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Working Paper No. 225

BANK LENDING TO DEVELOPING COUNTRIES
AND POSSIBLE SOLUTIONS
TO INTERNATIONAL DEBT PROBLEMS

by

Peter Nunnenkamp

Institut für Weltwirtschaft an der Universität Kiel

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Kiel Institute of World Economics
Department IV
Düsternbrooker Weg 120, 2300 Kiel

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I. Introduction[1]

It seems relatively easy to explain why developing countries (DCs) increasingly appeared on international capital markets in the last decade. Frequently, reference is made to the unfavourable economic environment in the seventies and early eighties, characterized by oil price hikes, a slackening world market demand and extremely high international interest rates. However, in order to explain widespread difficulties of DCs in servicing their external debt it is far from sufficient to refer to negative external shocks. The observation that some DCs declared default, notwithstanding that they did not unduly suffer from external shocks, whereas others (some of which remained creditworthy) were severely hit, strongly points to the importance of domestic economic policies in managing adjustment burdens and preventing debt crises. It was shown elsewhere that most Asian borrowers did significantly better in adjusting their economies to the unfavourable economic environment than Latin American countries (Campbell, 1982a; Nunnenkamp, 1985b). Thus without considering effective policy re-orientations especially in today's problem countries it is impossible to formulate lasting solutions to the ongoing difficulties in servicing foreign debt.

The rise in foreign indebtedness of DCs might have been substantially narrowed if international commercial banks had refused to meet the Third World's mounting demand for foreign funds. That is why the emergence of debt problems was not the sole responsibility of borrowers. The central hypothesis of this paper is thus that current problems could have been mitigated by more prudent lending policies of the banks.

Data limitations and the lack of a comprehensive and empirically testable theory of bank behaviour makes it rather difficult to subject this hypothesis to high-powered methods. What

[1] Paper presented at the Asia Pacific Bankers Club Symposium, Bangkok, January 28-29, 1985.

can be done instead is to analyse a set of plausible arguments which may shed some light on bank lending to the Third World. This is the approach taken in this paper (Section III), after presenting a short overview of the extent and some major characteristics of credit-relations between Western commercial banks and the DCs. Particularly the questions will be raised whether banks followed a lemming-like behaviour in lending to DCs, whether they were subject to risk-illusions or even could discount the risks involved because of incentives to moral hazard.

As is well-known, the Mexican debt crisis in mid-1982 marked a milestone in banks' lending policies to DCs; the provision of fresh loans was abruptly and drastically reduced. This turnabout resulted in a restrictive policy that - according to widespread belief -, macroeconomically is no less harmful than the expansive behaviour until the early eighties. Sometimes it is argued, that the commercial banks can or will no longer play their role in channelling a sufficient amount of financial resources to the Third World. Accordingly, official creditors, both national and international, are asked to step in and close the perceived gap. This reasoning will be critically analysed in Section IV. Additionally the most important elements of a comprehensive solution to the ongoing debt problems will be presented, with particular emphasis on the interplay between public authorities and private creditors.

II. Bank Lending to Developing Countries: Some Major Characteristics

In mid-1984 gross long- and short-term debt of non-oil developing countries (NOPECs; for a definition, see note 3 in Table 1) vis-à-vis banks reporting to the Bank for International Settlements (BIS) stood at $ 265 billion (Table 1). Within a decade gross figures had soared about eightfold, until 1982 by more than 25 per cent per annum as compared to an annual

Table 1 - International Claims of BIS Reporting Banks on Different Groups of Countries, 1973-84 (in billions of US $)[1]

	Total	Reporting area[2]		Non-oil developing countries[3]							
				Total		Latin America		A s i a		A f r i c a	
		gross[4]	net[4]	gross[4]	net[4]	gross[4]	net[4]	gross[4]	net[4]	gross[4]	net[4]
1973	296.0	n.a.	n.a.	32.0	4.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
1974	361.0	n.a.	n.a.	47.0	15.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
1975	441.7	235.1	-35.0	63.0	26.3	43.5	27.2	12.9	2.5	3.3	-0.8
1976	547.4	269.5	-50.1	80.9	31.1	57.4	35.1	14.7	-0.2	4.4	-0.9
1977	689.7	349.9	-58.6	97.2	36.5	64.7	40.2	19.5	0.3	7.8	1.2
1978	893.1	467.5	-66.8	119.9	44.1	79.1	46.6	22.9	0.7	11.3	4.0
1979	1111.0	588.2	-97.7	155.7	67.1	102.5	64.8	31.1	5.1	14.3	5.1
1980	1321.9	704.4	-119.7	193.3	101.9	129.2	93.2	38.4	11.1	15.9	6.1
1981	1549.5	821.2	-129.8	229.6	131.5	158.3	118.6	42.8	13.4	16.9	7.0
1982	1688.2	895.0	-130.8	247.2	146.2	169.2	132.3	47.1	12.7	18.0	9.2
1983	1754.5	923.6	-149.0	255.8	145.1	175.8	132.9	49.9	10.9	17.3	8.4
1984[5]	1819.3	1007.5	-143.0	265.2	143.2	182.8	133.1	51.3	7.6	17.2	7.9

