factors are shown above only where detailed in the articles.

Key to the systems reviewed:

A Feder/Ross: World Bank (G. Feder and K. Ross) 1977

B C. M. North, University of South Carolina, Ex First National Bank of Chicago

C J. N. Robinson, Chase Manhattan Bank NA (1981)

D K. Janoeri, Union Bank of Switzerland (1980)

E Amsterdam and Rotterdam Bank NW (1981)

F Business International Country Risk Assessment Service (1981)

G P. J. Nagy, Bank of Montreal (1978)

H H. R. Heller, Bank of America (1980)

I P. Gutmann, National Westminster Bank Ltd. (1980)

J American Express Bank (1980)

K A. Von Agtmael, Bankers Trust Co. (1976)

L C. Johnson, Lloyds Bank (1985)

SOURCES: Group of Thirty (1982), C. Johnson (1985).

the awkward question of what is the optimum quantity of lending, it is undeniable that current methods of assessment have failed to prevent mistakes from being made.

4. PROPOSALS FOR REFORM

A critical evaluation of risk analysis leads on to the question of how things might be improved. One approach would be to undertake a series of statistical tests to identify which variables best anticipate and predict debt-servicing difficulties and with what length of lag. A second approach is to try and identify *a priori* what factors are likely to determine whether a country will encounter difficulties in meeting its obligations and then to isolate quantifiable measures of these determinants.

Without constructing a formal model of debt capacity it is possible to suggest what some of these factors may be. A key factor is the future capacity of the borrower to generate net foreign exchange. Important determinants of credit-worthiness are therefore those that influence foreign exchange earnings and expenditures. Furthermore the intertemporal dimension needs accentuating. Risk relates to events and developments in the future. In this context it is interesting to note that banks have generally been reluctant to engage in forecasting, viewing this as being subject to an unacceptable degree of error. They have preferred to concentrate on current statistical indicators. One cannot deny the problems associated with forecasting. For example, an expectation that oil prices would stabilise in the early 1980s, and might even rise, brought with it an assessment of Mexico's credit-worthiness which was unjustified by subsequent events.⁴

However, while such specific forecasting may be problematic, it is possible to assess countries' vulnerability and sensitivity to different outcomes. A range of scenarios can then be considered and a range of possible outcomes contemplated. The more sensitive a country is to the different scenarios the greater will be the risks of lending in terms of the standard deviation from a central scenario. Consideration of a number of scenarios may enable banks to make some allowances for an uncertain future, without having to forecast the most probable outcome. Some banks are beginning to employ such sensitivity analysis but it has in no sense replaced the more conventional approach to risk assessment.

Ability to service future debt obligations will, in essence, be affected by four groups of factors which may be summarised as structural factors, policy-related variables, the scope for adjustment, and vulnerability. What is being evaluated is the chance that balance of payments difficulties will occur and that, should they occur, appropriate corrective action will be taken.

4.1 Structural factors

These include the structure and pattern of production and trade, the type of imports and exports, and their respective income elasticities. Countries with a low degree of structural flexibility, and producing and exporting goods which have relatively low income elasticities of demand are likely to encounter structural balance of payments difficulties.

A further structural indicator is the savings ratio. Many growth theories, as well as models of debt capacity, identify this as an important variable and indeed, there is some empirical evidence to suggest that it has a significant bearing on the subsequent development of debt problems.⁵ However, while information on the savings ratio clearly says something about the distribution of resources between consumption and investment, and therefore about future growth prospects, it may also be necessary to have information about the distribution of investment and the productivity of investment across sectors. Incremental capital–output ratios (ICORs) will vary in different industries, though it needs to be recognised that they may also fail to measure accurately the contribution of different types of investment to the growth process. There is the familiar claim, for instance, that investment in infrastructure makes a greater contribution than a narrow ICOR might suggest.

4.2 Policy-related variables

Given the central importance of the future outlook for the current account of the balance of payments in analysing country risk, a significant policy variable will be the real exchange rate. Countries where the real exchange rate becomes overvalued, because of a failure to modify the nominal exchange rate in the light of domestic rates of inflation, may be expected to encounter payments problems.

This, of course, presupposes that the relevant foreign trade elasticities are sufficiently high to comply with the Marshall-Lerner conditions for the type of country under examination. Many developing country governments have shown reluctance to devalue, ostensibly because of price elasticity pessimism. However examination of much of the available evidence suggests that such pessimism is generally unfounded.⁶ For the small country case the condition that the sum of the import demand elasticity and the export supply elasticity is greater than zero seems likely to be fulfilled.

Although many bankers monitor inflation rates, the monitoring is only very rarely associated with a formal examination of its effect on the country's real exchange rate. This is a significant shortcoming since real exchange rate movements are not perfectly reflected by variations in domestic inflation. Other important issues are: what is happening to the nominal exchange rate, what is the sectoral structure of inflation, and what is happening to inflation in competing countries? Narrow concentration on domestic inflation implies at best a rather uncritical and probably unjustified acceptance of relative purchasing power parity theory, with inflation standing as a proxy for deviations from this parity.

There are other reasons why the real exchange rate should be given more prominence in risk analysis. First, most studies confirm the *a priori* assumption that foreign trade elasticities are higher in the long run than in the short run.⁷ This means that examination of the contemporaneous real exchange rate provides some insight into future balance of payments performance. Second, the behaviour of the real exchange rate gives an indication of the general quality of macroeconomic management in the country concerned. Third, the real exchange rate has implications for structural change within the economy by creating appropriate price incentives. Furthermore, to the extent that there is a positive correlation between those goods that have relatively high price elasticities of export supply and those that have relatively high income elasticities of demand, exchange rate policy will have additional implications for the future evolution of a country's balance of payments. Finally, since international agencies such as the IMF and the World Bank emphasise the importance of the exchange rate, greater attention to it by the banks would facilitate closer co-operation between official and private lenders.

The bankers' response to these arguments is that it is difficult to get an accurate measure of real exchange rates. Basically they claim

that there is a data deficiency. However, if this is true, it would seem to be an argument for endeavouring to collect and present better data rather than for ignoring the real exchange rate. Such information may now be more easily provided under the auspices of the bankers' own Institute of International Finance (IIF) in consultation with the Fund and the Bank.

In addition to the real exchange rate, the fiscal deficit is another important policy variable which should be included in potential lenders' country risk analysis. Again, there are a number of reasons why. First, irrespective of whether an absorption or monetary approach to the balance of payments is adopted the size of the fiscal deficit emerges, in principle, as having a significant impact. Second, there is some empirical evidence, as well as *a priori* reasoning, to support the view that balance of payments deficits are connected with the size of fiscal deficits.⁸ Even though other factors, such as movements in a country's terms of trade, are important, the effects of the fiscal deficit on the balance of payments cannot be ignored.

Third, variation in the fiscal deficit would appear to occur ahead of, or to lead, variations in the balance of payments. As in the case of the real exchange rate, therefore, information on the fiscal deficit may provide an early warning of difficulties in servicing debt and in meeting future obligations.⁹ Fourth, and again as in the case of the real exchange rate, the fiscal deficit is a policy variable which is frequently included in negotiations with the IMF. For the banks to give more attention to it could offer more uniformity in approaches to country risk analysis. Finally, the status of the fiscal balance is not unconnected with changes in monetary aggregates and interest rates which, in turn, may have implications for structural developments within the economy.

Indeed there are arguments for giving more specific emphasis to the rate of interest in assessing country risk, as well as to the relationship between the rate of interest and the marginal productivity of capital. Theories of debt capacity identify this relationship as a fundamental determinant of the ease with which countries will be able to meet their future debt-related obligations. Furthermore the level of interest rates has a bearing on the generation of domestic saving and therefore has structural implications. Along with the exchange rate, the level of interest rates will also affect the size of capital flight. Countries anxious to re-attract such capital cannot, therefore, afford to ignore the level of domestic interest rates. However it also needs to be recognised that interest rate policy can

have distributional consequences. Credit policy should not be viewed as an exclusively macroeconomic policy instrument but also as one that can be used to foster certain sectors of the economy which may make a significant contribution to the balance of payments in future years.

It emerges from the above discussion that, although the real exchange rate, the fiscal deficit, and the level of interest rates have been referred to as policy variables, they are variables that have a significant impact on some of the structural features of the economy discussed earlier. As a result, inappropriate policies will not only have an adverse effect on the balance of payments contemporaneously but are also likely to have detrimental effects on its future performance and, in this regard, should be of particular concern when assessing country risk. Balance of payments accounting conventions may be used to double check any forecasts made on the basis of export and import performance, the savings ratio and the fiscal deficit.

4.3 The scope for adjustment

While, in principle at least, it is relatively easy to monitor many of the structural and policy-related variables mentioned up to now, it is more difficult to form a view as to how likely a future government is to take appropriate corrective action should the need arise. It is here that it may become tempting for lenders to undertake some, albeit judgemental, analysis of likely political developments and responses. On the other hand, knowledge of the values of certain economic coefficients, such as the import coefficient, may help in assessing the costs of various adjustment options.¹⁰ It is often argued that the least developed countries find adjustment particularly costly and difficult to implement because of the rudimentary nature of many of their markets and because of structural inflexibility. In other better-off developing countries adjustment might be much easier to implement and might be less costly in terms of the required sacrifice of domestic economic policy objectives. It may then be assumed that political support for adjustment will be positively related to the ease of implementation and negatively related to the costs of adjustment. If this is the case, there may be less need to undertake any direct assessment of political factors. Of course it has to be accepted that political aspects cannot always be legitimately

viewed as an exclusive function of economic variables. Events in some parts of the world suggest that other influences can exert an impact. Lenders may alternatively gain some insight into the likelihood that adjustment will be pursued by examining the history of countries' efforts. Countries that have found it difficult to adjust in the past may continue to find difficulties in the future.

There will, however, always be problems in endeavouring to predict a future government's commitment to adjustment, and doubts about this will affect the willingness of lenders to lend. As noted earlier, fear of undisciplined economic policies being pursued when IMF programmes come to an end has been one reason why banks have been unenthusiastic about making new loans to developing countries. One way out of the conundrum might be to reduce this element of risk by requiring borrowers to accept an arrangement whereby, should economic performance deteriorate in certain specified ways, they will turn to the Fund (or the World Bank) and negotiate a programme of policies supported by the Fund (or the Bank). Such arrangements have been used as a short-term device for facilitating rescheduling, but could be considered as a more permanent way of encouraging future private financial flows. Again the idea is to reduce one element of country risk as perceived by potential lenders.

4.4 Vulnerability

Concern over how countries might respond to balance of payments difficulties presupposes that such difficulties arise. The likelihood that they will depends to some extent on how vulnerable a country is to external shocks. Such vulnerability in turn depends on the types of goods imported and exported, the degree of export concentration, the variability in the prices of strategic exports and imports, the level of debt and the variability in world interest rates. The greater is a country's vulnerability to externally caused variations in its terms of trade or interest rates the greater are the risks associated with lending to it.

Given the vulnerability features identified above, lenders have basically two approaches to assessing their impact on country risk. The first is simply to view them as adding to uncertainty and count them as a negative element. The second is to attempt to forecast future trends in commodity prices and world interest rates and

calculate the effects of these trends on the balance of payments of specific countries. After all, there is some advantage rather than disadvantage in concentrating on the production and export of a good, the demand for which and price of which rise. However, given the problems with forecasting, such an exercise is itself risky. The scenario approach discussed earlier in this chapter would seem therefore to be a more appropriate way of dealing with the problem of vulnerability. Lenders can then reach a view on what would need to happen to commodity prices or interest rates before it created difficulties for the borrower.

Policy variables may also be significant in discussing vulnerability since measures designed to promote diversification, to the extent that they are thought likely to be successful, may themselves be interpreted as reducing risk.

5. ADVANTAGES FROM REFORM

On the basis of the discussion in the previous section, banks would emerge with a rather different list of variables that they would consult in order to evaluate country risk than the list upon which they seem to concentrate at present. Although it may be difficult to wean them away from their concern over levels of debt, reserves and national income, and indeed it should not be argued that these statistics are completely unhelpful, a better thought-out approach to risk analysis should yield advantages for the banks, in terms of higher profits.

Other advantages would be the following. First, there might be greater uniformity amongst banks in risk assessment. Countries would then have a clearer idea of what policies would serve to raise their credit-worthiness. As things stand, countries may not possess such information and, to the extent that they do, there may be very little that they can do to affect potential lenders' perceptions of the risks of lending to them, since these are based on indicators such as the ratio of debt to GNP which it is difficult to alter in the short term. Greater uniformity might also be achieved if research into methods of risk analysis were to be undertaken by the IIF with the conclusions then being made available to individual banks. While banks clearly remain independent organisations, and will wish ultimately to reach their own conclusions about country risk, scope for a better co-ordinated approach still exists.

Second, general agreement on a set of risk indicators would reduce the susceptibility of lending behaviour to waves of optimism and pessimism. The destabilising effects of 'disaster myopia' might thereby be somewhat neutralised and a rather more scientific approach adopted which is based on the 'real' situation. Having said this, it would be unrealistic to suppose that differences in the interpretation of a range of given values could be eliminated. Perceptions and 'feel' will remain a crucial element in lending decisions.

Third, use of the indicators discussed here would eliminate any tendency to overestimate the co-variance of debt problems. Unless debt problems are caused by common external factors which affect all borrowers alike, there is little rational reason to believe that geographical proximity should have any great influence over the analysis of risk.

While the indicators discussed here have only rather loosely been defended in terms of their theoretical foundations, there is a gradually emerging literature based on the experience since the early 1970s which appears to confirm that the structural characteristics of countries, combined with the conduct of economic policy in terms of exchange rate policy, and the management of aggregate demand, primarily through the fiscal balance, are important determinants of the balance of payments and the incidence of debt problems.¹¹

6. CONCLUDING REMARKS

This chapter has suggested that benefits are to be gained from reforming the methods of country risk analysis used by the banks. These benefits, although significant, should not, however, be overstressed. The reforms are primarily addressed towards improving the underlying economic rationality and stability of bank lending rather than increasing the flow of such finance.

Furthermore to suggest that there is scope for improving the decision making of the banks in their lending policies is not to argue that reform needs to focus *only* on the banks. There are things that governments can do to influence their own credit-worthiness as perceived by potential lenders. There are also things that the official sector can do to support and assist bank lending as well as, on occasions, to act as an alternative to it.

Perhaps, particularly in the case of the world's poorest countries, improved techniques of risk assessment are unlikely to lead to substantial inflows of bank finance. These countries, at their current stage of development, require concessionary rather more than commercial assistance. However, by raising the efficiency of the private sector, more flexibility may be created for the official sector to assist these less advantaged economies.

3 Commercial Bank Provisioning against Claims on Developing Countries

1. INTRODUCTION

Although this chapter focuses on 'provisioning' by commercial banks against their loans to developing countries, it is important to put this development into the general context of the evolving Third World debt problem. As is well catalogued in the literature, the seeds of this problem were, in many ways, sown following the first major hike in oil prices in 1973. Developing countries facing large balance of payments deficits were attracted to the alternative of financing which enabled them to adopt a slower speed of adjustment than would otherwise have been necessary. Even some oil-rich countries were encouraged to borrow on the strength of their oil resources. The required financing was, in large measure, provided through the intermediation of the private international banks with the official sector adopting a relatively muted role.¹

By 1982, however, there were visible signs that this spate of lending had problems associated with it. Mexico announced that it would be unable to meet its debt obligations and the debt 'crisis' became a matter of wide public debate and concern. A series of potential reforms were put forward by various commentators, but, in practical terms, the crisis has been largely managed by a combination of adjustment in the debtor countries and rescheduling.

Initially there were some indications that this policy approach, applied in a flexible fashion, would prove adequate, and there were even press reports in late 1984 and early 1985 suggesting that the crisis was over. However, such optimism was short lived and, in retrospect, depended crucially on the ability of the United States to sustain the rapid economic growth it had achieved during 1984. By

the mid-1980s there were many signs that the global debt problem was in fact getting worse rather than better, and some signs that the debtor countries might begin to adopt a somewhat more aggressive posture in their negotiations with creditors. In July 1985, for example, Peru's government announced that it would limit its payments of principal and interest to a maximum of 10 per cent of the country's export earnings.

Towards the end of 1985 the United States endeavoured to seize some of the initiative by putting forward a set of proposals, the Baker Plan, designed to encourage more lending to heavily indebted developing countries in return for structural adjustment within them. In practice the Plan had very little discernible impact on the quantity of financial flows. With much of 1986 being dominated by eventually successful attempts by creditors to negotiate an acceptable package of policies with Mexico, under the auspices of the IMF, February 1987 saw Brazil suspending interest rate payments on part of its international debt.

It was against this background that Citicorp decided to add \$3 billion to its existing loan loss reserves in May 1987; a move which was fairly quickly matched by other money centre banks in the United States and by many international banks elsewhere.

While broader reviews of the commercial banks' role in the Third World debt issue are already available (Sachs and Huizinga, 1987) this chapter sets out to examine various aspects of this spate of commercial bank provisioning. It is divided into four principal parts. Section 2 examines the nature and extent of provisioning, drawing out the differences that exist between countries, and explaining the implications of provisioning for banks' balance sheets. Section 3 looks at the various factors affecting the decision to provision, and tries to differentiate between those of a long term and secular type and those of more short term and proximate relevance. Section 4 examines the implications of provisioning for both creditors and debtors. Section 5 raises the question of whether provisioning has been adequate. A concluding section endeavours to set provisioning into the broader perspective of resolving the Third World debt problem.

2. THE FACTUAL AND STATISTICAL BACKGROUND TO PROVISIONING

Although the phrases are sometimes used interchangeably, there is an important distinction between writing off, writing down and

provisioning against loans. In the case of writing off or writing down a loan, the creditor institution reduces the book value of the asset in its balance sheet, to a level which reflects its net present value more accurately. In general, banks have been reluctant to write down loans and have only done this against claims on a fairly narrow range of countries. Instead, what they have done is to 'provision' against certain loans by putting aside reserves in low earning but risk free assets in order to cover the possibility that repayments of principal or payments of interest might not be made. Extra provisioning therefore is the same thing as building up loan loss reserves.

These reserves may be 'general' or 'specific'. The former represent the normal business practice of allowing for the fact that there is a statistical probability that a certain proportion of loans will encounter problems. Specific provisions are, however, set aside against loans to a particular country or group of countries where a specific risk has been identified.² Apart from anything else, the distinction between general and specific provisions is significant since tax deductions are not allowed against general provisions (in the United States this has only been the case since 1986 when Federal Tax Law was changed), whereas creditors may be able to negotiate some tax reductions against specific provisions.

Because the setting aside of reserves reduces the provisioning institution's earnings, it has an adverse effect on profits. While the creditors' extent of risk exposure is reduced by provisioning, a price has to be paid in terms of reduced short-term profits.

However, neither writing down a loan nor provisioning against it alleviates the debtors' contractual obligations. Such relief will only be given where the lending institution translates the write down into a reduction in debt service payments from the debtor. Here the bank will be forgiving a proportion of the debt.

In attempting to provide some form of factual and statistical background against which the causes and effects of provisioning may be assessed, this section examines the following questions. First, to what extent has provisioning or reserving by the banks occurred, and does it vary between banks, across countries and over time? Second, do tax and regulatory environments differ in terms of their treatment of provisioning, and third, to what extent does the provisioning by banks that has occurred reflect the discount on LDC (less developed country) debt observed in the secondary market?

A major difficulty in giving comprehensive answers to these questions is the lack of data concerning provisioning against LDC

loans, the confidentiality with which much of the data that are available are treated, and the general degree of opaqueness in some countries relating to issues such as the position and attitudes of the regulators and the tax authorities.

Most of the data used in this chapter are drawn from IBCA (International Bank Credit Analysis Group, London) sources, although, even here, the data are constrained by the factors just listed.

Table 3.1 shows the percentage reserves held against LDC loans in a number of countries at the end of 1986. The Table also reveals that there have been significant differences between banks even within the same country. The contrast between the US money centre banks and the regional banks is particularly marked. Furthermore, although many banks do not make available information concerning their reserving against individual countries, what information is available suggests that there may be quite wide divergences. Thus, for a bank with an overall provision of (say) 25 per cent, the reserve against one Latin American country may be as low as 5 per cent, while that against another may be as high as 35 per cent.³

What Table 3.1 does not show is the absolute exposure of the banks, by country of origin, to the highly indebted countries, nor their exposure relative to bank capital or their overall portfolio of loans. In fact, data on absolute exposures reveal the dominance of the US banks, with over 32 per cent of world wide bank exposure

TABLE 3.1 *Banks' reserves against LDC loans, 1986*
(per cent and by country)

| | |
|-------------|-------------|
| Belgium | 15 |
| Canada | 10-15 |
| France | 33-45 |
| Germany | 35-70 (40)* |
| Japan | 5 |
| Netherlands | 24-26 |
| Spain | 7-68 (10)* |
| Sweden | 35-80 (50)* |
| Switzerland | 30-60 (40)* |
| UK | 6-10 |
| US | 5 |

* Figures in brackets give an approximate average where there is a considerable range of experience amongst banks.
SOURCE: IBCA Banking Analysis (London).

in Latin American countries in 1986. Exposures were also significant in the cases of the Japanese (12.6 per cent) and UK (12.3 per cent) banks, becoming less significant in the cases of banks in France (8.8 per cent), Germany (7.7 per cent) and Canada (7.1 per cent), and much less significant in the case of those in Switzerland (2.8 per cent) and Italy (1.4 per cent). However, it needs to be noted that the overall portfolio of the US commercial banks was also significantly larger than that of banks in other countries.

To some extent the different pattern of behaviour with regards to provisioning may reflect the traditionally different attitudes of bankers throughout the world to the optimum point on any return/risk trade off. German bankers, for example, are not infrequently critical of the rapid expansion of loans to LDCs by US banks during the 1970s precisely because of the risks it involved and because of their own more prudent approach to lending.

Beyond this, however, is the question of the importance of differences in the tax and regulatory environment in explaining international differences in provisioning. In order to offer some answers to this question in Section 3, we need to identify what differences there are in the regulatory and tax environments across countries.⁴

In the United States most large banks are regulated by the Federal Reserve Board (Fed) or the Office of the Comptroller of the Currency. Because of its insurance role, the Federal Deposit Insurance Corporation (FDIC) also has a hand in determining provisioning regulations, as well as rules relating to capital adequacy. The regulators' attitudes to provisioning are co-ordinated through the Inter-Agency Country Exposure Review Committee (ICERC). It is this agency which sets standards for how banks should treat loans to countries that are not servicing their debts.⁵

Under existing regulations US banks must hold reserves equal to at least 5.5 per cent of total assets, and capital equal to at least 6.0 per cent of total assets. Beyond establishing these ratios, there are no further regulations relating to general provisions. The regulatory bodies may, however, require banks to make specific provisions against individual countries in the form of allocated transfer risk reserves (ATRR). In the first year following such a requirement the ATRR has to cover 10 per cent of the loans, rising to 15 per cent in subsequent years. Such reserves are tax deductible but they have been fairly rarely used in the past.

