Research Department
Federal Reserve
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FRBSF Weekly Letter

Clouds Over International Lending

Widespread concern over the risks associated with international lending by banks has lately been triggered by the unstable political situation in Poland, the Falklands War and, more recently, the emergence of Mexico's debt-servicing problems. The concern climaxed at the Joint Annual Meetings of the International Monetary Fund and the World Bank in Toronto in early September. Since then, although the worst of the storm has blown over, dark clouds linger and serious concern over the potential threat of major national defaults to the stability of the international banking system remains.

In the following, we shall discuss the subject with four questions in mind: (1) What are the facts behind the concern? (2) What are the causes of the present situation? (3) What does the future hold? and (4) What safeguards are there against a potential international banking crisis?

Basis for concern

Although the press has exhaustively reported the basis for worry, it is useful to sort through the facts and pinpoint the areas of concern. Primary among these is the rapid expansion in recent years of loans to the less-developed countries (LDCs). One estimate reports that debts of non-OPEC LDCs doubled between 1978 and 1982, from $350 to $700 billion. About half of this debt is owed to banks and much of the debt is concentrated in about a dozen countries, many of which have found it difficult to service their debts on schedule. The number of countries that rescheduled debts rose from 2 or 3 a year in the 1970s to 6 in 1980 and 20 in 1982. The total amount rescheduled rose from an average $1.3 billion a year in the 1970s to $28 billion in 1982. All these countries had to put off repaying the principal; a few could not even pay the interest.

Rescheduling their debts was necessary because the borrowing countries were obligated to repay more than they were able to. The debt-servicing problem reached serious proportions in a number of countries this year. For instance, Morgan Guaranty's *World Financial Markets* estimates that 1982 total external debt-servicing amounts to 179 percent of Argentina's exports of goods and services, 129 percent of Mexico's, 122 percent of Brazil's, 116 percent of Chile's, and 95 percent of Venezuela's. These figures, however, seriously overstate the debt-servicing problems as they include short-term debts which are customarily rolled over under normal circumstances. The portion of total debt made up of short-term debts in each case is hard to say. In any event, even disregarding the repayment of principal, interest payments *alone* amount to 44 percent of Argentina's exports, 37 percent of Mexico's, and 45 percent of Brazil's. Since these countries had to pay for imports essential to their economies, debt rescheduling could not be avoided.

The LDC debt-servicing problem is of concern to many large U.S. and foreign banks. It has been reported that loans to several "problem" countries represent a high proportion of these banks' capital and reserves. Although, in the event of default, the banks could write off the loans over a number of years, defaults by several major borrowing countries could seriously erode their capital bases and trigger a general panic that would threaten the entire international banking system.

Causes

Before evaluating the likelihood of this scenario, it will be useful first to identify a number of developments that have led to the present situation. First, following the second oil-price increase in 1979-80, the world economy slid into a prolonged recession. The effects have been twofold: a fall in the world demand for LDCs' exports, and a drop in the prices of primary products which many LDCs export. This result contrasts with that after the

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first oil shock of 1973-74 when, after a sharp but short recession, the world economy recovered strongly with the help of a long and vigorous expansion in the United States.

The difference this time is that the U.S. and all the major industrial countries have made the fight against inflation their first priority. The short-term cost has been widespread recession and unemployment. In the process, the market for LDC exports shrank. Worse, the developed countries have also raised protective barriers against imports, especially those from the LDCs.

Second, interest rates have climbed to historical heights in the developed countries. Eurodollar loan rates rose from an average of 8.5 percent in 1974-77 to 18 percent in 1981. When deflated by the U.S. inflation rate (GNP deflator), the real interest rate rose from a little over one percent in 1974-77 to nine percent in 1981. Such high interest rates have increased the burden of interest payments for developing countries. High interest rates have also caused borrowers to shift to short-term credit in order to avoid being locked into high-cost loans. But when previous medium-term credit arrangements become due, they "bunch up" against the new short-term obligations and create a liquidity crunch for borrowers.

Third, several LDCs have followed policies that made their problems worse. Some countries, for example, have maintained fixed exchange rates in the face of rapid domestic inflation. An overvalued currency discourages the country's exports, encourages imports, and provides an incentive for speculative capital outflow. The situation has also been aggravated by inappropriate domestic monetary policies that aim at maintaining unrealistically low interest rates in domestic financial markets for the purpose of encouraging domestic capital formation. Given the low domestic returns, capital has flowed abroad instead and made the countries even more dependent on foreign borrowings for domestic investments.

Finally, many banks abruptly cut off new credits to the LDCs having trouble repaying their debts. Morgan Guaranty reports that medium-term Euro-bank credits to LDCs dropped from $38 billion at an annual rate in the first half of this year to only $16 billion in the third quarter. Individual banks must protect their own interests and determine what is most prudent for themselves. But, should many of them refuse to roll over credits to the borrowing countries, they would upset an already precarious situation for all banks.