[1]Interbank lending included. - [2]Group of Ten countries plus Luxemburg, Switzerland, Denmark, Ireland and Austria; 1984: Finland, Norway and Spain additionally. - [3]Excluded are: OPEC member countries, Bahrain, Brunei, Oman, Trinidad and Tobago and developing countries classified as offshore banking centres. The sum of figures for the three regions does not add up to the totals for all NOPECs because figures for the less important NOPECs located in the Middle East are not presented here. - [4] Gross: total (short- and long-term) assets of BIS reporting banks, in domestic and foreign currency, vis-à-vis borrowing country groups; net: gross figures minus total liabilities of banks vis-à-vis country groups. - [5]End of June.

Source: BIS, International Banking Developments; BIS, Annual Report.

growth in total international claims of BIS reporting banks of 21 per cent. In the same period overall external debt of NOPECs against official and private creditors increased by 19 per cent per annum, finally reaching $ 710 billion in 1984. In other words, growth in bank lending to NOPECs significantly outpaced the extension of both bank loans to other borrowers and credits to NOPECs from other - i.e. mainly official - sources[1]. As a share in NOPECs' overall long-term external liabilities, private financial institutions accounted for 35-40 per cent in the most recent past, against only 15.5 per cent in 1973 (IMF, World Economic Outlook). Netting out borrowing countries' deposits placed with BIS reporting banks, the NOPECs formed by far the largest debtor group. In the early eighties banks' net claims on them exceeded $ 140 billion, whereas other net borrowing country groups (i.e. the developed economies outside the BIS reporting area and the Eastern European countries) owed only $ 67 and $ 30 billion in 1983, respectively, on a net basis.

However, it is not only the huge amount of NOPECs' bank debt or the considerable growth in liabilities that may cause concern. With respect to the analysis of bank behaviour and the discussion of possible solutions to present debt problems in the next sections, it is primarily the following characteristics of credit-relations between the Third World and Western commercial banks which need to be stressed. First it should be noted, that a significant part of the DCs' bank debt has been raised via syndicated bank loans. This seems important as it will be argued later, that the remarkable spreading of loan syndications gave an impetus to imprudent lending. According to Table 2, NOPECs absorbed a rising share of capital available in the medium- and long-term Euro-currency market for syndicated credits on a floating interest rate basis. Whereas

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[1] The growing importance of bank lending is of course not evenly spread across the NOPECs. For the significant differences as regards the role of private creditors in Asian DCs, see Campbell (1982a).

Table 2 - International Medium- and Long-Term Bank Loans by Borrowing Country Group, 1973 - 83 (in billions of US $)

	Total	OECD countries	OPEC countries[1]	NOPECs	Eighteen major Third World borrowers[2]	Eight major problem borrowers[3]
1973	20.86	12.36	2.83	4.54	3.41	2.73
1974	28.54	18.29	0.81	7.41	6.26	4.23
1975	20.58	6.22	3.21	8.03	7.57	4.79
1976	27.92	9.90	3.40	10.97	10.64	7.66
1977	33.78	13.04	6.33	11.56	10.79	8.53
1978	65.81	30.37	9.72	21.84	23.59	15.76
1979	79.08	29.07	8.77	36.00	35.65	27.58
1980	79.92	41.16	6.84	28.16	27.56	19.34
1981	146.42	97.49	5.76	41.30	37.36	25.04
1982	97.66	55.07	9.02	31.35	32.25	22.49
1983[4]	67.46	32.93	6.34	25.59	23.46	15.21

[1]Included are also Bahrain, Oman and Trinidad and Tobago. - [2]Argentina, Brazil, Chile, Colombia, Egypt, India, Indonesia, Ivory Coast, Korea, Malaysia, Mexico, Nigeria, Philippines, Thailand, Turkey, Venezuela, Yugoslavia, Zaire. - [3] According to the analysis presented in Nunnenkamp (1985a), the following countries are regarded as major problem borrowers: Argentina, Brazil, Chile, Mexico, Turkey, Venezuela, Yugoslavia and Zaire. - [4]Estimates on the basis of data for January to November.