While US banks can no longer claim any proportion of general provisions against tax, such provisions do count as part of the banks'

capital base and therefore do not damage the banks' position as far as the regulations relating to capital adequacy are concerned. Furthermore, US banks can claim tax allowance for actual 'write downs' against provisions. More broadly, it is through this tax mechanism that regulators may, in principle, encourage banks to offer some form of debt relief to debtor countries.

In Germany the tax laws are particularly favourable to provisioning and permit reserves to be deducted from taxable profits. Furthermore, the financial authorities have actively encouraged German banks to be prudent in the valuation of their claims of developing countries. French regulations are slightly less liberal inasmuch as provisions against sovereign debt are only tax deductible if the debtor country concerned is on a list of 41 countries compiled by the country's Banking Commission. For such countries, provisions are deductible from taxable profits up to 100 per cent of the face value of the loan.

By contrast, in Japan, banks may not deduct more than 20 per cent of their provisions from taxable profits. Moreover, regulations permit them to hold reserves against no more than 5 per cent of their total loans.

In the United Kingdom, regulators have traditionally encouraged the banks to consider the adequacy of their provisions with respect to their LDC loans without setting formal minimum or maximum values. However, in August 1987, the Bank of England sent a letter to all UK-incorporated institutions authorised under the Banking Act with exposures in developing countries. It encouraged them to reconsider the adequacy of their provisions with a view to increasing them 'where appropriate' to reflect 'the deterioration in the prospects of their recoverability'.

Stressing the need for objective analysis the Bank developed a framework (matrix) designed to measure the extent to which the chances of full recovery had deteriorated, and therefore the extent to which provisions were justified. This was to be used as a basis for discussion between the Bank and each individual institution. The matrix was in many respects similar to those used by the commercial banks in assessing country risk (see Appendix, p. 88).

Specific provisions in the United Kingdom do not count as capital, and general provisions are not tax deductible. The tax status of specific provisions is unclear. There is certainly no presumption that these may be automatically offset against tax. Much would seem to depend on the particular negotiations between an individual bank and the tax district handling its affairs.

The large increases made by the banks to their loan loss reserves in mid-1987 had a number of effects. In the case of the US banks, as shown in Table 3.2, the additional provisions raised their reserve to LDC exposure ratio to something around an average of 25 per cent; although again there was significant variation amongst individual banks. At the same time, it had an adverse effect on their earnings and on the ratio between their equity and assets. Although the provisioning generally increased the ratio between primary capital and assets, it uniformly reduced the equity component of primary capital.

IBCA calculated that an increase in the provisions of the UK banks to a uniform level of 30 per cent would shift two of the five banks examined from profit into loss.

Just as interesting as the effects of the additional provisioning on the balance sheets of the banks was the timing of the decisions to increase reserves. As noted earlier, the initiator was Citicorp which added to its reserves on 19 May 1987. After a lapse of one week Norwest and Chase Manhattan followed suit. Then during little more than the first two weeks of June another fifteen major US banks also responded by raising their provisions. A similar lagged response was seen in other parts of the world, with the UK banks beginning to set aside extra provisions in mid-June.

3. FACTORS INFLUENCING PROVISIONING

Without doubt there is a range of factors which, in some sense, impinge on the decision to set aside provisions. Some of these may be fairly general, affecting most banks in a broadly similar way, others may be more specific to a group of banks, perhaps in a particular country, or indeed, to one specific bank. The difficulty is not so much in thinking of a list of factors which might, in principle, influence provisioning, but in classifying these in a coherent fashion and in assigning them relative weights. With regard to the latter problem, the quantity and quality of the data does not permit any sophisticated empirical investigation of the issues involved. Instead, the empiricism used here is of a fairly casual sort, with conclusions on the relative importance of different factors being drawn rather more from discussions with those people involved in the actual provisioning decisions.

Inasmuch as there is an underlying model on the basis of which provisioning may be explained, we may begin by assuming that the

TABLE 3.2 Effect of additional provisions for LDC debt (US\$ millions)

| | LDC Exposure | Additional provision | Second quarter earnings 1987 | Reserves | | | Reserve/ LDC exposure % | Non-LDC reserves/ NPLS % | Common equity/ assets % | Total equity/ assets % |
|---|--------------|----------------------|------------------------------|----------|-------|-------|-------------------------|--------------------------|-------------------------|------------------------|
| | | | | Total | LDC | Other | | | | |
| Citicorp | 15 590 | 3 000 | (2 500) | 4 900 | 3 500 | 1 400 | 22.5 | 41.2 | 3.30 | 4.01 |
| Bank America Corp | 10 000 | 1 100 | (1 000) | 3 300 | 1 800 | 1 500 | 18.0 | 37.2 | 2.44 | 3.13 |
| Manufacturers Hanover Chase | 8 400 | 1 700 | (1 400) | 2 700 | 1 850 | 850 | 22.0 | 39.8 | 2.74 | 3.62 |
| Manhattan J. P. Morgan* Chemical New York | 8 700 | 1 600 | (1 400) | 2 700 | 2 000 | 700 | 23.0 | 36.1 | 3.45 | 4.09 |
| Bankers Trust | 5 900 | 1 100 | (1 100) | 2 074 | 1 380 | 694 | 24.8 | 47.9 | 3.27 | 3.79 |
| First Chicago | 4 000 | 700 | (570) | 1 300 | 1 000 | 300 | 4.5 | 34.1 | 4.36 | 4.36 |
| Security Pacific | 2 800 | 800 | (700) | (435) | 1 370 | 935 | 33.4 | 53.1 | 3.89 | 4.74 |
| Wells Fargo & Co* | 1 850 | 500 | (175) | 150 | 1 300 | 650 | 35.1 | 54.3 | 4.19 | 4.68 |
| First Interstate | 1 900 | 750 | (455) | (200) | 1 200 | 530 | 33.1 | 65.6 | 4.45 | 4.46 |

NOTES: * Neither of these banks had announced a reserve increase at the time this table was completed, though they did so subsequently.

Several of the banks stated that their LDC reserves were 25 per cent of LDC exposure, but this was accomplished by adding back the 'Allocated Transfer Risk' to reserves. Our table does not add back this reserve and thus the ratios are slightly lower.

Bank America indicated that its reserve was for 25 per cent of its \$10 bn LDC exposure, but that ratio is achieved only after adding back about \$800 mn of 'Allocated Transfer Risk' reserves and prior charge-offs of LDC loans.

The non-performing loan totals are for year-end 1986 and thus do not include the Brazilian loans placed on non-accrual status in the first quarter. The adjusted equity to assets ratios assume that the holding companies pay the same dividends in 1987 as in 1986 and that asset totals at year-end 1987 are the same as at year-end 1986.

Adjustments have been made in the data for Chemical to reflect the acquisition of Texas Commerce in May 1987.

banks set out to maximise expected profit. In so doing, they have to consider both return and risk; utility being a positive function of the former and a negative function of the latter. Bank decisions in general, and decisions relating to loan loss provisioning in particular, may then be interpreted in terms of attempting to move towards a preferred combination of return and risk.

One component of risk for the managers of banks, however, relates to the possibility of take over. Decision makers within banks will therefore be concerned about the competitive position of their firm in the banking industry as is reflected by the price of its shares on the stock market. In this context, managerial theories of the firm that stress such factors are relevant.

The time dimension is also important when analysing the objectives of the banks. Do banks want to maximise expected profit in the short or long run? It is reasonable to assume that they want a fairly stable profit performance, and may be prepared, in certain circumstances, to trade off a proportion of current profit or return in order to reduce risk and secure future profits.

Against this analytical background, the remainder of this section distinguishes between those influences of a broad secular type which created an environment within which provisioning was more likely to occur, and those that may have been of more immediate relevance in explaining why it took place when it did.

Having identified a number of factors that may, in principle, have impinged on the decisions of banks to set aside extra loan loss reserves, a third sub-section takes a brief look at two specific cases: Citicorp's decision to add \$3 billion to its loan loss reserves on 19 May 1987, and the related decisions of other US money centre banks, and National Westminster Bank's decision to add £466 millions to its sovereign debt provisions on 16 June 1987 and, again, the related decisions by the other UK clearing banks.

3.1 Secular factors

3.1.1. Economic performance in debtor countries

Over the years, and particularly in the light of experience since 1982, commercial banks have come to reassess the economic performance of the highly indebted developing countries to which

they have made loans in the past, and therefore to reassess also the risk attached to such loans. Banks, generally speaking, have become increasingly sensitive – some might even argue over-sensitive – to risk, having perhaps failed to pay sufficient attention to it, and too much attention to nominal return, during the earlier phases of lending.

In essence, provisioning reflects a reassessment of the risks associated with a given portfolio of loans. As perceived risks rise, so there will be a tendency for provisioning against these risks to rise as well.

Economic performance amongst the highly indebted countries is most unlikely to be perfectly positively correlated, even though, to a certain extent, all debtor countries will be similarly affected by some world economic developments such as rising interest rates and increasing protectionism. This lack of correlation will encourage banks to examine countries individually, to form views on their separate creditworthiness and on the extent to which they should provision against them. This is the case even though the banks usually publicly provision against a group of countries rather than individual countries. Given this case by case approach, it may be somewhat misguided to look at data for an aggregated group of countries. Yet, if this is done, plenty of evidence may be found to support the view that the underlying economic performance of the major debtor countries has been deteriorating over recent years. Although some debtor nations have achieved a notable strengthening in their current account balance of payments, this has frequently been achieved against a background of stagnating growth and falling levels of trade. In many ways perhaps the most worrying sign has been the falling investment ratio in many highly indebted countries.⁶ While banks may regard some measure of short-run domestic demand deflation as an appropriate component of economic adjustment, they also recognise that the ability of countries to service their debt hinges, in the long run, on sustained economic growth. Given the central significance of investment in generating economic growth, falling investment ratios can do little other than cause concern to creditors about the long-run capacity of countries to cope with their debt.

At the same time as there are signs of deteriorating economic performance in the highly indebted countries, various debt indicators also suggest that the debt position is itself getting worse. The most frequently consulted ratios, such as the debt service ratio and the interest payments to exports ratio, show a significant deterioration.

Moreover, the banks can hardly fail to acknowledge that the change from positive to negative net transfers may prove unsustainable given current economic growth rates and living standards in the indebted countries. In this way the switch to negative net transfers brings closer the threat of default, as the perceived benefits of debt repudiation rise relative to the perceived costs.

Given the picture as painted above, provisioning may be viewed as an entirely appropriate recognition by the banks of what is, according to various criteria, a worsening situation. A discrete decision to provision might, of course, be associated with some stochastic shock which weakens both the economic and debt position of the highly indebted countries, or as a response to a gradual and more prolonged weakening in their position. Inasmuch as it is indeed the underlying economic strength of the debtor countries which is the fundamental determinant of provisioning, it might be anticipated that provisioning activity will vary through time as economic performance changes. A decision to set aside provisions of a certain amount at one moment in time does not therefore mean that these will necessarily be seen as appropriate in the future.

Since the economic performance of the debtor countries is a phenomenon which may be fairly objectively monitored and which is largely outside the control of the banks, it might initially be thought that all banks would tend to hold similar provisions. Further thought, however, reveals that this need not be the case. Different banks will have different exposures in different countries, may be more or less risk averse, and may interpret a given set of data differently. Their perceptions of risk may therefore vary. Moreover, as will be seen in the rest of this chapter, there are various other factors which influence provisioning, and differences amongst the banks in relation to these factors may account for differences in the extent of provisioning.

Building on this notion of a deterioration in the economic performance of the highly indebted countries, some commentators maintain that, in the period since 1982, the debt crisis has gone through a series of stages. At different times emphasis has been placed on economic adjustment in the debtor countries, rescheduling of existing debt on more or less stringent terms, and the injection of new money. An approach encompassing these various components was built into the Baker Plan of 1985.

The hope has clearly been that these various policies would, in conjunction, solve, or at least effectively alleviate the debt problem. The hope has not, however, been realised. Indeed, in some instances,

the banks have viewed the approach as becoming less successful as time has gone on. They certainly perceive a 'weakening' in IMF conditionality in recent years. From this perspective, provisioning represents a response by the banks born out of frustration with the inability of the international economic system as a whole to resolve the debt problem. Rather than sustain the belief, or the impression, that the problem will be resolved within a reasonable time span, provisioning is an internal legitimisation by the banks of the situation as it is. In a sense, provisioning reflects the gradual change of mood amongst bankers from optimism, or at least guarded optimism, to pessimism with respect to the prospects for solving the Third World debt problem.

3.1.2 World macroeconomic outlook

While the above discussion suggests that provisioning will be affected by the past and contemporaneous performance of the debtor countries, the banks are in fact taking past performance as an indicator of future performance; it is this, after all, that will affect the countries' ability to service their debts. The future economic performance of debtor countries will, of course, depend on the performance of the industrialised economies of the world. Various models and estimations have been made of the degree of interdependence between the developing world and the industrialised world, and opinions vary on its significance. Yet clearly a scenario of falling rates of economic growth within the industrialised countries, rising rates of interest and increasing protection suggest, in combination, that debtor countries will face difficulties in expanding their export earnings and in increasing debt service payments. In these circumstances, the banks will again tend to perceive an increase in the risk attached to a given portfolio of loans to developing countries and may be encouraged to increase their provisions against such loans. A pessimistic global economic outlook may make other bank assets also appear more risky, but perhaps developing country loans are particularly vulnerable to the economic variables listed above.

Since bankers' perceptions in the first half of 1987 were of a low-growth world economy, a view based largely on projections from various international and quasi official agencies, it follows that their view of the riskiness of their loans to developing countries was likely to be adversely affected.

3.1.3 Changing methods of risk assessment

There has been plenty written in the literature to suggest that the banks' techniques for assessing risk as used to appraise loans during the 1970s were not very scientific, and there are some suggestions that since that time they have improved on their assessment methods.⁷ With loans being continually reassessed, it might be expected that the use of different techniques across the banks would result in different perceptions of risk.

Although this argument might, in principle, explain why developing country loans have gradually come to be regarded as more risky by the banks that made them, in practice the modifications in country risk analysis are probably not sufficiently important to constitute a major factor. What is true is that the more traditional methods of risk analysis would also be suggesting increased risk. Furthermore, as noted earlier, experiences since 1982 have simply made the banks more risk averse than they were before.

3.1.4 Internal adjustment within the banks

Emphasis has usually been placed in the literature on the need for adjustment within debtor countries brought about by the acquisition of debt and its related obligations. While this need cannot be denied, developing country debt has also brought about a need for adjustment within the banks that have made the loans. Banks have indeed for some time been engaged in this process of adjustment by strengthening their capital bases and by looking for new and more secure lines of business. Although some banks have pursued this process more successfully than others, the trend has been fairly general. Provisioning reflects the fact that, within this secular process of adjustment, banks now feel sufficiently strong to stand the cost of provisioning.

Moreover, internal adjustment within the banks is unlikely to comprise only growth in other lines of business. The banks are without doubt anxious to remove some of their developing country loans from their books. However, this is difficult to do while the loans have full face value in their balance sheets yet a discounted price in the secondary market. Provisioning, which essentially recognises the market valuation, gives the banks much more flexibility in terms of how they can manage their portfolio of loans,

and may be seen as a necessary component in the banks' overall strategy for handling their developing country exposure.

The conclusion from the above discussion of secular factors is that there were indeed certain trends in effect during the mid-1980s which pointed in the direction of greater provisioning. Of these, perhaps the most important were the changing assessment of the economic performance of debtor countries and a desire by the banks to do something positive in terms of their own balance sheets. But these secular trends hardly explain why the surge of provisioning in the summer of 1987 occurred when it did, nor do they explain entirely satisfactorily why different banks behaved in different ways. It is to an examination of more proximate and bank-specific factors that we now turn.

3.2 Proximate factors

3.2.1 The tax and regulatory environment

Early reports in the media suggested that Citicorp's decision to add to its provisions could be largely explained in terms of certain unspecified tax advantages. Moreover the review in Section 2 of this chapter implies that the tax and regulatory environment has been more supportive of provisioning in countries where banks have conventionally held somewhat higher provisions such as in Germany. But it may be unwise to draw the conclusion that there is necessarily a strong causal link between provisioning and the tax and regulatory environment. Prior to the change in Federal Tax Law in 1986, for example, US regulations were rather more liberal than in the United Kingdom, and yet US banks did not hold proportionately higher reserves. In this case, the reluctance of US banks to add to their reserves almost certainly reflected their high exposure; but it does serve to show that the tax and regulatory environment may not be a dominant factor.

This is confirmed when an inter-temporal rather than cross-sectional approach is adopted. Concentrating again on the United States, the changes in the tax treatment of provisions in 1986 should, if anything, have made additional loan loss reserves *less* attractive. Yet it was in the following year that the principal increases in such reserves by the US money centre banks were made. The media

reports that Citicorp's decision was largely influenced by tax considerations appear to be entirely without foundation, as discussions with both Citicorp and the US Treasury confirm. Indeed meetings between Citicorp and the Treasury were held *after* the bank's announcement of extra reserving to clarify the tax position, largely because of the confusion caused by these press reports. Similarly, decisions to increase provisions by the UK clearing banks were made even though the tax treatment of these provisions was yet to be agreed. Again, the most formalised statement about provisioning by the UK regulatory authorities was made *after* the additional reserves had been set aside. Certainly those involved in the provisioning exercise do not ascribe any significant role to tax and regulatory factors in explaining inter-temporal changes in the extent to which it occurred. However, to argue that it has not been an important factor in the past is not to argue that it might not be an important factor in the future. It is difficult to believe that a more interventionist approach by the regulators, or a clearer and more cohesive statement of the tax treatment of provisioning would be inconsequential.

Before leaving the question of the tax and regulatory environment, it may be noted that provisioning may itself have an effect on the tax and regulatory environment. Provisioning may be made by the banks in the hope of putting pressure on the tax authorities to make concessions. Similarly, greater provisioning may be used by the banks in an attempt to forestall the introduction of formal regulations which would mandate reserves against specific countries.

3.2.2 Market valuation

While banks may set out to maximise some notion of profits, and while their behaviour may be most nearly approximated by applying this traditional theory of the firm, it is also the case that they are concerned about their market valuation as reflected by their share price, since this affects their ability to fend off potential take over and indeed to acquire competitors. In relation to this, they are sensitive to the rating they receive from bank analysts.

Prior to the wave of extra provisioning begun by Citicorp, banks were under significant market pressure to acknowledge the weakness of many of their developing country loans. This pressure took the form of a share price which was largely discounted in proportion to

individual banks' exposure in particular countries, the discount on the secondary market value of developing country debt, and, connected with these phenomena, somewhat gloomy reports on the banking sector in general and the relatively highly exposed banks in particular, from market analysts. The market had essentially discounted developing country debt in advance of the banks, and bank provisioning can be seen as, in some sense, a response to and recognition of this judgement.

It is not coincidental, therefore, that as banks provisioned, their share price tended to rise – although as will be seen later this effect was essentially temporary. Normally, of course, one would expect share price and profitability to be positively related, but, in this case, it seems that the market was welcoming what was seen as a more realistic approach by the banks. The fact that the banks had come formally to accept the risks associated with their developing country loans raised market confidence in the provisioning banks.

Furthermore, it was, in part, through the market mechanism that actions by key debtor nations impacted on the banks' provisioning decisions. Although Peru's limitation of debt servicing had relatively little effect on market mood, Brazil's suspension of interest payments did have an effect, and, through this indirect route, if not through more direct routes to be outlined below, Brazil's actions are relevant in seeking to explain why the banks took the decisions that they did at the time that they did.⁸

3.2.3 The competitive process and bank strategy

It needs to be remembered that banks are in competition with one another. Even though there may be elements of market segmentation, this is not sufficiently pronounced to allow banks to have effective areas of monopoly. Within the competitive process, banks employ various weapons covering both the range and price of the services they offer to their customers. Banks also compete via marketing and advertising. Given the significance of competition amongst the banks, and since the structure of the banking industry is such, in most countries, that large banks are able to identify their principal competitors, it might be supposed that any decision made by one bank will take into account its effects on competitor banks and, in turn, their likely responses.

In this type of market environment firms will be inclined to take actions which they deem to be *relatively* advantageous. Even an action which damages short-run earnings and profits might become attractive if it forces competitors to take similar actions which have effects on their earnings and profits which are even more damaging. In such an environment the initiating firm will strengthen its relative position within the industry. Since provisioning affects earnings, profits and share prices, it seems likely that the implications of it for a bank's competitive position within the industry will feature in the decision.

How important a factor this is depends on how wide the differences are between banks in terms of their ability to set aside provisions and how aggressively competitive are the banks in the relatively stronger positions. In a highly competitive environment, as well as one in which there is some discussion of excess capacity within the banking industry, a decision by one bank to raise its provisions might even be viewed as a predatory policy, akin to the practice of predatory pricing in other industries.⁹

Broadly speaking, the more profitable a bank and the greater its ability to foster and develop other lines of business, the more inclined it will be to set aside relatively large provisions. It will be the banks with the smallest exposure in developing countries that will be inclined to set aside the largest proportionate provisions against these loans.

In addition to this, however, some banks may be in a stronger position to exploit the opportunity for debt-equity swaps which, as will be seen later, is facilitated by provisioning. A bank with a relatively wide network of branches and with good information about investment opportunities in developing countries may be more enthusiastic about the scope for such swaps and may therefore be more anxious to prepare the ground for them. A bank with a less sanguine attitude to swaps may be expected to be less anxious to engage in provisioning.

3.2.4 The politics of decision making

The discussion in points 3.2.1 and 3.2.2 above suggests that financial and economic factors are the only ones that have an effect on bank decisions. It needs to be recalled, however, that banks are

bureaucratic structures and decisions will reflect managerial utility functions. Changing managerial regimes within any firm may cause a shift in policy. An incoming chairman may, for example, wish to distance himself (or herself) from decisions taken by a predecessor and to impose a new personality and authority. An outgoing chairman may wish to secure the company's position before departing in order to minimise the personal risk of being retrospectively blamed for ill-founded decisions.

While it is difficult to model these factors and to treat them in a rigorous way, those with experience of working in large organisations recognise that personalities and internal organisational politics are often important in decision making. It would, therefore, be unwise to ignore such influences when trying to explain commercial bank provisioning.

3.2.5 The games theory of debtor-creditor relations

Provisioning by the banks has not been an isolated action, but represents one component in an ongoing set of negotiations and relationships between debtor countries and creditor banks. While the debtors wish to minimise their servicing obligations without damaging their prospects of future market access, the banks wish to maximise their receipts. Such maximisation may involve agreeing to terms which are not so stringent as to encourage debtors to opt for all out default. Within such a set of negotiations, the participants will be constantly 'positioning' and trying to send 'signals' to each other designed to strengthen their own bargaining stance. The adoption of a new position by one side will tend to induce a change in the position adopted by the other side.¹⁰

Within this context, a decision by banks to increase their provisioning against claims on developing countries may, in principle, be interpreted as a desire to send a new signal to debtors in advance of forthcoming negotiations. Such action could be initiated by the banks or could represent a response to a perceived change of position by a particular debtor or group of debtors.

