Research Department
Federal Reserve
Bank of
San Francisco

December 23, 1983

FRBSF Weekly Letter

International Debt Management

The choice of solution to the current international debt problem depends critically on how one interprets the development of international banking in the last twenty years. Whether one views the development as an extension of domestic banking or as an irreversible process of international financial integration leads to divergent policy recommendations. In this *Letter*, we shall propose a simple operating rule for choosing between the two approaches, and suggest that the policy measures adopted thus far as being consistent with both.

Two polar views

The widespread difficulty non-OPEC, less-developed countries experience in servicing their debts has raised questions about banks' prudence in international lending. Particularly disturbing have been reports of banks competing to offer loans on exceedingly favorable terms in disregard of the risks involved. Some have maintained that the banks' behavior was completely rational because they had correctly counted on the national and international authorities to bail them out.

This view suggests that banks must be made to bear the consequences of their imprudence, and the public "bail-out" of imprudent banks is not only unacceptable in a free-enterprise economy, but also sows the seed for future debt crises. The policy prescription, according to this view, is to let the debtor countries default, and the banks fail, so that the market will learn from past mistakes. As long as there is adequate deposit insurance (expandable by legislation) and monetary growth is kept stable, this view holds that individual banks may collapse but not the banking system.

The alternative view focuses not on the behavior of individual banks but on the world environment for international banking. It recognizes that the worldwide expansion of international banking activities over the last twenty years has increasingly integrated the world's financial markets. This change in international banking has allowed banks to diversify risk on an international scale in normal times. However, because integrated markets also transmit economic disturbances—monetary or real—throughout the world, generalized shocks result in systemized risks that quickly turn well-diversified asset portfolios into highly risky ones. This is the same principle as in a national economy: the risk of a generalized financial crisis is greater, the higher is the degree of financial integration of the various regions in an economy.

The financial-integration view attributes the international-debt problem to a series of related, generalized shocks—the oil-price increases in 1979–80, the subsequent world recession with falling world demand and falling primary-commodity prices, and unprecedentedly high real interest rates. The problem has been aggravated by the liquidity crisis that has developed since mid-1982 due to the worldwide withdrawal of banks from international lending. This view's policy recommendation is to ensure adequate supply of international credit in the short run and structural adjustments in external payments in the longer run.

Distinguishing rule

To choose between these two approaches, it is necessary to examine their respective underlying assumptions and compare their empirical relevance. Finance involves risk-taking, and prudence in financial management means making sound judgments on the basis of reasonable assessments of the likelihood of future events. In terms of elementary statistical theory, this means that individual bankers must project future events with an implicit, subjective probability distribution and choose a level of risk that they are willing to accept in making loans.

Research Department
Federal Reserve
Bank of
San Francisco

Since the probability distribution is based on each individual banker's past experience, its basis must lie in the past even though the projection is into the future.

Within this framework, there are three possibilities for a loan to go "bad." First, the loan assessment may have been made by an inexperienced banker who did not know his business, that is, he did not make an accurate assessment of economic reality. Second, the probability distribution may have been realistic, but the banker chose too high a level of risk. Third, the underlying economic reality may have changed so drastically that past experiences are no longer reliable for judging the probability of future events. The banking-imprudence view considers the international-debt problem as the result of a combination of the first two cases; the financial-integration view stresses the third.

The choice between the two views might appear to be necessarily arbitrary. However, most people would perhaps agree to a "majority rule," which states that although individual bankers may be ignorant or reckless or both, it is unlikely that the majority are. This rule does not presume a favorable pre-disposition towards bankers' intelligence or integrity, but it does presume a belief in the efficacy and stability of a private banking system, buttressed by public supervision and regulation for helping insure competition and sound banking, without hampering private risk-taking. The fact that over the past fifty years, this banking system has been basically stable seems to indicate that this proposition is more than ideology.

The rule breaks down, however, if banks are neither ignorant nor reckless, but are shrewdly conniving to take high risks for high profits, counting on the authorities to get them out of trouble. If so, any policy measures that directly or indirectly help banks to get out of trouble might encourage banks to become reckless and, hence, to lead to greater financial instability. There is, however, little empirical evidence for this attitude. First, in domestic banking, banks have always known that central banks would help out in the event of any generalized loan defaults. But, in spite of this knowledge, there have been cases of individual recklessness leading to bank failures, but no recurrent financial crises in major industrial countries over the last fifty years. Second, even if banks have different expectations in international banking than in domestic banking (there is neither reason nor evidence for this), according to this view, the massive amounts of international aid to the debtor nations since mid-1982 should have vindicated their earlier risk assessment; hence, there should be no ground for them to withdraw from international lending. In fact, international bank lending has declined precipitously, thus lending credence to the opposite view that the banks were indeed surprised by the severity of the international-debt problem.