Source: OECD, Financial Statistics.

at the beginning of the period under consideration roughly a quarter of loans were raised by NOPECs, their share climbed to an average of 38 per cent in 1975-80. Gross lending of NOPECs amounted to $ 117 billion in this latter period. In the early eighties another $ 98 billion were borrowed.

A second critical aspect of bank lending to DCs can be seen in the widespread use of public guarantees, which may result in risk illusions on the creditors' side and, accordingly, induce too expansive lending policies and badly diversified credit portfolios (Lessard, 1983). Already in the first half of the seventies more than 50 per cent of NOPECs' long-term debt from private sources were publicly guaranteed by borrower governments. This share was further raised to about 70 per cent in the most recent past (IMF, World Economic Outlook). Especially private financial institutions were the beneficiaries of the intensified use of official guarantees. In absolute amounts, their claims on NOPECs bearing a public guaranty exploded from only $ 17.3 billion in 1973 to $ 210 and $ 243 billion in 1983 and 1984, respectively.

A third characteristic of bank lending to the Third World which must be emphasized is the extremely high concentration of claims on a rather small number of borrowing countries. Table 1 indicates that, on a gross basis, the share of Latin American NOPECs in all NOPECs' bank liabilities steadily exceeded 65 per cent. Adjusted for DCs' deposits, the exposure of commercial banks in different Third World regions was even more unbalanced. In Africa - where already gross figures remained negligible - and particularly in Asia, gross debt due to banks was largely matched by deposits. Consequently, Latin America accounted for more than 90 per cent of the banks' net assets vis-à-vis all NOPECs. In the mid-seventies the five most important Latin American problem countries (Venezuela and the four NOPECs Argentina, Brazil, Chile, Mexico) held about 40 per cent of BIS reporting banks' gross claims on all DCs (OPEC countries included). This concentration further increased and exceeded 50 per cent in the early eighties (BIS,

International Banking Developments)[1].

The concentration of bank lending to only a few heavily indebted DCs has as a consequence that banks are vulnerable to the inability or unwillingness of these borrowers to service their external debt. Because of fears according to which bank failures may even result in critical tensions in the worldwide financial system, it is frequently argued that public authorities in creditor countries must be prepared to implement quick rescue programs for banks threatened by default. This reasoning will be critically discussed in the following sections. It can be hardly denied, however, that - without official bail-outs - those banks heavily engaged in the most important problem countries may run into considerable difficulties, if these borrowers fail to fulfill their debt obligations for long. Table 3 portrays the fourth crucial aspect of bank lending to the Third World by taking the US-banks as an example[2]. Relative to US-banks' capital base, claims on all NOPECs averaged 130 per cent in 1977-84. The ratio was considerably higher for the nine largest US-banks, amounting to an average of 195 per cent. In both cases, the exposure to only Brazil and Mexico accounted for more than 40 per cent of figures for all NOPECs. Again the banks' exposure to the most heavily indebted countries (as also to all NOPECs) still increased during the late seventies and the early eighties. Taking the five major Latin American problem borrowers together, the claims of selected US-banks relative to their capital reached 140-260 per cent in 1982. In some cases, loans to a single borrowing country exceeded 70 per cent of the capital paid-in.

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[1] In the latter period South Korea and the Philippines - the two most important Asian DC-borrowers in international capital markets - together accounted for 8 per cent of BIS reporting banks' gross claims on all DCs.

[2] Similar information for the commercial banks of other creditor countries is unfortunately hardly available. However, scattered evidence indicates, that also the largest German and Britain banks are heavily exposed to credit risks in the Third World, though apparently to a somewhat lesser extent (Junge, Nunnenkamp, 1984; Johnson, 1983).

Table 3 - US-Bank Lending to Non-Oil Developing Countries Relative to Bank Capital, 1977-84 (in per cent)

	1977	1978	1979	1980	1981	1982	1984[2]
All US-banks							
All NOPECs	114.9	114.4	124.2	132.3	148.3	146.1	133.3
Brazil and Mexico	56.8	52.0	50.3	53.0	61.2	63.4	60.3
Nine largest US-banks							
All NOPECS	163.2	166.8	182.1	199.3	220.6	221.2	208.7
Brazil and Mexico	74.8	72.8	69.9	77.1	85.2	90.2	88.9
Selected US-banks[1]	Argentina	Brazil	Chile	Mexico	Venezuela	All five countries	
Manufactures Hanover	47.5	77.7	28.4	66.7	42.4	262.8	
Crocker National	38.1	57.3	26.5	51.2	22.8	196.0	
Citibank	18.2	73.5	10.0	54.6	18.2	174.5	
Chemical	14.9	52.0	14.8	60.0	28.0	169.7	
Bank of America	10.2	47.9	6.3	52.1	41.7	158.2	
Chase Manhattan	21.3	56.9	11.8	40.0	24.0	154.0	
Bankers Trust	13.2	46.2	10.6	46.2	25.1	141.2	
Morgan Guaranty	24.4	54.3	9.7	34.8	17.5	140.7	

[1]End-1982. - [2]End of March.