However, there is considerable ambiguity about what signal is being transmitted by increased provisioning. From one point of view it may be seen as a softening in the banks' position since, in effect, it reflects a recognition by the banks that they are unlikely to receive full payment on their developing country loans. The whole rationale of provisioning is associated with such increased risks. From this

angle, the signal may be seen as one which says that the banks, having provisioned, are now in a better position, and are more willing, to make concessions to the debtors.

Bankers vigorously deny that this is the signal that they are sending via provisioning. Indeed, they tend to down-play the entire game-theoretic approach to provisioning. If anything, however, they argue that provisioning suggests that the banks will adopt a 'tougher' or 'more realistic' position *vis-à-vis* borrowers in rescheduling negotiations. The logic here seems to involve two elements. First, the banks are now in a better position to 'take a hit' on their LDC loans. And, second, since provisions are now being set aside against such LDC loans, it is going to be more difficult for debtor countries to attract new money from the banks.

Consideration of these elements suggests that, while there is some truth in the second (which is examined more fully later, in the section of this chapter dealing with the implications of provisioning), the first argument is more doubtful. The demonstration by the banks that they are in a stronger position to withstand a 'hit' may actually make it *more* likely that they will have to sustain one. Statements by bankers that provisioning does not represent a softer position by the banks and may, indeed, represent a harder one, would seem to be designed merely to limit the damage that might otherwise be done to their bargaining position. Chances of the banks being fully repaid are not enhanced by actions which suggest that the banks accept that they are unlikely to be fully repaid. Given the ambiguity over the way in which debtors might be expected to interpret bank provisioning, it is difficult to believe that the increase in provisioning during mid-1987 was purely a bargaining response to the Brazilian decision to suspend interest payments in early 1987.

Of course, banks will not only be concerned about how their decisions will be interpreted by the debtor countries. They also have to consider their interface with the official sector. Here, in an environment where the banks feel that excessive pressure has been put on them to provide new money in recent negotiations – in particular those involving Mexico – and see themselves as often assuming the role of lender of last resort, they were pleased to send a message, via provisioning, that new money would be less easily available in the future, and thereby put more pressure on the official sector; especially since the banks have been quite critical of certain elements of the official sector, notably the Paris Club, the export guarantee agencies, and, latterly, the International Monetary Fund.

Although the above discussion has tended to lump all the banks together, it is quite possible that there are slight, but still significant, differences between banks in the signals they wish to send to individual debtor countries. A bank with a relatively large exposure in a particular country may be inclined to adopt a rather different approach from a bank with a smaller exposure.

3.3 Assigning relative importance

What we have done so far is to identify some factors which might, in principle, have an influence on commercial bank provisioning against developing country loans. What now needs to be done is to assign some relative importance to these factors in attempting to explain the spate of additional commercial bank provisioning that happened during mid-1987.

First of all, drawing on the distinction between secular and proximate factors used above, it seems that secular factors were necessary but not sufficient for provisioning to occur. Stated most extremely, if there had not been a deterioration in the economic and debt positions of the highly indebted countries, there would have been little need for banks to provision. Yet this gradual deterioration does not provide the proximate cause of provisioning.

Taking the case of the extra loan loss reserves made by the United States money centre banks, most of this may be seen as a response to the lead set by Citicorp. Provisioning by the other banks was largely in defence of their market position. Most representatives of such banks suggest that extra provisions would not have been set aside had it not been for the Citicorp move. The question now becomes why Citicorp decided to increase its provisions. Some guidance is provided by Citicorp's own account which emphasises the importance of market pressures, and the desire to create more flexibility within its balance sheet and to pursue debt equity swaps. However, it is reasonable to presume that Citicorp would not necessarily provide a full analysis of its own decision. The general consensus amongst competitors and commentators is that there were other important factors. First, there was the desire to gain a competitive advantage over other US money centre banks. The Citicorp announcement was carefully orchestrated and well marketed, and it did undoubtedly embarrass some of the other banks.

Although Citicorp was heavily exposed in developing countries in absolute terms at the end of 1986, and had more exposure than the other money centre banks, its exposure to equity ratio was significantly below that of Bank of America and Manufacturers Hanover, was broadly similar to that of Chase Manhattan and Chemical Bank, was somewhat above that of Bankers Trust, and significantly above that of the other US money centre banks. Citicorp was therefore not in a uniformly stronger position to set aside provisions, but was in a rather stronger position than its closest competitors, particularly given its aggressive attitude towards debt equity swaps.

Second, there was the personality of the Citicorp chairman, which some observers feel suggests that internal bank politics, as described earlier, was an important factor.

Of much less importance was the desire to send a coded message to debtors, and to Brazil in particular, since, as mentioned above, the precise message is difficult to decode. Also apparently of no importance was the tax position, in spite of the fact that early press reports suggested that tax advantages lay at the heart of the decision.

Similarly, the regulatory environment was apparently of little relevance, except to the extent that Citicorp was anxious to forestall moves to change the regulations in a way which would have required greater specific provisioning.

Broadly the same story emerges when one examines the additional provisioning undertaken by the United Kingdom clearing banks. Here again the process was led by the bank regarded as perhaps the most aggressively competitive, the National Westminster Bank. Moreover, National Westminster, with relatively low loan exposures in developing countries, was in the strongest position to provision against such loans. As with the Citicorp move, Nat West's additional provisioning strengthened its market position and this induced the other clearing banks to take similar measures. Again in the United Kingdom the regulatory environment and the tax position with respect to provisioning does not seem to have had a significant impact. Although UK banks had been encouraged by bank regulators – essentially the Bank of England – to review the adequacy of their provisions, the tax treatment of provisioning was undefined at the time the National Westminster took its decision. Discussions with representatives of National Westminster also suggest that game-theoretic explanations did not have an important part to play. Instead the feeling was that Citicorp's move had altered the 'market

environment' and that it was therefore an appropriate time for the bank to bring greater realism into its accounts. In the case of Nat West there was a less well-articulated internal bank strategy for handling its exposure than there was in the case of Citicorp.

This review of the causes of provisioning suggests that it reflects a combination of general secular trends and narrower, more proximate and bank specific, factors. Without doubt the overall performance of debtor countries in the mid-1980s and beyond was providing little evidence that their ability to service debt was going to improve in the short run. The financial markets certainly made this assessment, which was reinforced by greater difficulties in rescheduling and by unilateral decisions by key debtors to limit their debt payments. As a result, the market valuation of the banks' loans to LDCs was discounted. Provisioning represented a response to this deteriorating situation. However, within the banking industry, provisioning has also been used in a competitive way; there was no uniformly agreed approach to it, but rather one of action and counter action. Although banks have been anxious to ensure that their negotiating position is not damaged by provisioning, it is doubtful whether the prime rationale was to send a positioning signal to debtors. Subsequently, in December 1987, Brazil agreed with its Bank Advisory Committee to correct its interest rate arrears under an arrangement which sees the banks disbursing \$3 billion to Brazil and Brazil paying creditor banks \$4.5 billion in interest payments. Similarly, while different regulatory and tax environments may help to explain why banks in different countries have provisioned to different extents, changes in this environment do not seem to have exerted any discernible impact on provisioning over time. To the extent that decisions reflected internal bank politics, managerial theories of the firm may be more appropriate than the simple theory of profit maximisation.

4. IMPLICATIONS OF PROVISIONING

According to one point of view the implications of increased provisioning are likely to be rather marginal, since it is essentially an accounting adjustment which acknowledges and formalises a weakness in the bank's balance sheets which existed beforehand. Although there would appear to be considerable truth in this view,

it is possible to examine the potential implications of provisioning in a rather more thorough and systematic way.

In this section we approach the question by looking at the implications for the various actors involved in the international debt problem; the banks, the debtor countries and the official sector. We also briefly examine the implications of provisioning for relations between these various actors.

4.1 The banks

As already noted, provisioning has the effect of bringing the banks' actual balance sheets more in line with the market perception of what they should look like. Any discrepancy of this kind between the market view and the banks' view, as illustrated by their published balance sheets, will be a cause of concern within the market and will damage confidence in the banks. Removal of this discrepancy will tend to restore a measure of confidence. It might have been anticipated, as bankers themselves clearly did, that provisioning would improve the banks' market position. Data confirm the positive short-run effect of provisioning on banks' stock prices. The evidence also suggests that it was the earlier provisioners that enjoyed the greatest stock price increases.

However, it was always doubtful how durable this improvement would be. After all, provisioning does nothing to strengthen the basic position of those banks which have suspect LDC loans on their books. Neither, as will be seen below, does it really do anything to raise the probability that debtors will be able to service their debt obligations.

The expectation might therefore have been that provisioning would have only a short-run beneficial effect on banks' share prices, but that in the longer term the relative market valuation of the banks would not increase. For this to occur the banks would have needed either to shed some of their LDC loans, or to expand new lines of business or to continue to add to provisions. Alternatively, the economic performance and prospects of the debtors would have needed to improve significantly.

Clearly banks with less exposure in developing countries will tend to have a stronger market position than those with a heavy concentration of loans, although even non-exposed banks may find it difficult to distance themselves completely from the market's

judgement of the heavily exposed ones, not least because banks' fortunes may, to an extent, be inter-related through the inter-bank market.

The anxiety to shed LDC debt has, with little doubt, encouraged banks to consider the scope for debt sales, and for debt equity swaps. Either one of these will be encouraged by provisioning which marginalises the banks' decision to accept a discounted price for developing country debt.

In the past the quantity of debt swaps has been constrained, in part, by the unwillingness of the US banks to accept a reduction in the face value of their developing country assets. Although, as noted earlier, increasing loan loss reserves is not the same thing as writing down debt, it does suggest a presumption that some debt will need to be written down. For this reason one constraint on debt conversion will be relaxed by provisioning.

How significant this relaxation is depends on how effective the constraint is. Some observers have argued that debt swap activity is more effectively constrained by the range of suitable equity investments in highly indebted countries and by the attitudes of the debtor country governments to foreign investment. If these are indeed the effective constraints, then provisioning is unlikely to have any significant implications for the level of debt swapping.

Even amongst bankers there were, in 1987, significantly different views on just how important debt swapping would be, though all agreed that provisioning had the important effect of making their loan portfolios more flexible or 'malleable'. Some bankers saw debt equity swaps as a key integral part of their internal strategy. Citicorp, for example, made press announcements to this effect when reporting its additional loan loss reserves. Others saw the potential for debt swaps as being small in relation to the size of the debt involved.

In the twelve months since the surge of provisioning in mid-1987, the policy of the banks has become more clearly revealed. During the second quarter of 1988, media reports (see *New York Times*, 27 July 1988) suggested that thirteen of the largest banks in the United States sold or swapped about \$2.3 billion of their LDC loans, accepting 50 to 85 cents on the dollar; having off-loaded only about \$1.4 billion in the first quarter. At the same time, the banks have been building up their capital bases and, as a result, while their LDC exposure fell from \$51.6 billion in June 1987 to \$45.7 billion in June 1988, their exposure as a percentage of equity fell from 137 per cent to 101 per cent. Some of the larger US regional banks

have reduced their portfolio of LDC loans by 33–50 per cent within a year.

The apparently increasing willingness to use provisions to offset the loss from selling LDC debt at a discount can be explained, to a significant extent, by the market reaction it has induced. Banks with large LDC loan exposures relative to equity have seen their stocks trading at only 70 to 80 per cent of their book value, and may anticipate that shedding such loans will eliminate the discount and reduce their vulnerability to take-over. Indeed, those banks that have been relatively slow to reduce their LDC exposures (Manufacturers Hanover, Bank of America, Chase Manhattan and Chemical) between 1987 and 1988 have tended to be the ones with the largest market discounts on their own stock. Market concerns about Third World debt are illustrated further by the fact that those banks that increased their provisions to 50 per cent at the end of 1987 enjoyed significantly greater initial appreciation in their market value than those that did not. While, therefore, the trend would seem to be towards the further shedding of Third World debt by the banks, the reluctance of the major banks to swap their existing Mexican loans for new bonds issued by Mexico and with principal effectively backed by the US Treasury, as part of a plan launched in December 1987 to reduce Mexico's external debt burden, supports the argument that the banks are not prepared to swap LDC debt at any price.

While there is, then, some debate over the precise size of the impact of provisioning on debt swap activity, there is little disagreement over the point that, with other things remaining constant, provisioning will encourage banks to engage in more debt swapping than would otherwise have been the case.¹¹

There is similarly little disagreement that provisioning will make banks more unwilling to put new money into developing countries. The logic here is simply that, if a bank has provisioned against old loans, it will also need to provision against new ones. Provisioning is, in effect, a tax on new LDC loans and may therefore be expected to reduce their supply.

But provisioning will tend to reduce the supply of new bank loans in other ways as well. First, small banks may be expected to become even more reluctant to participate in new money packages since they see the larger banks as being in a stronger financial position. The argument that the involvement of the small banks is required to sustain the larger banks, and therefore the stability of financial

markets, may be more easily rejected than it has been formerly. Second, inasmuch as provisioning has been used, or has been perceived as having been used, by some banks as an aggressive weapon of competition, it may be more difficult to get the necessary degree of agreement amongst banks to put together new money packages. However, as the Brazilian deal mentioned earlier reveals, provisioning does not make new money impossible. Circumstances can clearly exist in which the banks still see it as being to their advantage to make additional finance available to developing countries.

Even so it can be expected that banks with relatively large provisions will generally be more inclined to favour some form of debt relief to developing countries in preference to the injection of new money. Indeed, the extent of provisioning has been used in the past to explain the different attitudes of US and German banks to the Third World debt problem, with the former holding relatively low loan loss reserves and favouring new money as opposed to any form of debt relief. The gloomy prospect from the debtors' point of view is that, while extra provisioning may disincline the US money centre banks and other international banks from making available new money, it may not result in greater debt relief. Indeed, in their public pronouncements, bankers are adamant that additional provisioning does not imply that the banks are prepared to accept anything less than the full servicing and repayment obligations associated with their LDC loans. They frequently maintain that provisioning is a response to market perceptions of effective default risk rather than a reflection of their own perceptions.

Of course, care has to be exercised in interpreting such statements. Bankers anxious to maximise the chance of being fully repaid are unlikely to make statements to the effect that they do not expect this to be what happens. They will be aware of the fact that such prophecies would stand a good chance of becoming self-fulfilling, with debtor countries immediately adopting a tougher stance in debt negotiations.

Many bankers in fact accept that a degree of debt forgiveness may be appropriate for some of the smaller debtor countries which they concede may be in intractable economic difficulties. But, at the same time, they are worried that it would be difficult, in practice, to offer significantly different terms to different debtor countries, and that the large debtor nations would expect to receive terms similar to the most favoured debtor.

A more detached viewing of the facts suggests that it could have been anticipated that bankers would say exactly what they have been saying. But it is difficult to reconcile actions which prepare the banks for some measure of loss on their loans with words which say that such losses are not expected. On the assumption that actions generally speak louder than words, it seems reasonable to conclude that the banks have accepted that they will be forced to grant a measure of debt forgiveness. The choice of words is designed to try and minimise the banks' losses.

While clearly the choice of technique adopted by the banks for giving *de facto* debt relief is aimed at minimising the amount of such relief, an interesting and related question is whether this technique is optimal from the debtors' point of view, or indeed systemically. Does the banks' chosen route maximise the real relief for any given financial cost? Or, in other words, does it represent an efficient way of handling the international debt problem? In principle, an alternative might be for the banks to opt for a structured, co-ordinated and centrally administered system of debt relief, to be attached to policy conditionality applied to the debtor nations.

Banks may be forced by circumstances to concede to some degree of relief. Indeed the scenario painted by many bankers is consistent with this conclusion, even though it may not be the conclusion they themselves draw. First, there is the deteriorating performance of the highly indebted countries. Second, there is the gloomy global macroeconomic outlook. Third, there is the fact that significant quantities of new monies cannot be expected from the banks. If neither private foreign investment nor the official sector fills the projected financing gap, the only option left open for debtor countries is to reduce their demand for foreign exchange through the imposition of direct import limiting measures or through domestic demand deflation; unless, that is, the debtors decide to reduce their demand for foreign exchange by defaulting on their debt obligations.

Banks need to recognise and address the issue that, while formalised debt relief does possess the problem of 'moral hazard' touched on above, failure to provide it may induce outright defaults which will make their losses even greater. This, of course, is the trump card that debtors possess in their game-theoretic negotiations with the banks.

However, while, for these reasons, provisioning might be seen as a potential step towards some greater measure of debt relief, the

way in which it has been enacted may have damaged the cohesiveness of the banks and therefore have made co-ordinated approaches more difficult to implement. As noted above, some US money centre banks feel that Citicorp's decision to add to its loan loss reserves was, in part at least, a predatory move designed to embarrass them and to give Citicorp a competitive advantage. This could change attitudes towards what has been the co-operative fashion in which debt negotiations have been handled by the banks, and this at a time when the growing reluctance of the small banks to participate in new loans is likely to place a larger burden on the large money centre banks. Indeed one of the most frequently cited criticisms of Citicorp's move from the rest of the banking community is precisely that it has disrupted what was formerly a co-operative approach by the banks, and that it will make the negotiation of new packages more difficult.¹²

This argument should not, however, be taken too far. Banks are always likely to take decisions based on what they see as being in their own best interests; and although greater provisioning may influence this perception, decisions within any set of debt negotiations are unlikely to be motivated simply out of desire to make life difficult for one particular competitor. While the discussions amongst the banks may therefore be somewhat less fraternal than they might have been, outcomes will be similar to those that would have resulted had the decisions to add to loan loss reserves been collaboratively agreed.

Again, in trying to gauge the relative importance of the factors discussed above, bankers clearly feel that the most significant implication of provisioning for them is the extra flexibility it gives in the management of their balance sheets. Increased loan loss reserves provide them with the scope to pursue a number of options which would otherwise have been effectively unavailable. Apart from this, and in and of itself, provisioning is not seen by bankers as having hugely significant implications for them.

4.2 The indebted countries

The consequences of provisioning for the highly indebted borrowing countries are generally regarded as being even less significant than for the banks. As pointed out by country representatives on many

occasions, provisioning does nothing to alter their contractual debt-related obligations.

Even so, there are, in principle, channels through which extra commercial bank provisioning might have consequences for the debtor countries. First, it may alter the negotiating environment, thereby altering the relative strengths of the debtors' and creditors' bargaining positions. Although, as already seen, the banks argue strongly that provisioning is a sign of their hardening or 'more realistic' attitude towards certain borrowing countries, it is difficult to reconcile this with the changing expectations of debt servicing that provisioning implies. Of course, just as the banks would not be expected to publicise a softening in their attitudes, if indeed this exists, the borrowing countries would not be expected necessarily to reveal their true interpretation of the effect of provisioning on their bargaining strength. Press stories therefore not surprisingly present the debtor countries' response to provisioning as having been fairly neutral, although some suggestions have been made that, since the banks have essentially written down the value of their LDC loans, developing countries should only be required to pay interest on the reduced real value of the debt.

Second, as already explained, provisioning reduces the likely size of new money flows from the banks to the highly indebted countries. If these flows are not replaced from other sources, and if there is no related relief in debt obligations, provisioning will have increased the size of negative net transfers. The sign and size of net transfers is an important ingredient in models of debt repudiation, with larger negative net transfers increasing the incentive to default. If, indeed, highly indebted countries do now perceive the benefits of default as exceeding the costs, and act accordingly, provisioning, which was designed to regularise banks' balance sheets to the existing debt situation, could make that situation worse. Extra provisioning, far from being the one-off action which some bankers present it as, could possess its own internal dynamics. A worsening debt situation brought about by provisioning could itself result in additional provisioning and a further deterioration in the debt situation.

The third way in which extra commercial bank provisioning affects the debtor countries is through its impact on debt swap activity. This is not the place to provide a detailed analysis of the potential effects of debt equity swaps on the 'host' country. Clearly, however, such swaps reduce the external debt obligations of the debtor country and may induce additional equity investment. If such benefits

outweigh the potential costs associated with exchange rate and monetary management, and the result is therefore that debtor countries derive net benefits from debt equity swaps, then anything that encourages swapping will be of advantage to the debtor country. As discussed above, extra provisioning does help to weaken one of the former constraints on debt equity swaps.

Provisioning would be of greatest relevance to debtor countries if it could be legitimately interpreted as part of a trend towards greater debt forgiveness by the banks. However, as yet, there is no strong reason for feeling that such a trend exists. In these circumstances its adverse affects on new money flows could easily mean that debtor countries lose out.

4.3 The official sector

Just as a reduced flow of new money from the banks has implications for the debtor countries, it also has implications for the official sector. In essence, it increases the pressures on the World Bank and the IMF to play a larger role both in financing balance of payments deficits, and in articulating appropriate adjustment strategies through the conditionality that both institutions can bring to bear on debtor nations.

More generally, if provisioning makes the debt problem worse by increasing the incentive for debtors to default, it increases the systemic need for compensating action to be taken. Since provisioning may be seen as a step by the commercial banks towards extricating themselves from their involvement in developing countries – certainly in the form in which it has taken place over recent years – it leaves more of a vacuum to be filled by the multilateral agencies.¹³

This is certainly a reasonable reflection of views within the banking community. The unanimous feeling is that the official sector, fairly widely defined, should be doing more to help resolve the debt problem, not only in making financial concessions and in refurbishing conditionality, but also in terms of orchestrating and taking an overall lead in the approach to Third World debt. An important implication of greater provisioning is that this expanded role becomes more likely.

More specifically, and perhaps in the shorter term, debtor countries facing greater difficulties in refinancing their loans from the private sector may find it progressively more awkward to meet

their outstanding obligations to the multilateral agencies and these will therefore not be exempt from the default concerns of the private sector.

While the banks are certainly not in a position to opt out of the debt problem, it would seem appropriate to shift the balance of significance more towards the official sector. To the extent that provisioning assists such a shift it could be of systemic advantage.

Within the official sector provisioning by commercial banks will force the regulatory and tax authorities to define their own attitudes more clearly. This could result in tensions within the sector. Regulators anxious to sustain the security and stability of the financial system may be expected to welcome additional provisioning, as indeed they have done. The tax authorities, on the other hand, may not be anxious to make the tax concessions that might help to encourage provisioning. Moreover, the wing of the official sector dealing more directly with financial flows to the developing world may be worried about the effects of provisioning on total flows.