Prospects

What about the future? The near threat of a few months ago has passed. The United States and other countries, under the auspices of the Bank for International Settlements, acted decisively and forcefully to extend emergency credits to Mexico to tide the country over the short run. In addition, Argentina has agreed to settle with Britain in return for Britain's agreement to lift its freeze on $1 billion of Argentine assets in London banks. Brazil has recenty received a large new loan from the United States. For the time being, international waters are quiet.

There are reasons to believe that the worst may be over and that things should look better in 1983. Falling oil prices, while hurting those countries for which oil is an important export, should help most others. Lower interest rates will help all the beleaguered countries. And a recovery in the world economy—even a weak recovery will be better than none—should boost LDC exports as well as primary commodity prices. Most important, the majority of the LDCs have already made serious adjustments in their economies by cutting the volume of imports, depreciating their currencies, and lowering output-growth rates.

The current-account deficits of LDCs remain large in nominal magnitudes, but, for a number of major borrowing countries—Brazil, Mexico, Peru, Korea—annual average deficits as a percent of exports in 1981-82 were considerably below those in 1974-75.

The adjustment burden for these countries should therefore be less now than it was in 1974-75.

However, to say that there is hope for improvement does not mean that no dangers lie ahead. For one, a large volume of LDC debts will come due next year at a time when the countries' economic conditions will not have improved sufficiently to enable them to service the debts. More reschedulings and requests for new credit will be needed. In one scenario, negotiations may be rough and even break down, payment arrears may increase, and banks may become alarmed and refuse further credit.

Safeguards
What has been done or can be done to avert potential threats to the international banking system? We can identify three lines of defense.

First, the borrowing countries must be encouraged to adopt, and be assisted in adopting, appropriate economic policies for achieving further balance of payments adjustments. In many cases, austerity cannot be avoided, and unrealistic exchange rate and interest-rate policies must be abandoned. The countries can be helped in making the necessary adjustments with bilateral and multilateral official financial aids. The United States stands ready to extend aid to those countries willing to undertake the necessary adjustments, as evidenced by the $1.23 billion short-term loan to Brazil announced by President Reagan on his recent tour of Latin America. Brazil has, over the last year and a half, pursued a vigorous program of belt-tightening to curb its balance of payments deficits.

In addition to bilateral aid, international lending agencies such as the International Monetary Fund have massive resources for aiding countries with temporary payments difficulties. In return for aid, these agencies ask for a commitment from the recipient countries to make appropriate adjustments in domestic economic policies. It is true that many debtor countries have in the past balked at adopting tough policy measures for adjustment as a condition for aid. However, when faced with the harsh reality of the cessation of all international credit (on which the normal functioning of their economies depended), they nearly always made the required policy adjustments.

Second, policy adjustments take time to yield benefits. In the interim, lenders must recognize that it is in their long-run interest to roll over their loans and, where appropriate, to extend new credits to countries with temporary payments difficulties. It is merely good business sense that they should do so. When, in a recession, many business firms find themselves in financial straits, banks almost never abandon their customers. Instead, they strive to keep them afloat while reviewing their financial management practices. Similarly, the world banking community has learned enough from past experiences with debt rescheduling to know how to assist debtor countries. Both the lenders and the debtors know that it is in their best interest to avert a crisis; neither can really afford to take the risk. This has, in the past, been the most effective defense.

Nevertheless, future payments crises cannot be ruled out entirely. But even before the threat of a major crisis develops into a general banking panic, the third line of defense stands ready. National monetary authorities would carry out their lender-of-last-resort function through open-market operations or their discount windows. This does not mean bailing out insolvent banks when they get into trouble becase of unwise management. Rather, it involves coming to the rescue when banks are threatened with a liquidity crisis as a result of general panic. Granted, in some cases, a hard line cannot be drawn between the two, but some say that it is the essence of the art of central banking not to draw that line in advance—not to encourage banks to undertake undue risks, but to stand ready to provide the necessary assistance when it is needed.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 11/24/82	Change from 11/17/82	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	161,743	341	7,480	4.8
Loans (gross, adjusted) — total#	142,119	274	8,781	6.6
Commercial and industrial	44,991	– 475	4,818	12.0
Real estate	57,493	3	2,025	3.7
Loans to individuals	23,553	167	163	0.7
Securities loans	2,527	470	589	30.4
U.S. Treasury securities*	6,577	70	1,065	19.3
Other securities*	13,047	– 3	– 2,366	– 15.4
Demand deposits — total#	40,709	– 496	– 411	– 1.0
Demand deposits — adjusted	27,586	– 463	220	0.8
Savings deposits — total	32,269	– 171	2,626	8.9
Time deposits — total#	98,762	– 132	10,989	12.5
Individuals, part. & corp.	88,674	– 113	9,580	12.1
(Large negotiable CD's)	35,339	– 526	1,083	3.2

Weekly Averages of Daily Figures	Week ended 11/24/82	Week ended 11/17/82	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	116	96	97
Borrowings	0	14	2
Net free reserves (+)/Net borrowed(–)	116	82	95

* Excludes trading account securities.
# Includes items not shown separately.

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