Source: Federal Reserve Board of Governors, Country Exposure Lending Survey; Cline, 1983.

III. Imprudent Bank Behaviour until the Early Eighties?

The considerable growth of international bank lending to the DCs in the last decade may be interpreted as the result of a combination of supply and demand factors (Dennis, 1983; Fleming, Howson, 1980). In this view it is often implicitly assumed that the Western commercial banks merely reacted to changed conditions in international financial markets rather than taking the initiative themselves and actively striving for intensified credit-relations with Third World borrowers. The "traditional" argument runs as follows: After the first steep rise in oil prices in 1973/74 most OPEC members were unable to immediately spend total extra oil revenues for additional imports. Searching for high-yielding financial investment opportunities abroad, they showed a strong reluctance to channel the funds directly to oil-importing DCs. Instead they turned to industrial countries and Western commercial banks as an outlet for investment. The international banking system reacted by accepting its role as financial intermediary. Since the demand for credits in recession-hit industrial countries was weak, it was mainly the oil-importing DCs which needed to finance balance of payments deficits. It was even hypothesized, that the DCs' loan demand was only met by commercial banks because these needed a substitute for the slackening absorption of financial funds by the advanced economies (Fleming, 1981).

I cannot believe that this is an adequate analysis of what had happened after 1973. There are a number of observations that point to a more active role of commercial banks in intensifying credit-relations with DCs (see also Campbell, 1982a). First of all it can be observed, that a stringently inverse relationship between bank lending to industrialized economies and NOPECs did not exist in the last decade. For sure, sometimes relatively small increases in banks' claims on non-NOPEC borrowers went along with particularly large expansions of NOPECs' bank liabilities (see Tables 1 and 2). This may indi-

cate that a switching of funds by commercial banks from developed to developing countries has taken place in some years. Regarding the period since 1973 as a whole, however, both rank correlation and simple regression analyses cast doubts on the relevance of the hypothesis of a generally inverse relationship; neither of these procedures produced the expected negatively signed coefficients (for further details, see Junge, Nunnenkamp, 1984; Nunnenkamp, 1985a). Moreover, it is striking that the expansion of overall claims of the BIS reporting banks clearly outpaced the increase in their total liabilities since 1973. This difference indicates that the commercial banks' role in the recycling process cannot be adequately characterized as a merely passive clearing-station between OPEC-supply and NOPEC-demand. Rather their actively performed lending policies resulted in a considerable "over-recycling" (Schlesinger, 1984, p. 340).

Searching for factors that may have led to over-recycling by commercial banks, a first hypothesis refers to the profit motive of private creditors. When the slackening loan demand in domestic markets threatened to reduce the banks' domestic profitability, the relatively high return from international lending provided an incentive for banks to strengthen their foreign credit engagements. Although it is hardly possible to conclusively evaluate the relative profitability of bank lending in different markets, scattered evidence speaks in favour of this hypothesis:

- For the mid-seventies Porzecanski (1981) presented estimates for the ten internationally most active US-banks, according to which the return on domestic assets was significantly outpaced by profit margins on international assets. Moreover, available evidence for US-banks pointed to particularly high returns in lending to DCs (O'Brien, 1981; for further details, see Salomon Brothers, 1980).

- In a worldwide survey asking bankers for their view on international lending in the second half of the seventies, 50 per cent of all respondents said that it has been more profitable than domestic lending (same as domestic: 27 per cent; Group of Thirty, 1982a).

- The impression that relatively high returns in international markets were largely due to bank lending to DCs is supported by an analysis of the development of spreads. According to World Bank data, the difference in spreads between DCs and industrial countries reached 0.5 percentage points in the late seventies (World Bank, Borrowing in International Capital Markets). This can hardly be attributed to higher loan losses in lending to DCs: Major NOPECs tended to have a proportionally (i.e. relative to banks' claims on them) better loss record than, for example, Western European countries, when aggregating total loan charge-offs in 1975-79 for more than 100 US-banks (Robert Morris Associates; see also Campbell, 1982b, p. 93). Moreover, evidence presented in Table 4 casts further doubts on the perception, that the level of spreads was closely related to the risks involved. Notwithstanding that risks in lending to DCs increased over time, spreads were considerably lower in the early eighties than in 1976-78. Accordingly, it may be concluded that at least in the latter period market conditions promised bright profit chances for banks; probably, this gave a strong impetus to lending to DCs.