In all the above discussion it would be a mistake to isolate commercial bank provisioning as being of the greatest strategic importance. Many of its implications are marginal and are frequently somewhat uncertain. Indeed some commentators have argued that one of the central implications of provisioning is precisely the additional uncertainty it generates. In terms of the principal issues involved in the resolution of the Third World debt problem, provisioning is probably of rather limited significance. Perhaps it would have greater significance if it reflected an attitudinal change on behalf of the banks but it is difficult to be certain about the extent to which this has taken place.

5. ARE PROVISIONS ADEQUATE?

One important question raised by the commercial banks' provisioning of mid-1987 is whether the level of reserves achieved was adequate. Some US banks certainly reached the conclusion that it was not, with larger regional banks such as the Bank of Boston increasing provisions up to about 50 per cent of their LDC exposure towards the end of 1987, an increase not matched by the money centre banks. Even prior to this, in September 1987, data provided by IBCA show clearly the different provisions held by the major US banks. The four with the largest LDC exposures, standing at over

\$8 billion each, (Citicorp, Bank of America, Chase Manhattan and Manufacturers Hanover) held, on average, 21.5 per cent reserves. In the next group, with exposure between \$2–6 billion (Chemical, JP Morgan, Bankers Trust, First Chicago and Continental Illinois) reserves were, on average, 26.4 per cent of LDC exposure. For the third group, with exposures between \$300 million and \$2 billion, (Wells Fargo, Security Pacific, Marine Midland, Mellon, First Republic, Bank of Boston, Bank of New York, PNC Financial Corporation, First Bank System, and Bank of New England) the reserving ratio was 34.6 per cent, more than 60 per cent higher than that of the large money centre banks. On top of this some banks with smaller LDC exposures, such as Amex, have begun to talk publicly about debt relief (see Robinson, 1988) and have also begun to write down or write off a proportion of their LDC exposure.¹⁴

One way of approaching the question of the adequacy of provisioning is to compare actual provisioning with the market discount on LDC debt. Data on the market prices of a sample of such debt over the period 1985–88 (see Table 3.3) show that, with the exclusion of Peru, the average discount on the debt of the five largest Latin American debtors was nearly 35 per cent in April 1987 and about 52.5 per cent by March 1988. In the case of Peru, a strongly negative assessment of a country's debt policies was reflected by a heavy discount in the market value of its debt, and, in the case of Mexico and Venezuela, the discount was affected strongly by external factors, in these cases variations in the price of oil.

The connection between the size of the discount on LDC debt and the amount of provisioning required is, to some extent, supported by admittedly sketchy information on individual country provisioning by the banks. In broad terms, bankers report that

TABLE 3.3 *Market prices of developing country debt (selected countries)*

| | <i>October 1985</i> | <i>October 1986</i> | <i>April 1987</i> | <i>March 1988</i> |
|-----------|-------------------------|-------------------------|-----------------------|-----------------------|
| Brazil | 78 | 76 | 64 | 48 |
| Mexico | 80 | 57 | 59 | 49 |
| Argentina | 65 | 66 | 60 | 29 |
| Venezuela | 82 | 74 | 74 | 54 |
| Chile | 69 | 68 | 70 | 58 |
| Peru | 33 | 20 | 18 | 7 |

SOURCE: International Bank Credit Analysis Group (IBCA), London and Salomon Brothers Inc, New York.

provisions are highest against those countries which have the greatest discount on their debt in the secondary market. However, the relationship is by no means perfect. In 1986, for example, some banks were setting aside significantly greater provisions against Brazilian debt than against Venezuelan debt, even though there was a marginally greater discount on Venezuelan debt in the secondary market. At the same time, provisions against Argentine debt were significantly greater than those against Chilean debt even though there was very little difference in the secondary value of their debt.

If one takes the market valuation of LDC debt as an accurate indicator of risk and of its net present value, it would appear that, if anything, many banks are still under-provisioned. However, it is not entirely clear whether the market valuation of debt is an accurate measure of the extent to which the banks should provision against it. First, there is the argument that the market is too thin and vulnerable to distortions to provide a balanced assessment of risk. Second, some banks argue that the debt is worth more to them than its market value suggests because the banks have leverage with the debtor countries. Third, bankers have maintained that their superior position with respect to participation in debt equity swaps and the rate of return on such investments serves to raise the value of the debt to them as compared with the market valuation.¹⁵ Certainly leading bankers have argued that they do not expect to have to use the entire amount of their loan loss reserves. Moreover, the apparent unattractiveness of the Mexican debt swap to the money centre banks reported earlier has been interpreted by some observers as suggesting that the major banks still value their loans to developing countries well above the secondary market price.

Some legitimate doubt may, however, be expressed over the above arguments. With the degree of current participation in the secondary market, there may be a reasonable presumption that it is relatively efficient, and that it provides as good a guide as anything to the net present value of developing country debt.¹⁶ Similarly it may be argued that the leverage on policy that the banks exert is actually activated via the intermediation of the IMF and the World Bank and that this will be incorporated within the market's valuation. Furthermore, the returns to equity investment are available to all participants in debt equity swaps and not just the banks, and it is doubtful whether the banks possess superior information on investment opportunities. Finally, evidence provided by Lamdany (1988) suggests that the bid offer prices made by the banks for newly issued

Mexican bonds were quite consistent with the claim that the secondary market price is a reasonably accurate measure of perceived risk.

Taking secondary market valuations as the best guide to country risk that is at present available, what would be the implications for the banks of raising provisions to the levels that such valuations imply? Such calculations suggest that additional global provisions of about \$14 billions would have been appropriate in 1987, raising total global provisions to about \$85 billions. By 1988 very significantly larger provisions would have been warranted by the sizeable fall in the secondary market price of LDC debt. Just taking 15 US banks with LDC exposure in excess of \$1 billion, it would appear that by March 1988 their reserves were some \$20 billion short of the value required, as implied by the secondary market price of LDC debt. This suggests that they needed to more than double their provisions. Indeed, on this basis, provisions appear, in many cases, to have been less adequate in early 1988 than they were before the increase in mid-1987. Moreover, use of the Bank of England matrix (see Appendix) confirms that provisions at 25 per cent were inadequate in early 1988. Additional provisions of the amount mentioned here would have significant implications for the balance sheets of the provisioning banks. The lack of general further action suggests that the banks have deemed extra reserves to have unacceptable consequences for short-term earnings, profits and capital adequacy.¹⁷ Instead, as noted earlier, many of the larger banks have attempted to increase their percentage provisions by reducing their LDC exposures.

6. PROVISIONING AND DEBT STRATEGIES FOR THE FUTURE

There is no shortage of opinion as to wherein lies the best chance of solving the international debt problem. At one end of the spectrum is the line of argument that market measures should be assigned the principal role. This sees the future as involving the expansion of secondary markets and of debt equity swaps. To the extent that there might be official intervention this would focus on capping interest rates. The optimists point out that debtor countries can simultaneously take on more debt and improve their debt

situation provided they achieve adequate rates of economic growth. Again the argument is that the best chance of securing such growth is to deregulate domestic markets and to allow the private sector to assume greater significance.¹⁸

At the other end of the spectrum are those who are more pessimistic about the future and are certainly sceptical as to whether the debt problem may be resolved by relying so heavily on the unimpaired workings of the market. Such scepticism spawns the view that the official sector should have an expanded role, and that new devices and initiatives from this sector will be required if the debt problem is to be overcome in an efficient fashion. Opinions, however, vary about the details of the devices and initiatives that are required.¹⁹

In the context of this chapter there is little point in undertaking a full review of the various schemes that have been put forward in the literature. Instead the approach adopted here is to investigate how provisioning might fit into and facilitate alternative global debt strategies.

In one important respect provisioning by the banks may be seen as fitting neatly into the market-related solution since, as pointed out earlier, it facilitates debt conversion. However, a common criticism of debt equity swaps is that they do not generate any significant additional resources but merely re-channel investment that would have occurred anyway. If this is the case, debt equity swaps emerge as being a better tool for dealing with one part of the debt problem, the overhang of debt, than with another part, the generation of future loans.

Some bankers deny that there will be a strong demand for new loans, or argue that the loans will only be forthcoming if the debtor countries pursue economic policies that are deemed sensible by the financial community and if their economic performance improves. Others argue that, while the market mechanism may help the banks to reduce their debt-related exposure in LDCs, future lending will have to rely on the official sector. Again, as mentioned earlier, there seems little doubt that provisioning will have a negative impact on the availability of new loans from the banks.

Yet bankers themselves remain sceptical of the feasibility of many of the plans designed to enhance the financing role of the official sector, and in particular of those which envisage establishing some form of International Discounting Agency which would buy the banks out of their LDC loans.²⁰

More often than not bankers emphasise the importance of a leadership role for the official sector, in particular the World Bank and IMF. Of late they express some concern over what they perceive as a weakening in Fund conditionality, and a general lack of stewardship by the multilateral agencies. To some bankers 'leadership' and 'stewardship' do not necessarily involve vast additional amounts of money, but instead involve a clearly thought out strategy, a clear statement of this strategy, and a firm but constructive use of conditionality. At present they see no clear and consistent message coming from the official sector.

In this environment it may be worth considering other, apparently less ambitious, proposals for setting up some type of international bankruptcy court, called, by one of its proposers, the International Debt Restructuring Agency (IDRA).²¹ This agency is envisaged as a joint subsidiary of the World Bank and the IMF. It would aim towards providing a setting within which a negotiated resolution of debt service difficulties could be achieved. Debtor countries unable to meet their debt obligations would be able to apply to IDRA, which would then bring together all interested parties. Within this framework, creditors might agree to offer the debtor some form of relief. But, in return for this, the debtor would have to accept a degree of policy conditionality. IDRA would then monitor the agreement, with the hope of seeing the debtor country restored to creditworthiness.

The advantages of this scheme are first, that it would enable the official sector to provide the leadership that many are calling for. Second, it would not require significant amounts of extra finance which are unlikely to be available: essentially there would just be the administrative costs of operating the scheme. Third, it would enable both official and private creditors to come together and, it is hoped, agree on an appropriate distribution of debt relief. Fourth, it would enable a cohesive and consistent debt relief and policy conditionality package to be assembled. The official sector would thereby be providing the necessary input in terms of the adjustment incentive. Fifth, and as part of such an adjustment input, the scheme would encourage closer co-operation between the IMF and the World Bank in the design of structural adjustment programmes. Finally, the inclusion of conditionality, as well as the structured way in which applications for relief would be handled, would help to deal with the 'moral hazard' issue, namely that debt relief to one

country would result in unmanageable pressures from other countries to receive similar relief.

The proposal has the more general advantage of offering an inducement to both creditors and debtors alike. To creditors, there is the reduced risk of debtor default and the attraction that debtor countries will be encouraged to pursue policies designed to enhance their future ability to pay. To debtors, there is the attraction of receiving relief on their debt obligations, the absence of which might force them to pursue a range of relatively more unpalatable measures. Moreover, both official and private creditors would be brought together to negotiate a common approach. This could help overcome the present position where there are significant problems of perception. The banks feel that first, undue pressure has been put upon them to act as a lender of last resort, second, they have been insufficiently consulted in the design of 'rescue packages', and third, many of the resources they have put in have, in effect, been used to bale out the official sector. Meanwhile elements of the official sector feel that the banks have been too reluctant to accept both their part in causing the debt problem and, in relation to this, an adequate share of the adjustment burden.

Of course proposals of the kind outlined above would have very little chance of success if the private banks were unwilling to offer any extended form of relief to debtors. However, in this context, and as noted earlier in this chapter, the act of provisioning may well imply that the banks are now more prepared to accede to a loss than they were before. They may perceive a new negotiating framework as offering the best chance of minimising these losses. Moreover, they may be prepared, in effect, to pay something for the greater leadership and refurbished conditionality that they deem appropriate from the official sector.

Although the proposal for a debt restructuring agency primarily focuses on the problem of the debt overhang, it could also have implications for the future flow of funds to developing countries. Not least, the sight of debt difficulties being handled in a more structured and organised fashion could do little other than help the restoration of creditworthiness; something which, as outlined above, would also be helped by the appropriate and effective use of conditionality. Furthermore, the bringing together of the World Bank and the private banks under the umbrella of such an agency could assist the expansion of co-financing.²²

If the banks and the official sector did agree to grant additional debt relief under the auspices of a new negotiating framework, a question to be resolved would relate to the form that this relief should take. Fairly clearly its purpose would be to reduce debt-related claims on debtor countries' foreign exchange and the end result would therefore have to lower current debt service payments. Such an objective may be achieved either by reducing payments of principal or of interest. In the past banks have favoured the rescheduling of principal and the continuation of interest payments but, given that some banks are encouraging the official sector to provide a mechanism for capping interest rates, they might be prepared to accept greater interest rate capitalisation themselves.²³ Indeed, in one sense, the provision of new money has represented a form of capitalisation. With less new money being made available in the future, the banks might be more prepared to redefine the way in which capitalisation takes place by attaching it to old loans.

A sensitive problem will remain that of the appropriate distribution of relief between the private and official sectors, and, indeed, within the official sector. Certainly bankers believe that they have frequently demonstrated more flexibility in attempting to alleviate the financing problems of debtor countries than has the Paris Club or to a lesser extent the World Bank and IMF. They will not accept, therefore, a set of arrangements which they see as offering unilateral relief on their side; hence the need for discussion and negotiation.

Finally, it needs to be recognised that the extent and form of relief may need to vary between debtors. Some of the poorest countries of Africa and Asia may, for example, warrant relief with a higher grant element than that given to Latin American LDCs. At the same time a reasonably clear rationale for such differences needs to be established. Without necessarily believing that a formula has to be rigidly applied, debtors need to be able to identify a uniformity in treatment according to an established set of criteria. Discussion of these criteria has, however, been defined to lie beyond the scope of this book.

Attempts to help resolve the debt problem along the lines outlined above should not be regarded as exclusive, but merely as one component of an armoury of policies. Banks will no doubt continue to develop new items to include on their 'menu of choice'. At the same time, proposals for international insurance schemes based on the official sector but privately financed, as well as for selective allocations of Special Drawing Rights, seem worthy of further

consideration and eventual implementation. Similarly, proposals for liberalising the Compensatory Financing Facility within the IMF, as well as those for setting up an equivalent Interest Rate Compensation Facility (IRCF), which have recently been implemented, could possibly make a contribution.²⁴ The debt problem is unlikely to be resolved by one particular policy, but rather by a broad strategy which encompasses a number of elements. The challenge is to ensure that there are enough elements in place and that they are consistent with one another and mutually reinforcing.

There can be little doubt that, while the banks have a role to play in this strategy, it is not their responsibility to devise and orchestrate it. Given such a supporting role, the significance of commercial bank provisioning to the strategy has to be put in proper perspective. Although not without importance, its importance should not be exaggerated.

7. CONCLUDING REMARKS

In terms of helping to resolve the Third World debt problem commercial bank provisioning has, in itself, made a marginal contribution. Indeed, to the extent that it discourages the banks from making new loans, provisioning may be presented as deepening rather than alleviating the financing problems faced by the highly indebted developing countries, and as increasing the risk of default.

Yet provisioning is also consistent with various general approaches to the problem of Third World debt that have been canvassed. It is consistent with an approach based on the market mechanism, since it facilitates debt swaps by the banks and the further evolution of a secondary market in developing country debt. Banks have increasingly sought to improve their reserving ratio by reducing their LDC exposure through debt sales and swaps. At the same time, it is consistent with plans for a more highly structured approach which incorporates an element of relief for the debtors. While new money is made less likely by provisioning, and while most bankers publicly resist the notion of debt relief, provisioning makes it easier organisationally, for the banks to move towards write downs and, at least, partial forgiveness.

There are strong reasons for believing that an initiative based on the granting of a measure of relief to debtors is required if the debt problem is to be managed successfully over the next few years.

Factors not dissimilar to those that encouraged the banks to add to their provisions are likely to put growing pressure on them to consider the relief option seriously. If the banks do move towards the greater use of debt relief, then their decision to add to their provisions in mid-1987 may retrospectively be seen as an important strategic step in their changing posture towards the problem of Third World debt.

APPENDIX: THE BANK OF ENGLAND'S PROVISIONING MATRIX

At the beginning of August 1987 the Bank of England sent a letter to all UK-incorporated institutions authorised under the Banking Act with exposures in developing countries. The letter encouraged banks to reconsider the adequacy of their provisions with a view to increasing them, 'where appropriate', to reflect 'the deterioration in the prospects of their recoverability'.

Stressing the need for objective analysis the Bank developed a framework (matrix) which is reported below, designed to measure the extent to which the chances of full recovery had deteriorated. This was to be used as a basis for discussion between the Bank and each individual institution. It will be seen that the Bank's matrix is similar in nature to those used by the commercial banks in assessing risk and discussed in Chapter 2.

The matrix

There are three stages in the process of deciding an appropriate level of provision:

- (i) to identify countries with current or potential repayment difficulties;
- (ii) to identify the nature of those difficulties and the extent of the country's problems; and
- (iii) to determine, at this point, what proportion of the debt is unlikely to be repaid.

A number of factors or criteria can be identified to help make this decision. These factors can be incorporated in a matrix and weighted to reflect their

relative significance for assessing the recoverability of a loan. They fall into three categories, namely:

- | | |
|-----------|---|
| A Factors | which evidence a borrower's inability or unwillingness to meet its obligations whether at the due date or thereafter; |
| B Factors | which show a borrower's current difficulties in meeting its obligations and; |
| C Factors | which help to assess the likelihood that these difficulties will not be overcome. |

The matrix includes a total of 15 factors under the three categories. They can be applied to any country and to any type of exposure taken either in aggregate or by type of exposure. The aim has been to identify a range of observable factors which point to the likelihood of a partial or total failure to repay. For this reason different weights have been attached to the factors to reflect their relative seriousness.

Category C factors alone are not thought to point to irrecoverability and the need for provisioning, which can only be triggered by a factor or factors taken from Category A or Category B. It is suggested that a minimum score of 10 from categories A and B is required before the question of provisioning arises. Nonetheless it is recognised that economic and other factors of the kind incorporated in the matrix are important in assessing the weakness of the borrower's position, how far it has deteriorated or may deteriorate in the future and what prospects it has for recovery. Thus when added to scores from Categories A and B they can have the effect of raising the percentage level of provision required.

The Factors and the weights attaching to them are set out below as are the definitions to be used in completing the matrix. It will be noticed that, for some factors, alternative weights are identified, depending on the relative seriousness of the position. Only one factor (15) is to be weighted within a range according to individual judgement.

Method of scoring

The first step is to see whether or not a criterion or factor applies to a country. The next step is to establish, where appropriate, the relative seriousness of that factor. The 'score' for that country is then the sum of the weights attributed to each applicable factor.

Setting the level of provisions

The scoring system will provide a country ranking which can be used to establish the relative ranking in the size of provision. Because the

methodology cannot produce precise results, levels of provision should be established within broad bands against bands of scores.

| <i>Score</i> | <i>Provision (%)</i> |
|---|----------------------|
| 10–24 (of which 10 from Categories A and B) | 5–15 |
| 25–40 (of which 10 from Categories A and B) | 16–25 |
| 41–55 | 26–40 |
| 56–70 | 41–60 |
| 71–83 | 61–100 |

Scope of application

There are two alternatives:

- (i) to apply the factors and resulting provision percentage against all claims on a country;
- (ii) to apply the factors and resulting provision percentage separately to different classes of asset.

The Bank's view is that, for supervisory purposes, the percentage provision should be applied to a bank's total exposure including risk transfers to a particular country unless it can be satisfied that a particular claim or class of claims is recoverable in full.

Conclusion

The conclusion of this analysis is that certain identified events or anticipated identifiable events cast doubt on the ultimate recoverability of claims on a particular country and result in the expectation either that the borrower will refuse to repay some or all the amount outstanding or that only by forgoing some part of the principal amount outstanding will the balance be repaid. Moreover some account should be taken of general economic and other miscellaneous factors in determining the level of provision because they contribute to a more rounded picture of the condition and prospects of the borrower. Changes in the circumstances of individual countries, which would be reflected in the scores which they attract, can be taken account of by annual updating of country scores.

(Bank of England, August 1987)

ANNEX Analysis of Country Debt Recoverability

| Category | A 'A' Factors | | | B 'B' Factors | | | C Economic & Other Factors | | | | | | | Total | | | | |
|-------------------|---|--|--|---|---|---|--|---|---|--|---|---------------------------------------|---------------------------------|---|---------------|--------------------------|------------------------------------|----------------------|
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) | (11) | (12) | (13) | | (14) | (15) | | |
| Country Criterion | Moratorium in Effect 0-3 3-12 Mths=3 Mths=6 >12 | Country Rescheduled At Any Time Since Jan. 1983, Or in Process of Rescheduling | Second Or More Rescheduling Of Principal Amounts Rescheduled Since Jan. 1983 | Arrears of Principal Interest to IFIs Over Threshold To Stop Disbursement | Arrears of Principal Interest On Original & Rescheduled Loans From Other External Creditors 0-3 Mths=4 >3 | Arrears Of Principal Interest On Original & Rescheduled Loans From Other External Creditors 0-3 Mths=4 >3 Mths=8 | Interest Service Ratio >15% = 2 >25% = 4 In 1986 | Visible Import Cover <2 Mths=4 <4 Mths=2 End 1986 | Debt/GDP Ratio >50% = 2 >75% = 4 End 1986 | Debt/Exports Goods & Services Ratio >300% = 2 >500% = 4 1986 | Not Meeting IMF Targets/ Unwilling To Go To IMF | Unfilled Financing Gap Next 12 Months | Market Price <80 = 2 <50 = 4 | Over-Dependence Single Crop Natural Resource Export | Other Factors | Score 'A' & 'B' (Max 51) | Score Misc. Econ. Factors (Max 32) | TOTAL SCORE (Max 83) |
| Weight | 3,6, or 10 | 10 | 5 | 10, 4 or 8 | 4 or 8 | 4 or 8 | 2 or 4 | 2 or 4 | 2 or 4 | 2 or 4 | 3 | 2 | 2 or 4 | 20 to 5 | Sub T. | Sub T. | TOTAL | |

ANALYSIS OF COUNTRY DEBT RECOVERABILITY

'A' FACTORS

(1) Moratorium In Effect

Unilateral action by a country to limit its debt-servicing payments, either totally or partially, to creditor (see footnotes). Score 3 if moratorium has been currently in effect for up to 3 months, score 6 for between 3–12 months. Any moratorium over 12 months scores 10.

(2) Country Rescheduled at any time since January 1983, or in Process of Rescheduling

Country that has rescheduled either commercial or official debt since January 1983 or is currently in rescheduling negotiations.

(3) Second or more Rescheduling of Principal Amounts rescheduled since January 1983

Country that has rescheduled principal already rescheduled since January 1983

'B' FACTORS

(4) Arrears Interest or Principal to IFI's over Threshold to Stop Disbursement

Country that is currently in arrears (see footnotes) on either interest and/or principal to the International Financial Institutions (IMF, World Bank, Regional Development Banks) over the threshold to be declared ineligible (in the case of the IMF) or to stop disbursement (in the case of the World Bank and Regional Development Banks).