Policy measures

The proposed "majority rule" and the empirical evidence validate the financial-integration approach to the international debt problem. Practical considerations of minimizing risk in policymaking lead to the same conclusion. The world is facing the serious threat of a financial crisis of large dimensions. To follow the policy recommendations of the bank-imprudence view and be wrong could lead to disaster for the world economy, including our own. But to follow those of the financial-integration view and be wrong would only mean that we have helped some banks that we should not have. A strategy of risk minimization would, therefore, call for extending aid to the debtor nations in order to ensure adequate supply of international liquidity and, at the same time, tightening supervision and regulation over international lending so as to guard against banks' laxity in vigilance in expectation of international aid to the debtor nations.

This interpretation appears to be consistent with the policy measures that have been taken thus far. In the world economy, without a world monetary authority, the central banks of major industrial nations have banded together through their monthly meetings at the Bank for International Settlements to monitor current developments and to pursue a coordinated strategy for ensuring the supply of international liquidity. Together with the national treasuries, they have provided temporary funds to help out cash-strapped debtor nations in order to give them time to negotiate for medium-term loans from the International Monetary Fund. The mainstay of the strategy, however, lies in the IMF credits, in conjunction with loan packages from banks, which are granted upon the condition that the debtor countries adopt austerity programs to reduce their payments deficits; that is, to adopt appropriate policy measures for structural adjustments to make their payment positions viable in the longer run. The IMF member nations have agreed to a 47.5 percent increase in IMF funding to carry out this important task.

In addition, the three Federal banking agencies—the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation—have jointly proposed a program to improve information about international banking and to tighten its regulation. The proposed measures include quarterly reports and prompt disclosure to individual banks' exposures to country risks, a requirement of a special reserve for protracted nonperforming loans, and new accounting rules for spreading loan fees over the life of a loan. In addition, the U.S. has strengthened its coordination with foreign bank regulators to ensure regulatory equity among countries. All of these may be regarded as appropriate supplements to the principal strategy of ensuring an adequate supply of international liquidity.

With these policy measures, much has been accomplished since the tensions started sixteen months ago. In this turbulent world, sheer survival is victory. The international debt problem is not resolved yet.However, with the revival of the world economy and the recovery of world trade there is ground for optimism that the world will achieve sustained economic recovery without a crippling financial crisis—provided that banks stop the back-sliding out of international lending that had continued through the first half of this year.

Hang-Sheng Cheng

FIRST CLASS

Research Department
Federal Reserve
Bank of
San Francisco

Alaska • Arizona • California • Hawaii
Idaho • Nevada • Oregon • Utah • Washington

FIRST CLASS MAIL
U.S. POSTAGE PAID
PERMIT NO. 752
San Francisco, Calif.

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/7/83	Change from 11/30/83	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	164,796	1,335	2,368	1.5
Loans (gross, adjusted) — total#	144,704	1,228	2,993	2.1
Commercial and industrial	44,196	215	– 727	– 1.6
Real estate	57,610	99	405	0.7
Loans to individuals	25,371	121	1,740	7.4
Securities loans	3,395	672	889	35.5
U.S. Treasury securities*	7,783	104	824	11.8
Other securities*	12,309	2	– 1,449	– 10.5
Demand deposits — total#	45,437	1,414	3,583	8.6
Demand deposits — adjusted	31,148	1,617	1,881	6.4
Savings deposits — total†	66,669	547	33,650	101.9
Time deposits — total#	70,340	165	– 26,965	– 27.7
Individuals, part. & corp.	64,476	– 2	– 22,932	– 26.2
(Large negotiable CD's)	17,414	42	– 16,102	– 48.0

Weekly Averages of Daily Figures	Week ended 12/7/83	Week ended 11/30/83	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	80	92	94
Borrowings	5	17	2
Net free reserves (+)/Net borrowed(–)	75	75	92

* Excludes trading account securities.
\# Includes items not shown separately.
† Includes Money Market Deposit Accounts, Super-NOW accounts, and NOW accounts.

Editorial comments may be addressed to the editor (Gregory Tong) or to the author . . . . Free copies of this and other Federal Reserve publications can be obtained by calling or writing the Public Information Section, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.