A second hypothesis that may lend further support to the just presented reasoning, refers to the country risk analysis of banks. The latter seems to bear part of the responsibility of over-lending, notwithstanding that the banks' credit policies were praised for long by most observers as economically sound and well suited for guarantying a smooth recycling of petrodollars. Severe difficulties prevailed in adequately judging risks, since the deficiencies of available indicator systems did not allow a safe prediction of future debt problems (OECD,

Table 4 - The Development of Spreads on Bank Loans for Major Third World Borrowers[1], 1976-84 (in percentage points)

	1976	1977	1978	1979	1980	I/1981	II/1981	I/1982	II/1982	I/1983	II/1983	I/1984
21 DC borrowers[2]	1.80	1.74	1.32	0.88	0.97	1.13	1.14	1.02	1.09	0.88	0.79	1.08
9 problem borrowers[3]	1.77	1.78	1.35	0.88	0.88	1.07	1.22	1.15	1.40	1.26	1.33	1.75
Argentina	(1.88)	1.83	1.35	0.80	0.81	0.82	0.95	0.99	-	(1.75)	-	-
Brazil	1.93	2.02	1.51	0.97	1.36	1.78	2.01	1.87	2.09	2.06	2.03	2.06
Mexico	1.54	1.57	1.47	0.81	0.84	1.09	0.86	1.20	0.68	(n.a.)	(1.88)	(n.a.)
8 non-problem borrowers[4]	1.86	1.66	1.16	0.85	1.14	0.94	0.79	0.74	0.65	0.70	0.62	0.63
Korea	1.92	1.85	1.10	0.61	0.84	0.95	0.74	0.72	0.56	0.77	0.68	0.65
Thailand	(1.25)	1.23	0.87	0.76	0.93	0.54	0.58	(0.46)	0.53	(0.61)	0.31	(0.58)

[1] Unweighted averages calculated from data for individual loans; in parentheses if the number of loans is less than four; "-" if no loans are reported; for details of country classification, see Nunnenkamp, 1985a; Junge, Nunnenkamp, 1984. - [2] In addition to borrowing countries listed in note 2 of Table 2, Cameroon, Morocco and Sudan were included. - [3] Argentina, Brazil, Chile, Mexico, Nigeria, Philippines, Turkey, Venezuela and Yugoslavia. - [4] Colombia, Egypt, India, Indonesia, Ivory Coast, Korea, Malaysia and Thailand.

Source: Euromoney Syndication Guide.

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1974; Sachs, 1982)[1]. Risk analysis was further complicated by the growing importance of systematically correlated risks among different borrowing countries. The two oil price hikes contributed to a parallel deterioration in the terms-of-trade of most NOPECs. Given increasingly coordinated macroeconomic policies in industrial countries, national business cycles were synchronized which, in turn, negatively affected exports of DCs. The roll-over technique quickly transmitted the rise in international interest rates to all those DCs with considerable bank debts. It is thus extremely dubious that "the lack of structural uniformity of the countries within the OIDC (oil-importing developing country) category ensures that lending risk is well diversified" (Fleming, 1981, p. 31). The rapid expansion of bank lending to DCs up to the recent past rather suggests, that systematically correlated risks have been overlooked or at least underrated.

Besides these practical hindrances in carefully assessing risks, it may be further questioned that the banks' lending decisions have been prudent and that later difficulties have exclusively arisen from unforeseeable developments (Williams et al., 1982). The lack of reliable information should have led banks to a rather cautious treatment of DCs' loan demands. It thus seems justified to consider additional influences which may have induced an imprudently expansive lending (Glismann, Nunnenkamp, 1983).

- A discounting of risks has been due to motivational structures in internal decision-making of banks. In the seventies loan-marketing officers seem to have aimed at maximizing loan approvals to the country or region they were concerned with, because annual bonuses and career prospects were at

[1] For the failure of country rating systems, see Institutional Investor Magazine. To mention just one example: the credit rating of Mexico deteriorated significantly only after the acute crisis was there.

stake (Palmer et al., 1983). Accordingly, incentives existed to stress favourable aspects of further lending and suppress objections to it. In cases like Mexico, an impressive raw material endowment was regarded as sufficient collateral, without taking into account whether it was used efficiently and productively (Group of Thirty, 1982b).

- In other cases, risk considerations have been overruled by political pressures. In the above mentioned survey by the Group of Thirty about 25 per cent of bankers responded, that loan decisions have been considerably influenced by governments in creditor countries.