(5) Arrears Principal on Original and Rescheduled Loans from Other External Creditors

Any current arrears on *principal* on loans (both original *and* rescheduled) from external creditors other than those in category (4). Score 4 for arrears currently of up to 3 months and 8 for arrears in excess of this period.

(6) Arrears Interest

Any current arrears on *interest* on loans (both original and rescheduled) from other external creditors. Score 4 for arrears currently of up to 3 months and 8 for arrears in excess of this period.

'C' FACTORS

Economic and Miscellaneous Factors (Columns 7–15)

Economic Ratios for 1986 (Columns 7–10)

(7) Interest Service Ratio

This is defined as interest payable divided by the value of exports of goods and services (in 1986) and rounded to one decimal place. An interest service ratio between 15.0 per cent and 24.9 per cent scores 2, one of 25.0 per cent or more scores 4.

(8) Visible Import Cover

This is defined as the number of months' import cover (that is, the annual value of imports divided by 12 and then divided into reserves, the result rounded to one tenth of a month. Reserves should include gold valued at 75 per cent of the market price at end-1986 (\$293 per oz). Import cover of 1.9 months or less scores 4. Cover between 2.0 and 3.9 months scores 2.

(9) Debt/GDP ratio

This is defined as total external debt divided by Gross Domestic Product for 1986 expressed as a percentage and the result rounded to the nearest one tenth of a percentage point. Ratios between 50.0 per cent and 74.9 per cent score 2; ratios 75.0 per cent and over score 4.

(10) Debt/Exports ratio

This is defined as the total external debt divided by the value of exports of goods and services for 1986 expressed as a percentage, the result rounded to the nearest percentage point. A debt export ratio in the range 300 per cent to 499 per cent scores 2. A debt exports ratio of 500 per cent or more scores 4.

(11) Not meeting IMF Targets/Unwilling to Go to IMF

A country should score 3 under this criterion if it is in breach of IMF targets (that is, performance criteria for any programme, for example, SBA or SAF) or is unable or unwilling to go to the IMF.

(12) Unfilled Financing Gap Next 12 months

Country has an unfilled external financing gap between its prospective payment outflows and its prospective inflows after taking into account all presently available sources of finance.

(13) Market price

Secondary market 'bid' price for the country's debt (as a percentage of face value): between 50.00 per cent and 79.90 per cent score 2, below 50.00 per cent score 4.

(14) Over-dependence on single crop/commodity

Score 2 if 30.0 per cent or more of the value of a country's exports of goods and services in 1986 comprised a single primary commodity.

(15) Other Factors

Score any number from 0 to 5 depending on your assessment of other conditions in the country (whether economic or political) which affect its ability to repay indebtedness both now and in the future.

FOOTNOTES

(A) Any creditor (see column 1)

It is only intended that a moratorium in respect of a general class of creditor should be scored. Thus, suspension of payments to an individual creditor or creditor country would not be scored. If a moratorium is about to end the score should be reduced to 3 where applicable.

(B) Arrears (see columns 4-6)

In this context arrears arising out of temporary administrative delay, which are expected to be corrected within a relatively short period of time, should not be scored whereas generalised, observable and non-correcting arrears should be scored.

SOURCES OF INFORMATION FOR COUNTRY DEBT
RECOVERABILITY MATRIX

The following sources can be used to score the fifteen categories of the country debt recoverability matrix. The list is not exhaustive and does not list national sources but is intended as a general guide.

A Factors Columns 1-3

- (1) *Moratorium in effect* Public declarations reported in press.
- (2) *Country rescheduled or rescheduling* IMF International Capital Markets Table 49, Institute of International Finance (IIF) surveys of official and commercial reschedulings, press.
- (3) *Country that has re-rescheduled debt* IMF International Capital Markets Table 49, IIF surveys of official and commercial reschedulings, press.

B Factors Columns 4-6

- (4) *Arrears to International Financial Institutions (IFIs)*
IMF – IMF Annual report, Press releases, IMF Survey (published fortnightly)

IBRD – Quarterly Financial Statistics. For countries whose loans have been put on a non-accrual basis.

- (5) and (6) *Arrears on principal and interest to other creditors* Various sources including Advisory Committee, press reports. IIF country reports provide information on interest arrears.

C Factors Columns 7–15

Factors 7–10 *Economic ratios*

World Debt Tables (1986–1987 latest edition) and International Financial Scene (published monthly, by IMF), IIF country reports. Other sources include IMF Balance of Payments Yearbook, World Economic Outlook (IMF), ‘Financing and External Debt of Developing Countries’ (OECD) and ‘The Debt and other external liabilities of developing CMEA and certain other countries and territories’ (OECD).

- (11) *Meeting Fund targets/willingness to go to IMF* Press reports
- (12) *Unfilled financing gap* IIF country reports, press reports.
- (13) *Secondary market price* Salomon Brothers Inc: ‘Indicative Prices for Less Developed Country Bank Loans’.
- (14) *Overdependence on commodity exports* International Financial Scene, IIF country reports.
- (15) *Other factors* Judgemental.

4 Swapping Developing Country Debt

1. INTRODUCTION

Although numerous proposals have been put forward for alleviating the debt problems faced by developing countries, policy has, in practice, concentrated on a combination of rescheduling and economic adjustment within debtor countries. In recent years, however, a number of countries have begun to devise and operate various schemes for converting or swapping their external, foreign currency denominated debt, into domestic debt or equity. The most publicised scheme has been operated by Chile since mid-1985, but similar arrangements have also operated in Mexico, Brazil, Argentina, Turkey, the Philippines and Nigeria.

This chapter undertakes a preliminary investigation into the economics of debt swapping, and attempts to identify the principal advantages and disadvantages of such schemes. Section 2 briefly examines the mechanics and theory of debt conversion. Section 3 reports on some recent country experience, while section 4 analyses, in a fairly general way, the effects of debt swapping on: the structure and problem-intensity of developing countries' external debt; their credit-worthiness; the repatriation of flight capital; foreign direct investment; the domestic money supply and fiscal balance; and exchange rates and exchange rate management.¹ Section 5 looks at the extent to which debt conversion has been and needs to be regulated. It also provides an estimate of the welfare gains from regulation. Finally, Section 6 tries to draw out some brief conclusions from the preceding analysis. In summary it is concluded that debt swapping offers some highly indebted countries a way of easing their debt problem. However, while, on balance, the benefits of such schemes outweigh their costs, debt swapping will not do very much to deal with the more fundamental problems which such countries encounter, and will certainly not solve the debt problem

on its own. This conclusion coincides with that reached by the World Bank, namely that, 'debt conversion represents a limited but significant contribution to the search for solutions to debtor countries' problems' (World Bank, 1987).

2. THE MECHANICS AND THEORY OF DEBT SWAPPING

The basic mechanisms by which debt may be converted or swapped are relatively straightforward, although the technical details sometimes become complex.

The idea behind all schemes is to swap external debt which is denominated in foreign currency (usually US dollars) into domestic debt or equity which is denominated in domestic currency. Any such swap involves a buyer and a seller. The buyer, either resident or foreigner, purchases the debt from the asset holder, usually a commercial bank, with the original holder thereby effectively cashing in the loan, but only up to a proportion of its face value. The buyer then sells the debt back to the government of the country of issue, receiving in exchange assets denominated in domestic currency. These assets may be either public or private debt, or equity. However the buyer will not be able to swap the debt at the official exchange rate, but effectively at a less advantageous one, receiving fewer units of domestic currency for each unit of foreign currency. Although the buyer of the debt may initially receive local currency in exchange for it, there will usually be limitations on how the currency may be used. For example, the money may have to be used for capital investment or to buy equity shares in domestic companies. The demand to buy a country's external debt may come either from its own nationals in possession of, or with access to, foreign exchange, but anxious to invest in the domestic economy, or from foreigners similarly anxious to invest in a specific national economy. Significantly, the common feature is the desire to invest in the country whose debt is acquired. Although the strength of this desire may be influenced by the size of the discount and by the effective exchange rate, the underlying assessment of the country's economic prospects is likely to be a more important factor.

Basically the demand function might look as follows:

$$Q^d = a_1D, a_2I, a_3C, a_4A, a_5L, a_6T$$

where D is the discount on the debt, I represents the availability of specific investment opportunities, C represents the country's overall

credit-worthiness, A represents the availability of and return on other assets, L stands for the limitations on capital repatriation and profit remittances, and T represents the charge for conversion, meaning that converters will receive fewer units of domestic currency at the end of the deal than the official exchange rate suggests. The demand for debt to convert may be expected to vary positively with D , I and C and negatively with A , L and T .

The supply of external debt onto the secondary market will clearly be provided by current holders of the debt, although it will only be those holders whose own internal risk-adjusted discount rate is at least equivalent to that on offer in the market that will put up their loans for conversion.

In principle the intermediation of a third party in a debt swap is unnecessary. The original holders of the debt could simply and directly convert their dollar-denominated claims on the country into claims denominated in the domestic currency. Their desire to do this will depend on their currency preferences, which will in turn be influenced by the current effective exchange rate and expected exchange rate movements.

The supply function of debt for conversion may look as follows:

$$Q^s = b_1D, b_2S, b_3C^*, b_4P, b_5W$$

where D is again the size of the discount, S is the size of debt held, C^* is the holders' assessment of country credit-worthiness, P represents the holders' preferences between risk and return, and W represents the extent to which the debt has already been written down. The supply of debt for conversion may be expected to rise as the discount falls, the size of debt held rises, the holders' perception of country credit-worthiness falls and the preference for risk avoidance strengthens.

The purpose of the market in debt conversion is clearly to meet the latent demand for transactions arising from different preferences and perceptions of credit-worthiness on the demand and supply sides of the market, as well as to identify the equilibrium or market clearing price. However it may be somewhat misleading to refer to 'the' price. One needs to distinguish between the price of the debt, which will be inversely related to the size of the discount, and the price of debt conversion. As far as the 'conversion price' is concerned, buyers and sellers face different prices. From the sellers' point of view, and ignoring transactions costs, the price of the conversion is indeed measured by the discount on the debt. From

the buyers' point of view, however, the conversion is measured by the discount adjusted for the differential between the official and effective exchange rate.² Holding the exchange rate element constant, it may be anticipated that 'normal' demand and supply relationships will apply. The demand for debt to convert will be positively related to the size of the discount (negatively related to the price of the debt) with the supply of debt to convert being negatively related to the size of the discount (positively related to the price of the debt). Table 4.1 provides some data and the size of discounts.

The government of a country may influence the market in debt swaps in a number of ways. First, by affecting the country's contemporaneous and expected economic performance, it may influence both the demand for debt conversion and the supply of debt for conversion. As economic performance and prospects improve the demand for debt conversion will tend to rise and the supply of debt for conversion will fall, the price of debt will therefore rise and the discount on it will fall. Indeed, to the extent that conversion is itself seen as strengthening the domestic economy, it will narrow the discount and tend to eliminate the incentive to convert. Second, by administering the differential between the official and effective exchange rate in some way, it may influence the demand for debt conversion. Widening the differential, and thereby effectively taxing conversion, will reduce the demand. However, as noted earlier, the exchange rate differential could also influence the desire of initial holders of debt to convert it directly into domestic currency-denominated debt, which would reduce the supply coming onto the market in discounted debt.

Instead of altering the effective exchange rate differential, an alternative way of eliminating the rent to debt swappers, or of eliminating their 'consumer surplus', is to auction the right to convert debt. Under this alternative the official exchange rate could be used for debt swaps. Auctions would essentially amount to the 'tax' on debt swaps being market determined. Again assuming that transactions costs are zero, for as long as the anticipated return on debt conversion exceeds that on other assets not involving conversion, the bid price will tend to rise. Assuming a near perfect market it will tend to rise until the rent element is eliminated.

A relevant question here, however, is: why should the authorities permit the auction price to rise rather than increase the quantity of debt conversion? The answer is that, in practice, fears of 'excessive' foreign investment and of creating external costs in the form of problems for exchange rate management and for domestic financial

TABLE 4.1 *The discounted price of developing country debt (July 1986)*

| | |
|-----------|----|
| Argentina | 66 |
| Brazil | 76 |
| Chile | 67 |
| Colombia | 83 |
| Ecuador | 65 |
| Mexico | 56 |
| Venezuela | 75 |

SOURCE: Shearson Lehman Brothers International.

management have led countries to administer the process of debt conversion. Governments have therefore suspected elements of market failure to be present in debt conversion.

Of course the scope for administering swaps relates not only to its total quantity but also to its sectoral or industrial distribution. By offering certain preferential terms on certain deals, governments may selectively encourage investment in priority areas such as the export or labour-intensive industries.

Debt buy-backs by the debtor country represent another variant of swapping and an alternative means through which the debtor may attempt to recoup part (or all) of the rent associated with the discount on the debt. Where the banks bid against each other to sell off the debt they hold, the intra-marginal surplus that would be associated with a pre-set price will be reduced or eliminated. The gains to the banks are associated with the reduction in risk, and with the chance that a reduced probability of default will raise the secondary market price of remaining debt. The means by which buy-backs are financed are discussed in Chapter 5, where there is also some discussion of specific buy-back schemes.

3. COUNTRY EXPERIENCE

Of the various countries that have used debt conversion schemes perhaps Chile has shown the greatest enthusiasm for them by modifying the Central Bank's Compendium of Rules for International Exchange to allow for unrestricted use of the local currency proceeds of debt conversion by residents and for direct investment by non-

resident investors. Foreign investors, however, face restrictions on the repatriation of capital and the remittance of dividends. Capital may only be repatriated after ten years and dividends remitted four years after debt conversion.

Concern over its external effects on the exchange rate and the domestic money supply has led the Chilean authorities to impose an upper limit on the amount of debt conversion by operating a quota system, under which potential resident swappers have to bid for the right to convert debt. Even with such restrictions, the World Bank reports that debt conversion was running at an annual rate of about \$565 million in 1986 with slightly under two-thirds of this representing transactions by Chilean residents.

In Mexico, 23 debt-for-equity operations, running to a total of \$300 million, had been completed during the first half of 1986, with debt conversions for the whole year expected to reach about \$700 million. The Mexican programme has differentiated its terms for conversion according to how the pesos acquired are used. Generally, the highest peso redemption prices have been paid where the money has been channelled into the privatised state sector, export- and import-substituting industries and into investments which create employment. Restrictions on capital repatriation and profit remittance have been rather stricter than in the Chilean case, and conversion was initially limited to foreign bank investors. More recently foreign companies have been allowed to acquire a maximum of 15 per cent stake in Mexican companies in exchange for an equivalent amount of foreign debt conversion.

In Brazil the tax system has at times been used to encourage debt – equity swaps. But after mid-1984 the conversion scheme became more restrictive, with investment being constrained to take place in the original debtor country and tax credits being discontinued. By the end of 1985 about \$1.3 billion of Brazilian debt had been converted into equity. Another \$600 million of business was expected during 1986.

In both Argentina and the Philippines debt swaps differentiate between high- and low-priority areas with more favourable terms being offered in the former case. In the Philippines, for example, a relatively low conversion fee (at 5 per cent) is charged and only lax restrictions on capital repatriation are imposed for investments in export industries and in agriculture. Furthermore there is no restriction on dividends in these cases. For other lower-priority investments the conversion fee rises to 10 per cent, capital repatriation

may only occur after 5 as opposed to 3 years, and profits cannot be remitted during the first 4 years of the investment. Moreover investors have to bring in additional foreign exchange equivalent to 10 per cent of the total debt-related equity investment.

In Turkey a scheme has been operated whereby creditors holding suppliers' credits not guaranteed by the creditor country may be paid in local currency, with the currency being used to undertake new investments or to increase equity shares in certain sectors of the Turkish economy.

4. THE EFFECTS OF DEBT SWAPPING

The country experience described in the previous section suggests that, while countries perceive that benefits are associated with debt swapping, they also believe that there are potential problems. This section systematically endeavours to identify the various effects that debt conversion may have.

4.1 External debt

Clearly the principal attraction of debt swapping to the country involved is to reduce the amount of external debt and convert it into something else which is easier to manage. By swapping its debt the debtor country reduces its obligations to make foreign currency payments by the extent of the conversion. By reducing contractual claims on scarce foreign exchange, debt swapping allows the country to relax its foreign exchange constraint and to reduce the rigidity of its balance of payments. Debt obligations now become denominated in domestic currency and are therefore somewhat easier to service inasmuch as the government has greater control over its own domestic money supply than over the country's net foreign exchange position and its ability to earn foreign exchange. Not only will there be long-term solvency gains, but there will also be gains from avoiding short-term liquidity pressures.

Where external debt is swapped for equity, the repayment of debt-related interest and principal is replaced with outflows associated with foreign direct investment. To the extent that conversion schemes limit capital repatriation and the remittance of profits, at least in the short run, the country's foreign exchange position will again be strengthened.

To the banks selling off their loans, conversion enables them to achieve a preferred combination of risk and return. Banks will only participate in debt swaps, however, if they perceive them as raising their welfare. Yet there will be constraints on the extent to which banks will trade in their loans to developing countries. Many loans were originally syndicated and there is the question of whether it has to be the entire syndicated loan that is sold off or merely components of it. Selling off a component of a syndicated loan will effectively mark down the value of the rest of the loan. Indeed, in general, banks may be reluctant to sell their loans at a discount and may prefer to keep them on their books at face value. Selling off some loans may again effectively write down the value of other loans, especially where the banks do not differentiate significantly between different debtor countries.

For the above reasons, it may be assumed that banks will be less willing to sell their loans where there is little chance that they will be able to sell a significant proportion of them. It will tend to be the small banks with relatively little and relatively concentrated lending in specific developing countries, or banks which have already written down the debt, that will be most likely to participate.³

From the countries' point of view the worry is that, having sold off the debt, banks will be unwilling to make fresh loans. The argument here is that it is only the fact that banks are locked into their developing country loans which entices them to make new ones, the purpose of which is to increase the probability that the old ones will be serviced and eventually repaid. The counter argument is that at present the banks are, in any case, unenthusiastic about making new loans to developing countries, so that the idea of an inter-temporal trade-off between current and future debt positions is irrelevant. Improving the debt position now does not imply worsening it in the future. Indeed it may be argued that the increased flexibility associated with debt conversion, which provides banks with a more continuous and continuing range of return/risk combinations, will make lending to developing countries rather more attractive than it might otherwise be.

4.2 Credit-worthiness

The ambiguous effects of debt conversion are again encountered when their impact on credit-worthiness is considered. For while, on the one hand, debt swaps reduce the total volume of external debt

and will, with other things remaining constant, tend to improve many of the debt indicators consulted by potential lenders, they also provide a market measure of credit-worthiness through the discounted price of debt. In order for a swap to be attractive to a purchaser it may be assumed that there will have to be a significant discount on the price of the debt. Therefore, in order to derive the increased credit-worthiness associated with reduced external debt obligations, a country may have to accept the reduced credit-worthiness associated with a fall in the secondary market value of its debt. The overall impact on the country's credit-worthiness remains uncertain.

Moreover the assessment of credit-worthiness is not a precise science. Historically banks have used various risk indicators, some of which have been fairly subjective.⁴ When debt conversion schemes lead to increases in the domestic money supply, faster inflation and currency over-valuation (more on this later), they may weaken a country's credit-worthiness. If, by contrast, they lead to smaller fiscal deficits and a perception that the country is actively endeavouring to do something about its debt situation, especially where regulations have the stated intention of minimising any adverse effects on other domestic macroeconomic variables, they may enhance credit-worthiness.

Given the above, it would seem that the effects of debt swaps on credit-worthiness are likely to be fairly marginal. Since a marginal change in credit-worthiness is unlikely to have a significant impact on the size of financial loans to developing countries, it would seem that such considerations will not feature greatly in the decision as to whether to operate a debt conversion scheme.

4.3 The repatriation of flight capital

Again a similar conclusion emerges from considering the impact of debt swaps on the repatriation of flight capital. This is largely because the same factors which influence credit-worthiness also underpin capital flight.

There can be little doubt that capital flight has been a significant problem in a number of highly indebted countries, although recent figures suggest that it may not have been quite as universal or as large as has sometimes been assumed. Thus, according to Khan and Ul Haque (1987), for eight major debtors capital flight over 1974–82

may have represented between 15–30 per cent of external debt at its 1982 level. Interestingly, these figures suggest that capital flight was not a problem in Chile where debt conversion schemes have been most fully developed.

Capital flight appears to be influenced mainly by the economic performance and prospects of the country from which the flight occurs. Over-valued exchange rates and the related expectation of devaluation, along with large fiscal deficits and the related expectation of inflation seem to be amongst the most prominent causes. Moreover capital flight no doubt partly reflects attempts by residents to find 'safe havens' abroad and to reduce the risk associated with their portfolios. But, in addition, it may reflect the pursuit of higher returns, if domestic monetary policy has been arranged so as to keep interest rates low. Of course, there may also be 'pull' as well as 'push' factors at work, with deposit insurance, tax advantages and secrecy in receiving countries attracting capital inflows.

From this discussion it would appear that, for capital flight to be reversed, certain fairly fundamental policy changes in the losing country are needed. Debt conversion schemes, in themselves, are unlikely to have a dramatic effect, since the relatively small price effect they generate may be dwarfed by these more fundamental factors. Indeed, in a recent review of the policy options that might be used to reverse capital flight, debt swapping was not even mentioned (Khan and Ul Haque, 1987). Having said this, debt swapping will offer a price incentive which works in the required direction, and it may be seen as one component of a more structured and aggressive programme to deal with debt. Moreover it may discourage further capital flight even if it fails to bring about repatriation. As was noted earlier, about two-thirds of Chilean debt swaps have involved residents.

4.4 Foreign direct investment

Some degree of scepticism would also seem appropriate in assessing the impact of debt conversion schemes on inward foreign investment since the marginal change in the cost of such investment that would be caused by debt swapping arrangements would seem unlikely to be significant by comparison with the uncertainty surrounding the other determining factors. Just as some types of domestic investment are generally seen as being insensitive to small changes in interest

rates because of the wider degree of uncertainty involved, so foreign investment in developing countries might be expected to involve a high degree of risk.

It is therefore perhaps doubtful how much new foreign investment will be fostered by the introduction of a debt conversion scheme. Much of the investment might have occurred in any case and may merely be rechannelled through a debt swap. It is for this reason that some schemes insist that a certain amount of additional foreign investment is brought in, over and above that associated with the debt swap.

This having been said, by offering a more attractive rate of exchange and possibly also more lenient regulations with respect to capital repatriation and profit remittance, an additional inducement for foreign investment is created. Moreover, by varying the inducements according to the direction of investments, governments can create another policy instrument through which they may attempt to modify the distribution, as well as the total amount, of foreign investments.⁵

Finally in relation to foreign investment, there is the question of whether governments will prefer investment to be made directly or via debt conversion. Basically this comes down to a question of whether they prefer to see a fall in external debt or an increase in international reserves. However it also needs to be noted that, for a given amount of investment denominated in foreign currency, investment via debt conversion will result in a larger fall in external debt because of the discount at which the debt is purchased.