Additionally, a number of innovations in international financing techniques may have induced imprudent bank lending. Mention should be made of the use of roll-over credits and loan syndications on a large scale. Although, in principle, these techniques seemed well suited to improve risk-sharing both among banks and between banks and borrowers, this was only one face of the coin. A cumulation of faults might have been the dark side which was overlooked until recently.

The syndication process permitted even smaller creditors to participate in international lending, whereas previously they were predominantly concerned with lending in domestic markets. Because of a lack of experience and expertise, many small newcomers heavily relied on judgements of major banks arranging syndications (de Grauwe, Fratianni, 1983; Goodman, 1983). According to the survey by the Group of Thirty, 36 per cent of smaller banks regarded it as appropriate to rely on country risk assessments by syndicate leaders etc. Independent decision-making of individual creditors was at least partly ruled out; this may have contributed to a lemming-like behaviour in international banking (Guttentag, Herring, 1984).

This line of argumentation would seem to be supported by empirical findings, showing that a high correlation between the debtor country structure of international bank portfolios of different banking groups exists. We have shown elsewere that all groups concentrated on a similar set of borrowers, irrespective of the measure chosen for ranking (absolute assets vis-à-vis borrowing countries, growth rates of assets or assets relative to the borrowing countries' exports, for example; for details, see Junge, Nunnenkamp, 1984). This holds for different groups of US-banks, classified according to their size (Federal Reserve Board, var. iss.), as well as for banks of different creditor nations (US, UK, West Germany), though at somewhat different levels of statistical significance.

Also for large banks the syndication process produced incentives to over-lending. Especially for syndicate leaders and managing banks high fee incomes were at stake, which increased parallel to the amount of loans provided. In the US it was common practice to treat major portions of loan fees immediately as income, i.e. during the quarter or year in which the loan was made (Weintraub, 1983). This accounting practice is likely to have induced short-term income maximization of banks at the expense of a comprehensive risk assessment.

Also the technique of rolling over short-term credits is supposed to have contributed to a discounting of risks by commercial banks. In this way the refunding risk of banks as well as the risk of rising interest rates was largely shifted to the borrower. Apparently, the creditors were on the safe side, a feeling which was strengthened by the fact that the bulk of credits was raised by DC governments or at least officially guaranteed by the debtors' governments. The assumption that DC governments would pick up the bill in case of failing projects, forms another reason why the amount of loans granted to DCs can be expected to have exceeded lending under conditions of undistorted risk-consciousness of banks. In lending to DCs,

the banks' control of how their money was used seemed often less strict than in domestic business.

Only recently, when many DCs could no longer manage rising debt service burdens, were risk illusions of creditors frustrated. However, even when the banks' confidence in borrowing countries' guarantees proved to be unsolid, a second line of defence existed against massive losses out of lending to DCs. According to the moral hazard hypothesis, risks in international lending not only were disregarded, but could even be disregarded without harm and needed not to be properly analysed. This is due to the widespread view that banks should be officially bailed out in a critical situation threatening their economic well-being, in order to prevent overall economic conditions from being negatively affected. The reliance on both domestic central banks and international organizations like the IMF, which were supposed to step in as lenders-of-last-resort if commercial banks ran into troubles, is likely to have further reduced the risk-consciousness of private lenders (Sjaastad, 1983). A second argument along these lines refers to moral hazard resulting from insurance schemes for bank depositors. Because depositors feel safeguarded against losses, they face insufficient incentives to critically review the banks' policies and to react by withdrawing their deposits if they consider lending decisions to be unsound. "Deposit insurance ... spares most depositors the cost of learning about the operation of banks. But, as a consequence, deposit insurance frees banks from the discipline and cost of those depositors' concerns" (Benston, 1983, pp. 7-8).

Experience in the recent past confirmed the banks' confidence in official support in case of DCs facing major difficulties in servicing their bank debt. In 1974 the central bank governors of the Group of Ten countries and Switzerland issued a communiqué, after having discussed the problem of the lender-of-last-resort in Euro-markets, that said: "They [the governors] recognized that it would not be practical to lay down in

advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means are available for that purpose and will be used if and when necessary" (cited in Wallich, 1977, p. 95). This statement may have induced moral hazard since it confuses two different problems: the insolvency of individual banks and an overall liquidity shortage. Actually, in the early eighties the Bank for International Settlements, acting on behalf of central banks of Group of Ten countries, provided bridging finance in several instances. Moreover, the IMF arranged many rescheduling programs and made available considerable amounts of official credits for debt problem-ridden developing countries. Although official lending was made conditional on further loans provided by private debtors, it seems likely that the IMF and other official activities were welcomed by banks because they got a chance to transfer their own risks at least partly to official agencies (Vaubel, 1983).

To sum up, it seems plausible to attribute continued bank lending to already over-indebted DCs at least partly to moral hazard, rather than to persistent hopes of only temporary repayment difficulties of borrowers. This behaviour was merely rational from the banks' point of view. The conditions for a socialization of private losses seem to have improved recently, as reflected by a review of major proposals presently discussed to alleviate the critical debt situation of DCs. Many of them argue for shifting the adjustment burden to the taxpayer (for an overview, see Campbell, 1982b; Junge, Nunnenkamp, 1984; Nunnenkamp, 1985a).

IV. Possible Solutions to the Debt Dilemma

The observation that the acute debt crises of 1982-83, especially in Latin American countries, have driven many banks to cut the expansion of their credit engagement in the Third World drastically, is commonly regarded as a dramatic shift in

private creditors' policies towards DCs. After having more or less successfully dealt with the immediate task of short-term rescheduling, the present situation of highly exposed banks which are reluctant to continue or resume lending has caused new alarm. Actually, we may face a severe dilemma in the coming years. If the persistent demands for fresh money by major problem borrowers are not met, this may rather add to the instability of the worldwide financial system (Campbell, 1982b). Borrowing countries that cannot afford negative net transfers for several years, may be forced to declare default, thereby precipitating massive write-offs in the creditors' balance sheets, which in turn may result in severe bank crises.

This bleak scenario has provoked a whole series of proposals as to how to fill the perceived financial gap. Although most suggestions address only specific aspects of the debt issue, due consideration should be given to those proposals which may help to diversify the capital import structure of DCs and to raise the internal economic resources in borrowing countries for servicing their external debt. In this context the conversion of loan claims of Western commercial banks into equity shares in the productive resources of borrowers (public and private enterprises in DCs) should be mentioned (Meltzer, 1983).

However, it remains questionable whether a diversification in financial instruments would increase the flow of private funds to the Third World to a great extent. That is why many observers advocate a stronger engagement of public creditors, both national and international (see, for example, Cuddy, 1983). This is intended to serve two purposes: On the one hand it should help to restore the financial equilibrium in external balances of DCs. On the other hand this suggestion is frequently meant to take part of adjustment burdens off the shoulders of Western commercial banks and shift it to the public. The most popular way of socializing private bank risks

or losses would be to officially acquire bank credits at no or only small discount (for an overview on different variants of this approach, see Bogdanowicz-Bindert, 1983).

Two major arguments must be raised against the proponents of tackling ongoing debt difficulties by mobilizing public funds for problem-ridden DCs and commercial banks. Provided that the overall amount of development assistance will continue to grow only modestly, public funds cannot compensate for bank credits to a significant extent without strongly interfering with traditional motivations for public aid. Moreover, if problem borrowers would receive subsidized credits at the expense of sound debtors, a severe moral hazard problem arises. The latter countries would be discouraged from following policies that seem well suited to prevent major difficulties in debt servicing, i.e. further problem cases would be invited. As concerns the commercial banks, the proposed strategy of public assistance would again result in moral hazard problems, as private creditors might be encouraged to carelessly repeat imprudent lending.

Accordingly, other ways of solving debt problems have to be found. Two targets have to be met: 1. to assure the stability of the international financial and economic system and 2. to restore a sufficient flow of private funds to DCs on a voluntary basis. Quite obviously, any attempt to meet these targets has to be rather comprehensive thereby combining different elements, each of which addresses specific underlying factors of the present debt situation. It thus seems adequate to shortly point to a few important conditions for a lasting solution of ongoing problems, before considering in some more detail the interplay between public authorities and private creditors.

- First of all, the crisis management characterized by the reschedulings in the early eighties has to be revised. Stabilization programs should not primarily aim at short-term

improvements in the balance of payments position of borrowing countries. Especially drastic and global import cuts may severely impede a sustainable adjustment of external balances in the longer run. This requires the IMF to abandon its emphasis on short-term therapies and instead concentrate on a durable revitalization of economic forces in DCs. Furthermore, in order to avoid moral hazard, debt renegotiations should not include the provision of officially subsidized loans. It does not seem plausible that DCs must be bribed in order to adopt adjustment policies that are actually in their own best interests. If organizations like the IMF are assumed to know better what borrowers and lenders should do, they should rather act as a paid agent providing information and organizing joint action of large and incoherent groups of creditors faced by free-rider problems (Vaubel, 1983).

- Without considering effective policy re-orientations of problem borrowers, it is impossible to formulate lasting solutions. Notwithstanding that specific adjustments required will differ from country to country, the following aspects need priority attention:

  1) export activities should be vigorously promoted;
  2) national currencies should be flexible enough to account for international differences in inflation rates and to avoid overvaluation;
  3) foreign direct investment should be encouraged;
  4) inflationary mentalities have to be overcome;
  5) the functioning of domestic capital markets must be improved or restored;
  6) the waste of scarce resources, for example by unproductive state activities, should be reduced.