4.5 The domestic money supply and fiscal balance

The provision of local currency by the central bank in exchange for external debt will tend to increase the domestic money supply. With other things remaining constant this will in turn have an expansionary or inflationary impact on the domestic economy. Fear of the domestic financial consequences of debt swapping has been an important reason for conversion schemes having been controlled and regulated.

In principle the inflationary monetary repercussions of debt swapping can of course be neutralised or sterilised through bond issues which mop up excess liquidity. But, in practice, the bond market may be ill-developed. The scope for sterilisation is therefore likely to have an important influence on developing countries'

attitudes to debt conversion. Where there is a high degree of substitutability between money and real assets but a low degree of substitutability between money and long-term financial assets the concern about inflation will remain strong.⁶

While governments may be worried about the direct monetary repercussions of debt swapping, the implications for the fiscal balance may be rather different. Inasmuch as the government, or its agency, receives a conversion fee, this will serve to raise government revenue and, in effect, reduce the fiscal deficit. Debt conversion allows the government of the converting country to derive a share of the discount on its debt. However an external liability is replaced by a domestic one, and this will have implications for fiscal policy in the future as revenue may have to be raised to service the debt.

4.6 Exchange rates and exchange rate management

Fear of exchange rate effects is another reason for governments having regulated debt swapping. This fear has been particularly marked in the Chilean case where much of the demand for debt conversion has come from residents. Specifically the concern is that debt conversion will increase the supply of domestic currency and the demand for foreign exchange in the parallel market and will therefore put downward pressure on the price of the local currency, that is to say, cause exchange rate depreciation. Residents, having acquired external debt, then swap it back into local currency through the conversion scheme. Assuming that transactions costs are zero such activity will be profitable for as long as:

$$D > E$$

where D is the discount on the debt and E is the discount on the parallel exchange rate as compared with the official rate, that is, on the price of the local currency in the parallel market as compared with the official market. Debt conversion will tend to reduce D and to increase E and will continue until:

$$D = E$$

Although the above course of events provides a specific scenario where the value of the local currency is forced down, more generally debt swapping may influence the exchange rate in either direction.

Any increase in the domestic money supply and the domestic rate of inflation will enhance the downward pressure by causing over-valuation at the old nominal rate. Moreover, to the extent that the formalised write down of a country's debt damages confidence, the capital account will weaken and again the relative value of the local currency will fall. By contrast, to the extent that debt conversion and the resultant reduction in external debt increases confidence and the demand for the local currency, its value will be increased and the nominal rate will tend to appreciate.

This discussion suggests that the short-run direction of change in the exchange rate resulting from debt swapping depends largely on whether the main demand for a country's external debt comes from residents or from foreigners. In the former case the rate will tend to depreciate and in the latter case it will appreciate. How important these movements are depends in turn on first, their size, and second, the costs of currency misalignment. Only where debt conversion business is large in relation to total foreign exchange transactions is it likely to have a significant impact on the exchange rate. Meanwhile concern over such exchange rate effects is only justified if the costs of currency misalignment are significant. There is, in fact, considerable debate about the impact of the exchange rate in the context of macroeconomic policy in developing countries. Generally speaking, over-valuation becomes less relevant as the value of foreign trade elasticities of both demand and supply fall. Where the elasticities do not comply with the appropriate Marshall-Lerner conditions, exchange rate movements will have perverse effects on the current account balance of payments. The conventional view is that the elasticities increase with the level of economic development. Critics of devaluation therefore normally concentrate on its use within low-income countries.⁷ For the more developed middle-income countries, which constitute the major borrowers and which would be expected to make greatest use of debt conversion, it is usually accepted that exchange rate movements will not generate perverse effects. For this reason it would seem that currency misalignment could have adverse implications for the balance of payments, and needs to be avoided where possible. However debt conversion schemes will not be the only source of currency misalignment. Indeed it may be anticipated that they will usually be relatively unimportant compared with other sources.

5. THE REGULATION OF DEBT SWAPPING AND WELFARE EFFECTS

As noted in the section on country experience, debt conversion schemes have often involved some form of regulation by the domestic government. The regulations have normally been of three types.

5.1 Type of investment, repatriation and remittances

Governments have frequently attempted to channel investment into priority areas by offering more favourable terms. The rationale behind this is clearly that the market may fail to reflect fully the external benefits from additional employment or the scarcity of foreign exchange. Regulation would seem to be appropriate if this is indeed the case, although governments need to ensure that, in attempting to maximise the net social benefits from foreign investment, they do not, in the process, discourage investment which would have yielded positive net benefits. It may be better to have investments in low-priority areas than no investment at all.

Similarly, by regulating capital repatriation and profit remittance, governments may attempt to increase the short-run benefits of foreign investment for the balance of payments and the foreign exchange position of the country concerned.

5.2 Taxation of rent

By charging a commission on debt swaps, or by administering relative exchange rates, governments may attempt to eliminate the rent element conferred on the purchasers of debt. The intention here is again not to reduce the amount of debt conversion but to redistribute the swapper's consumer surplus towards the government of the indebted country. Provided it is realistic to assume that the government will use the revenue more to the advantage of the country than would a foreign company, this seems to be a reasonable form of regulation, although the government's charging policy needs to avoid making debt swapping uncompetitive, if the net benefits are seen as positive.

5.3 Regulation of the amount of debt conversion

Another means of 'taxing' the rent element is to auction the right to participate in debt conversion. In a sense this is a more subtle technique since, under the assumption that swappers do not cartelise, competition should ensure that the intra-marginal consumer surplus is fully redistributed to the government. However governments may then also have to determine *ex ante* the volume of bids they will accept, thereby limiting the total amount of debt conversion. The rationale here is not entirely to capture the surplus. It also implies that the government feels there is an optimum amount of business and that beyond this the social costs exceed the benefits. Since the assumption is that the market may exceed this optimum, the implication is that the market fails by underestimating the social costs. The externalities ignored by the market may be assumed to be the effects of debt conversion on the money supply, inflation and the exchange rate discussed earlier. However, given the uncertainty surrounding these externalities, but the probability that they are small, there may be a somewhat weak case for this form of business-limiting regulation.

Moreover it may be recalled that market pressures will be at work which automatically tend to regulate the level of debt conversion. Excess demand for debt swaps will tend to force up the discounted price of debt, reduce demand and increase supply. Excess supply, on the other hand, will force down the discounted price, reduce supply and increase demand. Conversion activity will also tend to eradicate any super-normal profits that are to be made from debt swapping.

Worries by governments that the demand for conversion is too strong may be countered by the observation that the implied rise in the discounted price of the debt, and in the price of the local currency, will tend to reduce the level of conversion. At the same time, to the extent that debt conversion does damage credit-worthiness, this will be reflected by a reduced demand for conversion at any particular discounted price. The extent to which conversion will be led by the supply side depends on the willingness of banks to write down their loans to developing countries.

As noted above, the rationale behind charging for conversion or for auctioning bids is in part to capture a share of the discount on the debt and the related surplus enjoyed by the debt purchaser. The welfare effects of debt swapping may be modelled in a very

simple way. In Figure 4.1 the discounted price of the debt is shown on the vertical axis and the nominal quantity of debt converted is shown on the horizontal axis. D^d represents the demand curve for debt to be converted. Where the discount is zero, that is, the secondary market price is 100 cents on the dollar, the demand is zero. As the discounted price falls so demand expands.

S^d represents the supply curve of debt for conversion. It is assumed that below a specific discounted price banks will prefer to hold on to their loans, but that as the discounted price rises, so they will be more inclined to offer debt up for conversion. There are then both conventionally sloped demand and supply schedules, which, for simplicity, are assumed here to have constant slopes.

Imagine now that, at a discounted price of 70 cents on the dollar, debt worth a face value of \$700 million is converted. Total expenditure, TE , by the purchasers of debt will be:

$$\begin{aligned} TE &= \$700\text{m} \times 0.70 \\ &= \$490\text{m} \end{aligned}$$

However purchasers of debt will derive a consumer surplus as shown by the cross-hatched area. This represents the value of total utility from debt purchase minus total expenditure on it. Given a 30 cents discount on the debt, and assuming that the slope of the demand function is constant, the consumer surplus (CS) associated with the sale of debt is:

$$\begin{aligned} CS &= 0.5(\$700\text{m}) \times 0.30 \\ &= \$105\text{m} \end{aligned}$$

Purchasers of the debt would have been prepared to pay a total of \$595m for the debt instead of the \$490m they actually pay.

It is not only the purchasers of the debt that derive a surplus. The banks selling the debt also derive one. This is shown by the vertically shaded area in Figure 4.1. Assuming that the banks will supply no debt for conversion if the discounted price falls below 50 cents, and assuming further that the slope of the supply curve is constant, the banks 'producer surplus' (PS) will be:

$$\begin{aligned} PS &= \$490\text{m} - 0.5(\$700\text{m}) \times 0.20 \\ &= \$70\text{m} \end{aligned}$$

Although banks would have sold the traded stock of debt for \$420m, they in fact receive \$490m.⁸

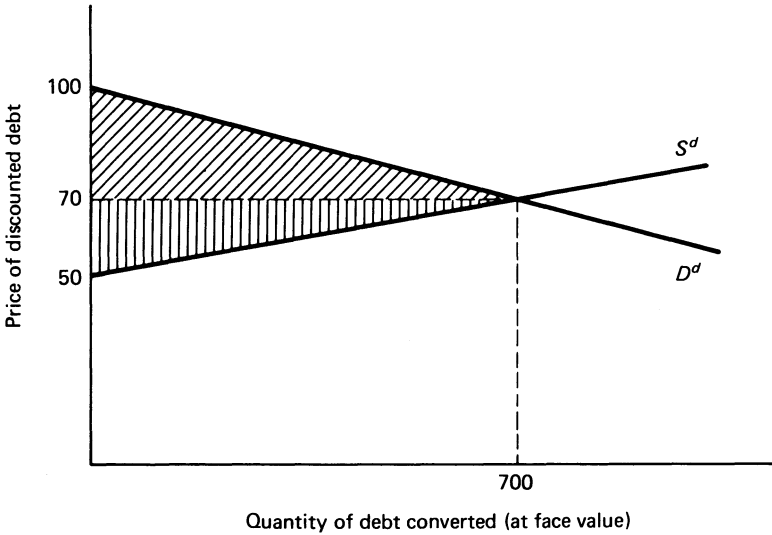


FIGURE 4.1

The government of the indebted country will, however, be more interested in the consumer surplus or rent derived by the debt purchasers, since this will be amenable to taxation. As mentioned above, there are basically two ways in which the government may attempt to redistribute the rent. The first is through making a charge on debt swap transactions. Charging on the nominal value of the debt will tend to reduce the level of conversions and does not allow for intra-marginal variations in the purchasers' consumer surplus. It will therefore be an imperfect way of taxing the rent.

Where differential charging which reflects such intra-marginal variations in consumer surplus is impracticable, auctioning the rights to participate in debt swaps offers an alternative approach. Here the government will fix the level of business on the basis of its assessment of the overall costs and benefits of conversion on the economy. An efficient auctioning system will then enable the government to derive the full consumer surplus. Thus, even at a lower level of conversion, the government may still derive a welfare gain which is greater than that associated with charges. For example, with swaps covering a nominal value of only \$500m, an efficient auction scheme could still yield a welfare benefit to the government (*GWB*) of approximately:

$$\begin{aligned}
 GWB &= \$105\text{m} - 0.5(\$200\text{m}) \times 0.086 \\
 &= \$96.4\text{m}
 \end{aligned}$$

In terms of Figure 4.2, by limiting the quantity of swaps below its equilibrium level and by auctioning the right to swap, the government is sacrificing the surplus represented by the shaded area, but is more efficiently capturing the remainder of the surplus, as shown by the area *ABCD*. Of course, where the government perfectly anticipates the equilibrium level of business or can iterate towards it, and deems this to be socially optimal, it can capture the entire surplus, *AED*.

Although the above analysis provides a reasonably systematic method for estimating the welfare effects of debt swaps, it leaves out of the calculations the other costs and benefits discussed earlier in the chapter and is therefore rather narrow in its treatment. It also ignores the option of direct debt buy-backs, though here the distribution of the welfare benefits between the debtor country and the creditor banks depends on the price at which the debt is bought. The lower the price, the smaller the benefit to the banks and the larger the benefit to the debtor.

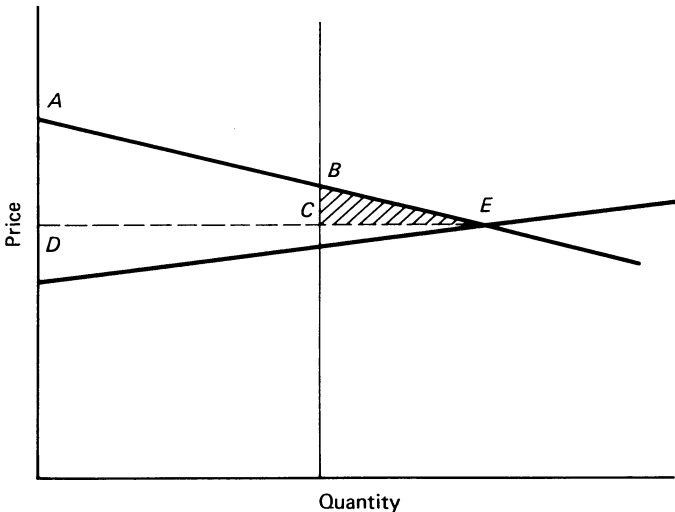


FIGURE 4.2

6. CONCLUDING REMARKS

The analysis in this chapter suggests that it is rather premature to reach firm conclusions about debt swapping in developing countries. What conclusions may be drawn are therefore rather tentative and require further statistical examination after there has been more experience of such schemes.

The fact that debt conversion has taken place suggests that participants perceive advantages, and the investigation in this chapter confirms that debtor countries, bank holders of debt and potential foreign investors do stand to gain from debt swaps. However, because of elements of market failure, resulting essentially from the existence of externalities, governments have also perceived the need to regulate debt conversion.

Regulation has taken on various forms and has had different purposes. The argument for it as a form of taxing the consumer surplus of debt swappers seems to be stronger than that for it as a means of limiting the volume of debt conversion. Most of the analysis here suggests that the possible costs of debt swapping for the country involved, in terms of currency misalignment, the domestic money supply and inflation, are likely to be small.

But, just as the costs may normally be insignificant, so it is easy to exaggerate the benefits. The debt position of a country, its credit-worthiness, the return of flight capital and the level of foreign investment all seem likely to depend much more significantly on factors other than the existence of a scheme for debt conversion.

The conclusion drawn, therefore, is that debt swapping will probably make a marginal, though still useful, contribution to alleviating the debt problems of a number of highly indebted developing countries, but that more fundamental reforms have to be sought elsewhere.⁹

5 The Future of Bank Lending to Developing Countries: The Debt Overhang and Market Access

All the indications are that bank lending to developing countries will continue to decline in the foreseeable future. The banks believe that they accumulated too high a stock of developing country debt in the 1970s and early 1980s and the process of portfolio adjustment therefore dictates attempts to reduce this debt overhang and not to add to it by making new loans. Projections of public debt service reflect this view. The World Bank, for example, envisages the servicing of developing country public debt held by private creditors falling from rather over \$89bn in 1988 to rather under \$33bn by 1994. The envisaged fall, in percentage terms, is even more marked for low-income Africa where public debt service is seen to decline from \$1.4bn in 1988 to only \$0.3bn by 1994.

With little exception, the analysis contained in this book confirms this prognosis. The theories lurking behind the leftward shift in the supply curve of bank loans investigated in Chapter 1, the changing perceptions of country risk discussed in Chapter 2, the provisioning and debt swapping undertaken by commercial banks and investigated in Chapters 3 and 4, all suggest that the surge of bank lending for balance of payments purposes that took place in the 1970s and early 1980s will not be repeated in the foreseeable future. Instead banks seem more likely to return to the sort of involvement they had with developing countries in the period prior to 1973, providing not only a much smaller share of total financial flows, but also finance of a more specific, as opposed to general purpose, type.

In an important sense such a change in bank lending would not be undesirable. For, as was seen in Chapter 1, bank lending of the 1970s variety involved both inefficiencies and inequities. However, before the withdrawal of the banks is too warmly welcomed as a systemic improvement, it needs to be asked whether the problems associated with bank lending could not have been handled in other ways. Furthermore, if the banks are not to provide finance for developing countries, from whence will the finance come?¹ Will another arm of the private sector in the form of foreign direct investment fill the gap, or will the official sector do so in the form of more foreign aid or more IMF and World Bank resources?² The withdrawal of the banks in isolation could have a devastating effect on those countries where development is effectively constrained by a shortage of foreign exchange, and where bank lending has played a key role in easing the constraint.

In this chapter we examine both the question of the overhang of debt held by the banks as well as that of the future of spontaneous or voluntary bank lending. The chapter identifies some of the various options that are available to help deal with these questions and tries to assess which of them are more and less likely to be pursued.

1. DEALING WITH THE DEBT OVERHANG

The objective of the banks, as profit maximisers, is clearly to maximise the present value of the developing country debt that they hold. This may involve the debtors continuing to service and eventually repay the loans that they received from the banks, or, where this is deemed unlikely, it may involve the banks selling off some or all of their developing country debt. The two courses of action are, of course, interrelated. Where banks attribute a low probability to continued servicing, they will be more inclined to sell off debt. With increased uncertainty about the future servicing of debts, banks are effectively applying a higher discount rate to future receipts. However greater involvement by the banks in the secondary market for debt, with the implicit acceptance that they will have to settle for something below the debt's face value, may in turn discourage the debtors from maintaining full debt servicing on their remaining debt.

For the first few years following the Mexican debt crisis in 1982 the banks opted for measures designed to encourage the debtors to

keep up with their debt service payments and to avoid formal default. The measures involved a combination of rescheduling old debt and of providing new money or refinancing. Table 5.1 gives a summary of debt restructuring agreements made between the debtor countries and the commercial banks between 1983 and 1987. A number of features of this table are noteworthy. First, there is the marked decline in both the number of agreements and the amount of debt restructured in 1985. This largely reflected the temporary upsurge in economic growth in the US economy which enabled some of the major Latin American debtors to strengthen their balance of payments through additional export earnings. It also led to premature claims that the debt crisis was over. Second, there is the subsequent increase in the amount of debt restructured. Third, there is evidence of a liberalising trend in the terms of restructuring with lengthening maturities, lengthening grace periods and falling spreads.

Indeed one of the central developments in the period covered by Table 5.1 was the introduction of multi-year rescheduling agreements (MYRAs) in 1984. Under such agreements debt was normally restructured for at least three years with the terms of repayment being relaxed. The hope was that such agreements would enable debtors to overcome their problems and renew their access to voluntary lending.

However, in reality, MYRAs did not fulfil these initial hopes. With a consistently hostile world economic environment, characterised by high interest rates and low demand for exports, domestic policy slippages and little new bank lending, liberalised rescheduling failed to bring about any significant improvement in the debt problem as measured by most debt indicators.³ Even encouragement from the governments and monetary authorities of industrial countries, most notoriously in the form of the Baker Plan in 1985, had little effect on the willingness of the banks to lend more money.

Dissatisfaction among the banks with the progress of rescheduling as a means of handling the debt problem, as well no doubt, as growing 'fatigue' associated with continuing debt renegotiations, resulted in some switch in the direction of bank policy towards developing country debt. The switch involved internal adjustments in the way in which developing country debt was regarded by the banks, with this being reflected by increased provisioning and a greater willingness to swap debt for equity in the debtor countries.

The switch in bank policy raises interesting questions for the

TABLE 5.1 *Debt restructuring agreements with commercial banks, January 1983–September 1987*

| | 1983 | 1984 | 1985 | 1986 | 1987 (June–September) |
|---|------|------|------|------|--------------------------|
| Number of agreements | 24 | 23 | 13 | 10 | 12 |
| Amount of debt restructured (US\$ billions) ¹ | 43.8 | 87.0 | 22.9 | 72.4 | 84.1 |
| Average consolidation period (years) | 1½ | 2¾ | 2¾ | 2¾ | 4 |
| Average repayment terms | | | | | |
| Maturity (years) | 6 | 9 | 11 | 10 | 15 |
| Grace (years) | 3 | 3 | 4 | 4 | 5 |
| Spread over LIBOR (percent) | 2.0 | 1.8 | 1.5 | 1.3 | 1.0 |

1. Includes previously rescheduled amounts.

SOURCE: World Debt Tables, 1987/8, World Bank.

future. For while, as established in Chapter 3, provisioning in itself does not provide any form of relief for the debtor countries, it facilitates swap deals which, in principle, do provide the opportunity for the debtor to receive some measure of relief, by effectively recouping a proportion of the discount on the debt. In the case of debt–equity swaps the proportion would normally be smaller than it would be in the case of buy-backs by the debtor country.

But should the banks take up the opportunity to extend relief to the debtors? There are a number of issues involved here: is debt relief an appropriate course of action systemically; if so, will the banks be prepared to provide such relief or, in other words, will they perceive the granting of such relief as being in their own self-interest; if not, are there ways in which they can be encouraged to provide it, and through what institutional mechanism could the relief be organised?

It would be unrealistic to expect there to be a clear-cut case either for or against debt relief. There are indeed arguments on both sides of the debate and any conclusion reached rests on weighing up the relative strengths of these arguments. An assessment of the arguments is, however, made more difficult by the fact that it is often difficult

to introduce any degree of quantification, since much depends on behavioural responses that are uncertain or unknown.

The case for relief covers both equity and efficiency. From the point of view of equity, it may be argued that relief represents an effective transfer of resources from rich to poor countries. Moreover, inasmuch as the debtor countries have certainly not been totally responsible for the problems they are encountering, contracts should be revised to share more evenly the distribution of the costs of a deteriorating international economic environment between debtors and creditors.

From an efficiency point of view, the arguments for relief are essentially as follows. First, by reducing their debt burden it would raise debtors' creditworthiness. Second, if relief is not offered, other measures which are more damaging to global economic welfare will evolve. Third, without relief there will be little incentive for debtors to adjust, since the domestic marginal returns will be low. Fourth, the debt problem is becoming more difficult and intractable as 'debt fatigue' sets in, reducing the incentive for debtors to carry on servicing their obligations and for creditors to put up new money or reschedule debt. A new initiative, such as would be provided by debt relief, is needed to restore progress.

The case against debt relief also incorporates equity and efficiency arguments. The equity argument is that the countries benefiting most from relief would be those that are most heavily indebted. These countries are not amongst the *least* developed nations of the world. If concessionary assistance is to be made available, should this not go to the poorest countries? Extending the equity argument, it is maintained that relief would reward the profligate and not the prudent. Critics maintain that it would be difficult to offer selective relief and that there would therefore be a 'free rider' problem.

These equity concerns also have efficiency aspects to them: if relief is provided to those encountering debt problems, will this not encourage countries to take on more debt than they have the capacity to service, precisely in order to gain access to the additional resources that relief implies: is there not a moral hazard involved with granting relief, even in circumstances where this is granted *ex post*?

Apart from discouraging appropriate adjustment policy, the argument against relief also suggests that it will reduce debtor countries' credit-worthiness and will therefore impair their access to

finance in the future and will also reduce their lines of trade credit, thereby inflicting an anti-trade bias. According to these arguments, relief is not in the interests of the debtors any more than it is in the interests of the creditors, global equity or efficiency.

Although, as noted above, there are grounds for disagreement on these issues, there is perhaps a reasonable presumption that events since the mid-1980s have strengthened the relative case for some form of relief. Credit-worthiness amongst the debtors is already so low that it is difficult to see how relief could have a significantly adverse effect on their market access, which is at present poor in any case. Meanwhile flexibility in the nature of the relief given, as well as the appendage of policy conditionality, could, in principle, deal with the problems of inequity, free riders and moral hazard.

While the arguments against relief can be neutralised, the positive case for it seems particularly strong at a stage in the debt problem when alternative measures have been tried and have largely failed, and when pressures may be mounting for inferior policy responses. Although it is easy to model the global conditions necessary for a resolution of the problem,⁴ these conditions seem unlikely to hold in the foreseeable future. The growth of developing countries' exports seems likely to be insufficiently high and the level of world interest rates to be insufficiently low to allow a global policy of inaction to be warranted.

But if there is a systemic case for debt relief, should the banks be the ones to provide it, and, if so, through what mechanisms should it be provided? If it can reasonably be argued that the debt problem is as much to do with over-lending by the banks as it is to do with over-borrowing by the debtors, then there may be some moral obligation upon the banks to accept a share of the costs of adjustment. Similarly, to the extent that debt difficulties have been caused by external factors which were unseen by debtors and creditors alike, this may be used as an argument for sharing the burden of adjustment between all participants. However, whatever the merits of such arguments, it is unlikely that the banks will be influenced by them. They are only likely to consider the provision of debt relief if they deem it to be to their own advantage.

Assuming that banks set out to maximise their expected profits, a concept which involves both return and risk, debt relief will be perceived by the banks as being self-serving if it increases the probability that countries will continue to service their remaining

obligations or, in other words, it reduces the probability of debtor default, thus increasing the secondary market value of remaining debt.

Of course, in one sense, the banks might be encouraged to offer relief to debtors if they believed that this would be well received by the market and would increase their own stock market value. This indeed could be a powerful incentive for providing debt relief.⁵

With recent moves in terms of provisioning and of limited debt sales at discounted prices, the banks have in a sense conceded that they are unlikely to receive the full repayment of their loans, although defence of their bargaining position discourages bankers from saying as much publicly. The key issue relates to the optimal distribution of the discount on the debt and the extent to which this should be allocated to the debtor countries. The banks having cleared their balance sheet constraints on the provision of relief have to weigh up the relative likelihood of the responses that relief (and non-relief) might generate. Will relief bring forth greater resolution and effort on the part of the debtors to meet remaining obligations and will it make a significant contribution to relaxing the foreign exchange constraint on economic development? After all, the best chance the banks have of getting their money back is for the debtor countries to enjoy a period of sustained growth. Or, on the other hand, will relief for some countries spill over into relief for all, and will it encourage countries to relax in their efforts to keep up with remaining obligations in the belief that further relief will be forthcoming? In a sense this reduces to the question of whether failure to service obligations reflects an inability or unwillingness to do so. If inability is the decisive factor the banks might be more prepared to offer relief.⁶

Moreover, unless banks did believe that relief provision would increase their own market strength, there would be little incentive for any individual bank to take independent action. While joint action might not be against the interests of banks as a whole, independent action could be against the interests of the bank undertaking it.

Different banks may, of course, have different views about debt relief, depending on the size of the developing country debt they hold, since, although absolute costs could be counterbalanced by larger absolute benefits, the uncertainties surrounding the response of debtors would mean that larger risks would be carried by those banks with larger amounts of developing country exposure. Debt

relief might be expected to have a more heavily adverse effect on the short-run profits of highly exposed banks. Having said this, the generalisation of provisioning amongst the banks has made it more likely that, if they are to continue to offer assistance, they will do so in the form of relief as opposed to new money. Moreover, if banks believe that relief is more likely to induce the pursuit of appropriate macroeconomic policies in the debtors than is new money which increases indebtedness, then it may again be in the interests of creditors to switch the emphasis towards the granting of more relief.

The practicalities of the debt problem are that an extension of debt relief by the banks is increasingly likely. Historically the resolution of debt crises has usually involved either creditors providing some form of relief or debtors defaulting; and it is difficult to see how the banks would gain by the latter course of events.

On top of this, the strength of the relative bargaining positions of debtors and creditors has been changing. For reasons mentioned earlier in this book, the pressures for debtor countries to default have been increasing while the costs of relief to the banks, as they have diversified away from developing country debt, have been falling. The banks are now in a stronger position to withstand the granting of relief than they were during 1983–6. This in itself reduces the chance that default would result in a major international financial crisis during which developing country exports would be seriously threatened, and thereby strengthens the debtors' bargaining position *vis-à-vis* the banks.⁷ Moreover the way in which provisioning was introduced served to weaken the solidarity of the banks and, for this reason, may have strengthened the bargaining position of the debtors.

Of course decisions of the banks relating to relief could be influenced by the official sector. Just as the banks have been under pressure to put in new money, they have also been exposed to the same pressure to grant relief.⁸ Banks might also be encouraged to offer relief through tax incentives; relief granted by the banks could be subsidised from the public purse. If there are systemic, public good-type efficiency gains from debt relief, as well as gains in terms of equity, then a subsidy might be legitimate. The problems with such a policy are twofold. First, to reduce the costs to the banks of inappropriate lending decisions might be inefficient, since it could, in principle, encourage inappropriate lending in future. Yet, as noted earlier in the book, the medium-term scenario is at present one of sub-optimal bank lending, and a measure which encouraged

more lending might therefore be seen as increasing efficiency. Second, if official money is to be provided in an attempt to alleviate the problems faced by debtors, should this not go to the low-income countries of Africa rather than the middle-income developing countries of Latin America?⁹ This is an important consideration. The provision of assistance for highly indebted countries should not be arranged in a way that crowds out aid for the poorest countries of the world.

To offset these arguments, however, it may be countered that, if it was government policy in the industrialised countries which caused or, at least, contributed to the debt problem, by means of forcing up world interest rates and forcing down the export receipts of indebted countries, it is legitimate that the same governments should now make a contribution towards solving the problem.

Assuming that, for some of the reasons listed above, the banks become more favourably disposed towards debt relief, the next question is through what institutional mechanisms might this be arranged?

2. MECHANISMS FOR GREATER DEBT RELIEF BY THE BANKS

2.1 Write-downs and write-offs

In a sense the simplest way would be for the banks to write down a proportion of the debt and the related servicing obligations. In the extreme, the write-down could be 100 per cent. However it is unlikely that the banks would countenance this unless a small amount of debt was involved and unless they had lent only to a very small number of, possibly very poor, countries. Although small banks may occasionally write off debt, it is more likely that banks in general will attempt to keep the loans on their books at face value and, instead, effectively vary the time period over which servicing and repayment of the debt is made.

2.2 Debt swaps, buy-backs and buy-outs

Rather than just write down the value of the debt and allow the debtors to modify their obligations accordingly, the desire to remove

existing developing country debt from their books is more likely to find expression through debt sales by the banks either for cash from a third party or as a swap for an alternative asset issued by the debtor country. In the latter case the banks would clearly need to perceive equity or bonds issued by the developing countries as being preferable claims to those that they already hold. To the extent that equity and bonds are attractive, debt swaps represent a potentially effective way of granting relief to indebted countries.

Chapter 4 provided some analysis of debt swapping in general and debt-equity swaps in particular. At the beginning of 1988 Mexico attempted to swap some of its medium-term debt held by commercial banks for 20-year non-convertible bonds. Simultaneously Mexico purchased non-marketable zero coupon bonds from the US Treasury to mature over the same period, and these were then used as collateral for its own bond issue. The take-up of the Mexican bonds by the banks was seen by some observers as somewhat disappointing; it was reported in the press that 199 banks traded in \$3.7bn of debt in exchange for \$2.6bn of new bonds, whereas it was intended that \$10bn of bonds would be issued. Moreover none of the larger banks seem to have participated, even though the bonds carried a more attractive interest rate than existing bank claims. The lack of participation suggests either that these banks believed that the discount on Mexican debt was excessive in relation to the prospects of the economy, or that they were not prepared to take the losses, which might have been interpreted to imply that their balance sheets were weaker than generally believed and that their existing provisions were inadequate. Given the analysis undertaken above, it is, however, perhaps not surprising that the smaller banks should have been more attracted by the swap than were the larger ones.

Whereas the Mexican deal offered new bonds in place of old debt, an alternative is that debtors buy back their debt directly, but at a market discount.¹⁰ The question that arises here is: why, if a country has the foreign exchange necessary to buy back its debt, should it not continue to meet its debt service obligations in the normal fashion, in which case there would not be a market discount on its debt? One answer is that donors may be prepared to offer financial assistance with the specific objective of helping to reduce a debtor's outstanding volume of debt. This was the situation in the case of Bolivia's debt buy-back in February 1987 in which 131 banks were involved. However it may be unwise to assume that the

Bolivian case will act as a model for other highly indebted countries. Bolivia was the least heavily indebted of the Baker 15 group of countries, had relatively low per capita income, was facing very severe economic difficulties and had virtually ceased servicing its external commercial debt. The discount on Bolivian debt was almost 90 per cent, and most banks had already written down the value of Bolivian debt either substantially or in full. The banks were probably pleased to get something for the debt rather than nothing. Moreover the price paid gave many banks an intra-marginal surplus and enabled them to off-load their entire stock of Bolivian debt.

A second answer to the above question is that debt buy-backs may represent a relatively efficient use of scarce foreign exchange in terms of reducing the debt overhang and of thereby easing eventual return to normal market access. Advocates of buy-backs maintain that it is an option that the debtors should pursue and that the banks would accept retrospectively, for the reasons discussed earlier. Buy-backs would help liquefy the banks' portfolios (at a price), would do so at minimum transaction cost and without the constraints of equity or bond swaps, and might raise the value of remaining debt held. The banks might then view buy-backs, or any form of relief, as a means of minimising losses on their developing country assets. It is in this sense, as noted earlier, that the granting of relief may be quite rational for the banks in terms of their own profit-maximising objectives. The key question here is the extent of the increase in the market value of the debt following a debt sale of any specified size – is the anticipated market value gain perceived by the banks to offset the face value loss? Furthermore advocates argue that buy-backs are not without historical precedent and that even with them *ex post* internal rates of return for creditors were respectable.

One variant of buy-backs sees the debtors calling for competitive tenders and buying back the debt on which the largest discount is offered. The extent of buy-backs from a debtor's viewpoint would be limited by its availability of foreign exchange, having covered short-term trade credits and obligations to international institutions. From the banks' point of view, however, it would be an option which, it might be assumed, they would prefer to avoid where the discounts on the debts of large debtors are themselves large. Indeed it could well be concern to avoid such schemes that will push the banks towards offering more muted forms of relief. Systemically buy-backs also have potential problems. For although they allow

the market to determine what the debt is worth, they also imply that the greatest relief is offered to those debtors on whose debt there is the greatest discount. This aspect of the scheme could give rise to both inequity and inefficiency.¹¹

Similar criticisms have been levelled at schemes which see an international debt facility purchasing developing country debt from the banks and then restructuring it in a way that provides debtors with relief, in exchange for which they would submit themselves to policy conditionality. If the banks are prepared to sell their developing country debt at a discount, it may be assumed that they will be largely indifferent as to whether the purchaser is the debtor country itself or an international agency. The banks will, however, clearly prefer to sell the debt where they get the highest price (lowest discount) for it, and where there is the greatest chance that conditionality will be brought to bear on the debtors. Appropriate policy conditionality will be perceived by the banks as maximising the chance of the remaining debt being serviced and of its market value rising. It is interesting to note that, whereas many commentators and the banks themselves present such discounting arrangements as involving a cost or *loss* for the banks in as much as they receive something below the face value of the debt, others have argued that, since the face value is unrealistic in any case, the welfare effects of international discounting are that the banks would *gain* in as much as there would be a positive effect in the secondary market price.¹² Where discounting enables debtors to return to normal debt servicing, the discount on remaining debt could, in principle, fall to zero. The actual welfare effects on the banks depend crucially upon whether the market price represents accurately the probability of the debt being serviced, and on the time preference, or internal discount rate, of the banks. Since participation in discounting schemes or buy-backs would be voluntary for the banks, revealed preference would suggest that their involvement implies a perceived welfare gain and their abstinence a perceived loss. Clearly the probability of remaining debt being serviced would be positively related to the amount of debt being bought back or discounted.

2.3 Interest rate capitalisation

Where banks find the terms for selling debt unattractive and therefore decide to keep it on their books, they could alternatively

grant debtors relief by capitalising interest repayments above a specified level. Essentially interest payments beyond this level would be rescheduled or deferred. The maturity of the rescheduling could itself be made to depend on future movements in interest rates with a sufficiently marked fall in interest rates serving to reactivate capitalised payments.

The operation of an interest rate-capping scheme by the banks has certain advantages over alternative proposals which suggest that a facility should be established within the IMF to provide additional resources to indebted countries in circumstances where there are interest rate excesses.¹³

Unless such an official scheme were to be financed by the banks, the relief provided to debtors would not be at the cost of the banks but could be at the cost of less indebted developing countries. There could therefore be worrying distributional implications if scarce official finance was too heavily concentrated in the direction of the major borrowing countries. If the banks were prepared to finance an official facility why should they not provide relief directly? Relief after all could still be tied to IMF conditionality. The only benefit might be the essentially artificial one that banks would be helping countries to meet formally their full debt service obligations. Although banks have generally been opposed to interest rate capping on the grounds that it would impair the market access of developing countries, this is a more difficult argument to pursue when access is already impaired. Indeed there are signs that the banks' resistance is weakening, especially amongst smaller banks and those with less developing country exposure.¹⁴

2.4 Liberalised rescheduling

Capitalising interest could constitute one component in a programme of debt relief through the liberalisation of rescheduling terms. This has been the route favoured by the banks in the period since 1984 after an initial round of rescheduling following the Mexican crisis which was on fairly restrictive terms. The elements of debt restructuring are shown in Table 5.2. Its failure to make a discernible impact on the debt problem may, however, indicate that liberalisation has not gone far enough. While there are good reasons to continue with the currency redenomination and interest rate options, there is also scope for further relaxing the terms of debt renegotiations

TABLE 5.2 Elements of debt restructuring (R) and new money packages (NM)

| | Currency redenomination | Interest rate options | On-lending re-lending | New trade facilities | Debt conversions | World Bank cofinancing parallel financing | Retiming | Securitization | Alternative participation instruments |
|-------------|-------------------------|-----------------------|-----------------------|----------------------|------------------|---|----------|----------------|---------------------------------------|
| 1987 | | | | | | | | | |
| Argentina | NM,R | NM,R | NM,R | NM | NM,R | NM | R | NM | R |
| Chile | R | R | R | | R | | R | | |
| Philippines | R | R | R | | R | | | R | |
| Venezuela | R | R | R | | R | | | | |
| 1986 | | | | | | | | | |
| Brazil | R | R | R | | R | | | | |
| Mexico | NM,R | NM,R | NM | | NM,R | NM | | | |
| Nigeria | NM,R | NM,R | | | R | | | | |

| | | | | | | | | | |
|-------------|------|------|------|------|------|----|------|----|---|
| 1985 | | | | | | | | | |
| Chile | NM,R | NM,R | NM,R | NM,R | NM,R | NM | NM,R | NM | R |
| 1984 | | | | | | | | | |
| Argentina | NM,R | NM,R | NM,R | NM | NM,R | NM | | | |
| Brazil | NM,R | NM,R | NM,R | NM,R | NM,R | | | | |
| Chile | NM | NM | NM | | | | | | |
| Mexico | NM | NM | NM | | | | | | |
| Philippines | NM,R | NM,R | NM,R | NM | NM | NM | | | |
| Venezuela | R | R | R | R | R | | | | |
| 1983 | | | | | | | | | |
| Argentina | NM | NM | NM | | | | | | |
| Brazil | NM,R | NM,R | NM,R | NM,R | NM,R | | | | |
| Chile | NM,R | NM,R | NM,R | NM,R | NM,R | | | | |
| Mexico | NM,R | NM,R | NM,R | NM,R | NM,R | | | | |

SOURCE: K. P. Regling, 'New Financing Approaches in the Debt Strategy', *Finance and Development*, March 1988.

by retiming interest payments, extending maturities, lengthening grace periods and reducing fees and spreads.¹⁵

Another argument for increased liberalisation relates to the high administrative costs of continuing renegotiations. Assuming that these involve a quasi-fixed cost, it may be more efficient to extend the number of years covered and endeavour to increase the chances that the liberalisation is sufficient to make a significant contribution towards enabling the debtor to sustain its resulting debt obligations. From this point of view, relief may again be an efficient policy for the banks to pursue.

3. INSTITUTIONAL FRAMEWORK FOR RELIEF

It is improbable that banks in general, of their own volition, will offer orchestrated relief to debtor countries. If they are to concede to such relief it will be in response to pressure placed upon them. This having been said, relief through rescheduling and through use of debt swaps may be expected to continue, but at a level which is unlikely to make a significant contribution to alleviating the debt problem.

Banks feel that they have been insufficiently involved in the design of financing packages for debtor countries and that they have been treated systemically as a lender of last resort.¹⁶ As noted in Chapter 3, there are reasons for establishing a new institutional framework under which debtors would discuss new financing and adjustment packages with all their creditors simultaneously. Debt relief might be expected to constitute an important element in the debt restructuring which emerged from these discussions. However the precise details of the relief, in the form of its terms and its distribution between creditors, would not be prejudged, but would be negotiated. The banks would be able to make an input into these negotiations. The framework would therefore offer some insurance against the banks' feeling that they alone are being singled out to provide relief. Within the negotiations, the banks would be able to exert some pressure on the official sector to carry a share of the costs of providing relief in circumstances where it was regarded as appropriate.¹⁷ The nature of the relief offered by this caucus of creditors would depend, *inter alia*, on the causes of the debtors' problems; on the liquidity/solvency aspects of the problem; on the market's assessment of what was a realistic value for the stock of

debt, as represented by the secondary market discount on it; on the per capita income of the debtor; and on the debtor's commitment to economic adjustment. Within an institutional framework which is universal to all debtors, a case-by-case approach would therefore evolve.

Although it is unrealistic to assume that the banks would take the lead in establishing the sort of institutional framework outlined above, it is reasonable to assume that they would participate in it once it had been established. Indeed statements by representatives of the banking community have suggested as much.

It is important to note that, whereas the framework for negotiations would bring a certain amount of order to debt restructuring, it would not attempt to impose any specific formula for relief. The emerging agreements would be related to market factors, but would seek to augment these where deemed appropriate. The negotiations should lead to agreements that deal with both the efficiency and equity sides of the debt problem.

4. RESTORING MARKET ACCESS: FUTURE BANK LENDING

Apart from dealing with the overhang of accumulated debt, another issue relates to the restoration of normal market access in which there is voluntary or spontaneous lending by the banks to developing countries. Some reservations have to be expressed about this objective. First, in as much as the banks overlent during the 1970s and early 1980s, it is undesirable to return to this old volume of lending. Second, for reasons discussed earlier in the book, short-term bank lending is, as a general rule, an inappropriate way of financing economic development. Non-debt-creating private flows, for example, in the form of foreign direct investment, or financing by the official sector through the multilateral agencies, might be deemed more appropriate. There is a strong case for not standing in the way of a systemic evolution which reduces the relative financing role of the banks.

Yet, at the same time, it is legitimate to raise the question of whether measures need to be pursued in order to ensure that bank lending is not at a sub-optimal level. Just as 'disaster myopia' may have caused overlending in the 1970s and early 1980s, it may, symmetrically, have caused underlending in the period since 1982. Reforms along the lines of those discussed in Chapter 2 should help

to eliminate some of the shortcomings of bank lending associated with inappropriate analysis of credit-worthiness. However it needs to be remembered that banks, as is the case with all lenders, will be looking at the returns and risks of lending to developing countries as compared with alternative options. In essence it has been the perceived increase in the risk of partial or full default since 1982 combined with increasing investment opportunities elsewhere which has disinclined the banks from lending to the Third World. It is therefore through measures designed to reduce risk that there may be some scope for encouraging bank lending in the future.

One way of attempting to reduce risk is to change the type of bank lending towards being trade-related, and towards financing investment covering projects with satisfactory cash-flow and repayment expectations. A similar motivation lies behind the greater use of negotiable instruments. For example, banks might be more prepared to lend by purchasing bonds if they regarded these as being less subject to default (senior assets) and as being more marketable. Indeed much discussion of the debt overhang has itself hinged on the 'securitisation' of the debt. Being able to lend by buying marketable assets clearly reduces the risks of lending in terms of increasing the flexibility of the resulting portfolio. If banks are to lend to developing countries it is clear that they have to be offered a wider 'menu of options' than was available during the 1970s and early 1980s. The menu includes: trade and projects lending; new money bonds; alternative participation instruments or exit bonds, under which banks with relatively small exposures would be able to avoid the obligation to participate in providing new money by accepting negotiable low-interest bonds; on-lending, by which banks would be able to channel funds to specific end users even under the umbrella of general balance of payments loan agreements; and notes or bonds that, it would be agreed *ex ante*, would be convertible into local equity. The menu is often defined to include more conventional debt conversion although, as noted in Chapter 4, there is some debate about just how much additional finance is associated with these. Although the selections on the menu have found verbal support amongst the banks, they have yet to generate any significant impact on the size of financial flows. Where, for example, exit bonds have been used, as in the Argentine rescheduling of 1987, they have not proved attractive to the banks because of the relatively low interest rate and long maturity and grace periods.

But there are other ways of reducing the risks associated with bank lending to developing countries and of thereby encouraging new lending. These involve the official sector and include co-financing, the insurance of loans and conditionality. Of course it should also be stressed that the governments of the debtor countries have a significant influence over the risks, as perceived by creditors, of lending to their country. The pursuit of policies that are deemed to be unwise by the international financial community, such as over-valued exchange rates and excessive budget deficits, are unlikely to do anything other than damage credit-worthiness and reduce still further the chances of renewed access to financial markets.