- A significant part of responsibility for overcoming transfer problems of borrowing countries rests with the creditor countries. The latter need to revitalize their economies; just as the DCs, the industrial countries have to bring their houses in order and have to correct policy failures. Most importantly, they should liberalize restrictive import practices in order to allow for more DC-exports.

In order to sustain the functioning of the worldwide financial system, official entities have to provide the public good of preventing a general run of depositors on their banks that threatens to result in an overall liquidity drain. However, the lender-of-last-resort function of central banks must be defined in a way which does not invite commercial banks to rely on public guarantees in their credit decisions. That is why it must be explicitly differentiated between the risk of insolvency of individual banks, which pursued imprudent policies, and the risk of illiquidity of the whole system. Only the latter should be counteracted by monetary policies. To this end increased liquidity preferences of the public have to be compensated for via open-market operations of central banks and - if necessary drastically - reduced reserve requirements for commercial banks. If the Western central banks would announce in advance that, in times of a crisis, they would follow the policy just suggested, the public would be assured that the severe failures of monetary policies in the 1930s will not be repeated (Vaubel, 1984). This certainty would in turn help to further stabilize the financial system.

This view is challenged by those who argue that direct official assistance should also be granted to troubled individual banks, provided that they face only temporary difficulties but can be supposed as solvent in the longer run (see, for example, Guttentag, Herring, 1983). To avoid moral hazard as far as possible, it is suggested to empower public supervisory bodies to effectively regulate the lending policies of commercial banks. However, this approach is bound to fail. The authorities would experience insurmountable difficulties to

decide which bank deserves public help and which does not[1]. Moreover, an intensified public regulation of commercial banks' lending activities is likely to result in a stalemate. Officially imposed credit ceilings or country limits would remain arbitrary since, as a rule, public authorities have no better information on the risks involved than private creditors.

As an alternative to public regulation, the mechanism of market control over bank policies should be strengthened. This requires different measures. Banks should be obliged to disclose more and better information as regards their credit engagements and their exposure in problem countries. This would provide bank depositors and shareholders with better opportunities to control bank business. In order to equally improve incentives to do so, insurance schemes for bank deposits should be limited in coverage, at least for major depositors. More disclosure can also be expected to encourage banks to (gradually) adjust their nominal claims on borrowers to actual market values. Particularly US-banks are lagging behind in this respect. A more widespread use of secondary markets for bank loans, where necessary write-offs are determined by demand and supply, would help this process.

Notwithstanding considerable adjustment burdens inherited from past lending to DCs, also in the coming years the commercial banks will have to play the central role in the transfer of financial resources from the North to the South, at least as regards the already advanced DCs. Official creditors cannot substitute bank loans to any significant extent. Attempts by creditor governments to indirectly interfere in the transfer of private funds are likely to do more harm than good. First

[1] It may even be argued that individual banks cannot face liquidity problems at all, unless there is a general liquidity crisis (Sjaastad, 1983; Vaubel, 1984). In the absence of a general crisis, each bank can always improve its liquidity position by selling long-term assets.

of all, official interventions would probably fail in achieving an expansion of overall financial resources at the DCs' disposal. A higher grant element in official guaranty schemes for export credits, for example, is likely to expand trade-related loans only at the expense of other bank credits. Secondly, official interventions frequently involve considerable social costs as they shift part of the credit risks to the taxpayer.

Presently a lot of scepticism prevails as to whether private banks will resume lending to DCs on a voluntary basis, when this will take place and what amount will be involved. Actually it cannot be denied that banks are faced with considerable uncertainties about the creditworthiness of borrowers in the Third World. Undoubtedly it is hard to decide where the provision of fresh money is justified and profitable and where not, especially with respect to today's problem borrowers. Economically, throwing good money after the bad makes only sense if debt difficulties can be expected to be overcome in a reasonably short period. However, even in the recent past banks did not indiscriminately refuse to continue lending. Apart from a short period in 1982, when net lending was negative for many sound debtors too, this group of DCs experienced no major difficulties in raising private funds after the debt crisis in Latin America had broken forth; whereas for problem borrowers net bank lending dwindled to only 20 per cent in the period July 1982 - December 1983 compared to January 1981 - June 1982 (for further details, see Junge, Nunnenkamp, 1984). It thus seems plausible to rely on private financial markets (see also Campbell, 1982b). If both debtor and creditor countries pave the way for necessary policy reorientations, commercial banks can be expected to fulfill their role in providing a sufficient amount of new loans.

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