4.1 Co-financing

For some years the World Bank has been involved with the commercial banks in co-financing development projects. Traditionally the Bank and the banks have made separate though parallel loans. More recently, however, the B-loan pilot programme has been evolved under which co-financing takes the form of syndicated lending, with the Bank being part of the syndicate; or guarantees, with the Bank guaranteeing the longer maturities of a private loan; or contingency liability financing, with principal payments being deferred to the end of the loan in the event of the interest rate rising above an agreed level, and the Bank standing ready to make a loan equal to that part of the principal remaining unamortised at the end of the loan's original maturity.

The intended purpose of the Bank's co-financing effort has been 'to help reinstate a net flow of commercial funds on the long maturities appropriate for development finance' (World Bank, *Annual Report*, 1984, p. 23). In principle there are significant advantages with the new form of co-financing. For example, in a situation where interest rates are volatile, the *de facto* variable maturity loan implied by the contingent obligation option has been advocated as representing an important advance.

In practice, however, there are problems associated with World Bank co-financing. Not least it remains unpopular with many banks which, while appreciating the World Bank's skills in project evaluation, see it as involving a disproportionate amount of bureaucratic 'red tape'. Moreover the banks argue that co-financing is appropriate only in a limited number of marginal cases where

countries hover on the borders of credit-worthiness. For the most part, bankers maintain that they would prefer to make loans based on their own evaluations, especially since they regard the cross default provisions of co-financing as inadequate. They also stress the different aims and objectives of themselves and the World Bank agencies and wish to avoid becoming involved with an institution which they see as offering 'aid'. Given the potential advantages of co-financing and the likely importance of 'marginal cases', as many developing countries seek to restore their access to private capital, perhaps the World Bank should carefully examine the bankers' concerns. Not only would there seem to be a strong case for modifying and expanding the B-loan pilot programme, but there might also be a case for extending the bank's co-financing activities to incorporate its structural and sectoral adjustment lending. In this way a formal connection between private lending and World Bank conditionality could be forged. Such a connection would clearly become more significant if the SAL programme was itself expanded. Since the argument can be made that the nature of World Bank conditionality is more appropriate to the needs of many developing countries than is that of IMF conditionality, expansion in the SAL programme combined with a co-financing provision would have other related benefits.

4.2 Insurance and guarantees

As noted above, guarantees have been included as an element in the World Bank's co-financing programme. However, the insurance of private loans is an idea that might be applied more widely. After all, insurance represents a long-accepted way of dealing with risk as individuals buy certainty for the price of a premium plus (usually) a deductible and the insurance company takes on the exposure but reduces its overall risk through the application of the law of large numbers.

The principle could be applied to bank lending to developing countries, with the banks taking out insurance against country risk. Indeed the IIE reports that just such a deal was put together between Citicorp and an insurance consortium headed by CIGNA. However, lack of support from other insurance companies and negative press reaction caused the deal to fall through.

Borrowers would gain from banks using private loan insurance since the benefits to the banks from reducing risk would, on the basis of revealed preference, outweigh the costs of the insurance cover. Private lending would therefore more nearly match the return-risk preferences of the banks and the flow of loans to developing countries would expand. Of course the possibility exists that banks would attempt to recapture the cost of insurance by increasing the spread, but to the extent that existing spreads already incorporate a risk element which would now be passed on to the insurer, it seems unlikely that spreads would rise. Indeed, if private insurance is a more efficient way of covering risk than syndicated lending, spreads might even fall.

As the collapse of the Citicorp-CIGNA deal suggests, doubts about private insurance arise more from the likely depth of the market on the supply side. If, however, insurance would benefit borrowers and lenders and would encourage additional flows of capital to developing countries with benefits for the world economy as well, are there not public good arguments for providing the insurance through an official agency such as the World Bank or the Fund?

Official insurance or guarantees would involve a number of problems. First, there is the worry that the provision of insurance would create a moral hazard both for the lenders, who might be encouraged to be less careful in their country risk analysis, and for the borrowers, who might feel that the costs of default have been reduced. However the payment of the premium and deductible should offset the moral hazard as far as the lenders are concerned, while, if an insurance claim were to be linked to the requirement that the country involved accept IMF or World Bank conditionality, this should deal with the moral hazard as applied to borrowers. Moreover default would no doubt raise the cost of insurance cover on the defaulter and since this might be expected to reduce the quantity of future loans this would also act as an incentive for countries to avoid default where possible.

A second problem is that while, once established, an insurance scheme should be self-financing or even profit-making, in the short run it will cost something to set up. There might also be a learning period needed to find out what the appropriate insurance rates are for this kind of business. The scheme would need to have sufficient resources to provide confidence that claims would be honoured. Clearly it would not be necessary to hold 100 per cent backing,

although this is what currently happens with some of the existing World Bank arrangements, but there would still be a significant initial cost. The difficulty in meeting this cost from official sources is not only that the money may not be available but also that to use scarce official resources in this way would be to deflect them away from other uses. Important distributional issues therefore arise. Should support of lending to better-off developing countries by the World Bank or IMF receive priority over its lending to the least developed countries?

An alternative would be for the World Bank or IMF to borrow directly from the private capital markets in order to provide the initial financing. No doubt this would be possible, but even this method of financing raises the question of whether the provision of guarantees would absorb resources that would otherwise have been lent directly to developing countries, with the result that there is no net addition to financial flows. Given the current situation where new loans are not forthcoming this anxiety may be over-stated. The introduction of an officially operated, but privately financed, loan insurance scheme would seem worthy of close scrutiny. The insurance cover would be offered only on new loans and could, in effect, be shared between the agency involved and the banks by applying only to a *portfolio* of loans rather than to *individual* loans.

An alternative form of guarantee would be not to insure the lenders but to provide the borrowers with additional finance in the event of payments difficulties, via, for example, the IMF. Such a scheme would, however, also be subject to the financing, moral hazard, and distributional problems discussed above and might be even more difficult to implement.

4.3 Conditionality

Both within the context of co-financing, and guarantee or insurance provision, as well as independently of these activities, conditionality is something that the official international institutions can offer in support of private lending to developing countries. Under current circumstances conditionality may be more efficiently organised through the institutions than through the private lenders.

Most of the discussion in the literature has focused on IMF conditionality, and has suggested that it has a catalytic effect on other forms of lending. However, criticism has been made that IMF

conditionality has been too inflexible to deal with the range of balance of payments problems that developing countries encounter and, in particular, with structural payments problems. The claim is that IMF-supported programmes have had only a muted effect on the countries in which they have been adopted, and that a more varied menu of policies should be considered which focuses on the 'real' economy rather than on financial indicators.

This is not the place to undertake yet another review of IMF conditionality or of World Bank conditionality. But the role of conditionality in fostering bank lending needs to be remembered, and one perspective on reviewing proposed changes in conditionality must relate to their likely impact on the catalytic effect.

5. CONCLUDING REMARKS

Although the above discussion clearly reveals that there is some scope, in principle, for increasing bank lending to developing countries over the levels of recent years, in practice it is difficult to see that any significant increase will occur in the near future. The wider menu of options through which banks might lend has not generated a large response, and institutional reform cannot be assumed.

With low levels of new lending in prospect, and increased provisioning, the case against, as well as the banks' bargaining stance against debt relief, is weakened and the bargaining position and resolve of the debtors strengthened. Unless there is a fairly fundamental change in the global economic environment, it would seem that there will be mounting pressure on the banks to offer more structured debt relief. Certainly some initiative may become of vital importance in breaking the vicious circle of debt, within which debt causes countries to become more heavily constrained through an insufficiency of unobligated foreign exchange, economic growth declines, and debtors, as a result, become even less attractive to creditors. Although it is unreasonable to expect the initiative to come exclusively from the banks, it may be equally unreasonable to expect them to be immune from it. Either their role will involve providing new money, as was the situation after 1982, or it will involve granting larger amounts of relief; circumstances have now moved in favour of the latter. Without some form of assistance from the banks, and in the absence of a significant expansion in the role

of the official sector, the debtors may seek to impose relief unilaterally. The banks seem likely to conclude that it may be better for them to have a hand in designing the nature of relief rather than to leave it entirely to the debtors.

Notes

1. Private Bank Lending to Developing Countries

1. For a fuller analysis of default see J. Eaton and M. Gersovitz, 'Debt with Potential Repudiation: The Critical and Empirical Analysis', *Review of Economic Studies*, April 1981; and John Williamson, 'The Outlook for Debt Relief and Repudiation in Latin America', *Oxford Review of Economic Policy*, vol. 2 no. 1, Winter, 1985.
2. For a review of the evidence on the relationship between interest rates and spreads see David Llewellyn, 'Modelling International Banking Flows: An Analytical Framework', in Black, J. and Dorrance, G. (eds), *Problems in International Finance* (London: Macmillan, 1984).
3. The statistics upon which this claim is made came from *World Economic Outlook*, Occasional Paper No. 21, IMF, Washington, 1983, Tables 25 and 58.
4. Price and quantity variables will move in the same direction following shifts in demand (assuming an upward-sloping supply schedule) and will move in the opposite direction following shifts in supply (assuming a downward-sloping demand schedule).
5. For a useful review and analysis of the evolution of commercial bank lending to developing countries see Llewellyn, 'Modelling International Banking Flows', op. cit.

2. New Approaches to Country Risk Assessment

1. This implies that reluctance to lend to developing countries has as much to do with internal portfolio balance as with the increased perception of the risk involved.
2. See, for example, Frank and Cline (1971) and McDonald (1982) and Sachs (1984).
3. See Eaton and Gersovitz (1981). Their approach, based on the costs and benefits of default, has been criticised for underestimating the costs, largely because the costs of forfeiting trade credit are ignored. However, for a further discussion which reaches the conclusion that countries may well decide to default even when they are able to meet their obligations, see Krugman (1985).

4. See Gutmann (1980) where it is argued that, having examined the risk associated with lending on the basis of a system which included various debt indicators, international reserves, export earnings, energy vulnerability and political factors, 'Mexico's oil resources . . . justify a reduction in the country's (risk) score.'
5. See, for example, Kharas (1984) and the World Bank (1985).
6. See Bird (1983) for a review of the available evidence.
7. For a review of the evidence see Stern, Francis and Schumacher (1976).
8. See, for example, Khan and Knight (1983).
9. See Thornblade (1984) for a discussion of some of the econometric evidence.
10. In the case of the import coefficient, the assumption is that the government pursues a demand deflationary approach to adjustment. The costs of such a policy in terms of reduced national income will vary negatively with the value of the import coefficient.
11. See, for example, Donovan (1984) and Khan and Knight (1983).

3. Commercial Bank Provisioning against Claims on Developing Countries

1. The official sector did respond in some ways. For example, the IMF established an Oil Facility to assist those countries particularly adversely affected by the oil price rise.
2. Most provisioning that has been made by commercial banks has publicly been presented as being against a group of (say) 35 countries. The banks themselves, however, arrive at the overall provision by aggregating notional provisions against individual countries.
3. These figures are derived from the practices of Dutch banks in 1986 as reported to IBCA Banking Analysis although similar divergences seem to exist amongst other banks.
4. Proposals have been made by the Cooke Committee to introduce some greater measure of international uniformity in the measurement and standards of capital adequacy. By 1992 banks must have equity capital equal to 4 per cent of their total assets.
5. The ICERC may classify debts as sub-standard, value-impaired or a loss. To be classified as value-impaired a debtor must fulfil more than one of four conditions; that it has not paid interest for six months; that it is failing to comply with an IMF supported program; that it has failed to meet its rescheduling terms for a year; and that there is little prospect for an orderly restoration of debt service in the near future.
6. Gross investment in the Baker Plan group of 15 heavily indebted countries fell from 24 per cent of GNP in 1982 to 17 per cent in 1986. Falling import volumes may also suggest that fewer capital goods are being imported.
7. For a critical review of banks' approaches to country risk analysis, see Graham Bird, 'New Approaches to Country Risk', *Lloyds Bank Review*, October 1986.

8. Brazil's subsequent resumption of payments in early 1988 is discussed briefly later in this chapter.
9. Some commentators have certainly identified a new era of the entrepreneurial spirit of competition. Similarly, and somewhat more graphically, the Chairman of Citicorp has been described by a fellow banker as the 'Rambo of the money centre banks'.
10. For a fuller analysis of the bargaining positions of creditors and debtors see Benjamin J. Cohen, *The Political Economy of LDC Debt*, mimeographed, August 1988.
11. For a more detailed analysis of debt swapping see, Graham Bird, 'Debt Swapping in Developing Countries: A Preliminary Investigation', *Journal of Development Studies*, April 1988.
12. At the same time fragmentation amongst the banks tends to strengthen the bargaining position of the debtors.
13. For a discussion of how the banks view their own future contribution to financing economic development see, 'Restoring Market Access: New Directions in Bank Lending', Institute of International Finance, Washington, June 1987. The emphasis is placed on projects and on backing the domestic private sector.
14. During 1987-88, for example, Republic Bank of New York wrote down some of its Mexican public sector debt; the Bank of Boston wrote off about 20 per cent (\$200 million) of its Latin American loans, an action followed by two other US regional banks; and Amex Bank wrote off all its private sector loans to Latin America. In the case of the Bank of Boston's decision to increase its provisions and write off loans, it is interesting to note that a new chairman had recently been appointed, and that he was anxious to make an impact and to raise the profile of the bank and create the image of a 'super regional'. Actions on Third World debt provided a way of generating a higher profile and attempting to create a competitive edge. This episode further confirms what was suggested in the cases of the Citicorp and National Westminster Bank decisions; namely that internal bank politics is an important proximate ingredient in explaining provisioning, and that managerial utility functions are important.
15. For this reason Citicorp have argued that the effective discount is no more than 20 per cent, and not the higher level shown by the secondary market.
16. About 250 banks and 50 non-financial companies are reported to be trading in the market with a turnover in 1987 expected to be \$10-15 bn. Salomon Brothers have argued that at this level of business market prices represent a more reliable consensus view than the subjective opinions of top banking executives which creditors currently accept.
17. Phillips and Drew in their regular review of the UK clearing banks point out how difficult it is to make comparisons of provisions adequacy between banks. However, examination of the ratio between provisions and non-performing loans (NPLs) for the British banking industry as a whole shows that this increased from 105 per cent in 1981 to 124 per cent in 1987, i.e. provisions have been rising relative to NPLs, showing a more conservative attitude amongst bank managements. Of course

- this does not necessarily mean that provisions were adequate in 1987; it could simply reflect the extent of inadequacy in earlier years.
18. For a concise presentation of this point of view see Martin Feldstein, 'Muddling Through Can Be Just Fine', *The Economist*, 27 June 1987.
 19. For a review of some of these see Graham Bird, *International Financial Policy and Economic Development: A Disaggregated Approach*, Macmillan, London, 1987.
 20. Even so, provisioning may provide greater opportunity for converting the LDC debt held by the banks into long term marketable bonds (or consols) issued either by the countries, with World Bank guarantees, or by the World Bank itself. Conventionally such proposals have floundered on the assumption that banks would not be prepared to take losses on their Third World debt in exchange for less risk in the form of guarantees, but greater provisioning calls this assumption into question.
 21. See Benjamin J. Cohen, 'Needed: An International Chapter II', mimeographed, June 1987.
 22. For a more fully developed analysis of the scope for expanded co-financing see, Graham Bird, *Developing Country Borrowing from Private Markets: Key Aspects and Prospects for the Future*, Report for the External Debt Division of the World Bank, June 1985.
 23. See, for example, the Annual Report of Deutsche Bank, 1986, for the advocacy of an 'interest subsidization fund'.
 24. However, for a critical review of proposals to set up an Interest Rate Compensation Facility within the IMF, see Graham Bird, 'Interest Rates and Debt: Would A Cap Fit?' *World Development*, September, 1987.

4. Swapping Developing Country Debt

1. The option of analysing the effects of debt conversion within the context of a fully specified macroeconomic model for a typical highly indebted developing country has been rejected here, partly because it is difficult to say, unambiguously, what such a model would look like and partly because the model would almost certainly prove too restrictive. Instead this chapter examines more broadly the processes through which debt conversion might influence specific key variables. In this way, of course, it implicitly draws on particular models but every effort is made to spell out the causal relationships that are assumed to hold, as well as the implications that follow if they do not.
2. This differential may arise from the fact that the agency handling the conversion charges a commission or that, from the debt converters' point of view, a less beneficial exchange rate than the official rate is used to convert external debt into domestic assets.
3. For this reason it has generally been suggested that debt conversion will be a less attractive option for the money centre American banks, although recent moves by the banks to provision against their developing country loans calls this view into question.

4. For a discussion of the ways in which lenders may attempt to evaluate credit-worthiness, see Bird (1986).
5. As is also the case with capital flight, one possible empirical approach would be to compare the actual amount of FDI with a debt conversion scheme in place with the amount that would have been anticipated without a scheme. This technique is fraught with problems. Two crucial ones are first, to measure accurately foreign investment (or even more so, capital flight) and second, to estimate what levels would have been observed in the absence of the scheme. In any case debt conversion schemes have not yet been operating long enough to allow such empirical investigation of their effectiveness to be made.
6. This, of course, skirts around the question of what causes inflation in developing countries, but the monetary model implied here may not be entirely appropriate.
7. Bird (1983) provides a review of the arguments for and against the use of devaluation in developing countries.
8. The above calculations can be rather more rigorously presented. In Figure 4.1, let p represent the price of the discounted debt and q its quantity. The inverse demand and supply functions are $p = f(q)$ and $p = g(q)$, respectively. The net consumer surplus is given by

$$CS = \int_{p_0}^{p_1} f(q) dq - p_0 q_0$$

and the net producer's surplus is given by

$$PS = p_0 q_0 - \int_{p_0}^{p_1} g(q) dq$$

In terms of the example in the text, the equation for the inverse demand function is $p = 1 - (0.3/700)q$, so that

$$\begin{aligned} CS &= \int_{0.7(700)}^1 [1 - (3/7000)q] dq - 0.7(700) \\ &= q - (3/14000)q^2 \Big|_{0.7(700)}^1 - 490 \\ &= 695 - 490 = 105 \end{aligned}$$

The equation for the inverse supply function is $p = 0.5 + (0.2/700)q$, so that

$$\begin{aligned} PS &= 0.7(700) - \int_{0.7(700)}^1 [0.5 + (2/700)q] dq \\ &= 490 - [0.5q + (2/14000)q^2] \Big|_{0.7(700)}^1 \\ &= 490 - 420 = 70 \end{aligned}$$

9. For a good general review of the debt problem and of potential solutions see Cline (1984).

5. The Future of Bank Lending to Developing Countries: The Debt Overhang and Market Access

1. After all it has been estimated that in 1982 the banks accounted for some 60 per cent of all outstanding loans to developing countries.
2. Although much has been made of the role that might be played by foreign direct investment, it would take a really dramatic increase to negate the effect of falling bank loans.

3. For a review of conventional debt indicators see Graham Bird, *World Finance and Adjustment: An Agenda for Reform* (London: Macmillan, 1985) ch. 8.
4. Such conditions which emerge clearly from debt simulation models involve a sufficient fall in the rate of interest relative to the rate of economic growth and export growth. For a clear review of such simulation models, see Phil Suttle, 'Debt Projection Models: A Survey', *Oxford Review of Economic Policy*, vol. 2 no. 1, Winter 1985.
5. It was noted earlier in the book that such considerations exerted a powerful influence over the banks' increased provisioning.
6. For a brief review of the economics of relief and repudiation see John Williamson, 'The Outlook for Debt Relief and Repudiation in Latin America', *Oxford Review of Economic Policy*, vol. 2 no. 1, Winter 1985.
7. For an interesting and readable review of the changing bargaining position and strategy of the debtors see Stephany Griffith-Jones, 'Debt Crisis Management in the Early 1980s: Can Lessons Be Learnt?', *Development Policy Review*, vol. 6, 1988.
8. See, for example, the World Bank's *World Debt Tables*, 1987-8, where, in discussing various forms of debt relief, it is argued that, 'banks should be encouraged to move further in these directions'.
9. In current circumstances the second of these two arguments appears to be the more powerful.
10. Buy-back schemes differ not so much in terms of their basic principles but in terms of how payment is made for the debt and who provides the resources. All schemes rest on the idea that a proportion of the discount on the debt is transferred to the debtor, that overall debt obligations are relaxed and that the debtor finds it easier to service its remaining debt. The operation of the schemes relies on the creditors preferring the certainty of below par payment now rather than the chance of full payment later, and the debtors preferring part payment now. Schemes differ in terms of the asset exchanged for the debt (compare the Mexican and Bolivian schemes described in the text) and in terms of who provides the payment: the debtor, international financial institutions and aid agencies or creditor countries. Some proposals envisage the aid tied to buy-backs being backed by equal amounts of domestic developmental expenditure, although such schemes can lead to domestic financial problems such as those discussed in Chapter 4. Where aid is provided to pay for debt buy-backs donors would need to believe that the returns to such aid were higher than those to normal aid. From the debtors' point of view they would be anxious to ensure that aid related to buy-backs was additional to other aid flows. For a review of buy-backs see Mike Faber, 'Dissent on Debt', *Development Policy Review*, vol. 5, 1987 and Richard Portes, 'Debt and the Market', Centre for Economic Policy Research, September, 1987.
11. The worry that relief might encourage countries to pursue policies designed to attract further relief could be dealt with by attaching IMF or World Bank conditionality to buy-back deals.
12. For a detailed analysis of the welfare effects of an international debt facility see Max Corden, 'An International Debt Facility?', IMF Working Paper, February 1988.

13. For a fuller review of such a proposal, see Graham Bird, 'Interest Rate Compensation and Debt: Would a Cap Fit?' *World Development*, vol. 15 no. 9, September 1987.
14. For a general review of the banks' attitudes to interest rate capitalisation see *Restoring Market Access: New Directions in Bank Lending*, A Report by the Board of Directors, The Institute of International Finance, Washington DC, June, 1987. A scheme for interest rate relief has been proposed by Deutsche Bank, which has advocated the setting up of an Interest Rate Compensation Fund, based partly on bank finance. Other bankers privately concede that interest rate capitalisation may have to be accepted by the banks before too long. See also the plan put forward by James Robinson of Amex Bank, *A Comprehensive Agenda for LDC Debt and World Trade Growth*, The Amex Bank Review Special Papers, no. 13, March 1988. Moreover debt restructuring has not uncommonly involved a switch from variable to fixed interest rates. While this clearly provides some protection against rising rates it is not to the debtors' advantage when rates are falling.
15. A good review of the modalities of restructuring which clearly explains the various components is to be found in Klaus Regling, 'New Financing Approaches in the Debt Strategy', *Finance and Development*, March 1988. This article also contains useful brief descriptions of the components of the 'menu approach' to new bank lending which is discussed later in this chapter.
16. See the IIF Report referred to in note 14 for a clear presentation of this view.
17. A strong feeling amongst bankers is that, while they have been under pressure from the official sector to provide relief, the official sector itself has been reluctant to offer relief.

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