International debt: a central banker's view

Mr Brian Quinn, an Assistant Director of the Bank concerned with banking supervision, looks at some of the developments that have led to the present international debt conjuncture.[1] He goes on to consider possible ways forward and concludes that the approach that has been followed of flexible management, case by case, seems to offer the best prospect at present of dealing with the problem.

My remarks, described as a central banker's view, are just that: one man's view. They are also partial, not in the sense of taking sides, since I do not see it as my task to judge who should carry the responsibility for the situation in which we find ourselves, but in the sense that I do not propose to offer a thoroughgoing analysis of all the factors at work. That seems to me to be the job of the economic historian, one of the few occupations where the application of hindsight is not only permitted, but is actually required. I will instead engage in the task of looking ahead and offering a view on the prospects for a way out of our current difficulties—a much easier task since at the moment no one can actually prove me wrong.

Before discussing the prospects for solving the debt problem I nevertheless think it is important to look at some elements of the financial system as it developed over the ten or fifteen years before the problem emerged. In the Bank of England's evidence on the secondary banking crisis in the United Kingdom to the Wilson Committee, we suggested the crisis arose because a number of contemporary factors came into play simultaneously on a financial system which had undergone structural change and which had developed certain weaknesses. Even in the midst of the current problems I think I see certain similarities; and would like to examine some of them.

The historical background

Most diagnoses of the current situation start from the first oil price shock of 1973. I do not believe this is the correct starting point, and think some of the roots of the problem go a little deeper. During the decade leading up to 1973, generally solid economic growth in the industrialised countries of around 5 per cent per annum had provided expanding export markets for the less developed countries, enabling them to enjoy a slightly faster rate of economic growth. Capital resources were also transferred at an increasing rate to the developing world and the financing pattern was fairly stable: the principal source of finance, amounting to 39 per cent of the total on average during the 1960s, was direct investment. Official finance and the commercial banks provided the rest in roughly equal shares. Both nominal and real interest rates were generally low by recent standards and the fact that much of the financing was on concessional terms meant that debt service was a relatively light burden for the borrowers.

This pattern of financing was already changing before 1973. Major banks had expanded their international operations in order to provide a full service to their multinational customers, whose number and size had grown significantly in the expansive international climate of the time. The promising growth prospects of the developing countries made them an attractive market into which commercial banks could lend. For their part, the developing countries welcomed the opportunity to borrow from commercial banks as they felt it gave them greater control over the management of their resources and conferred a certain status.

The 1973 oil price rise brought pressure on the developing countries on two fronts: a sharp rise in the cost of their oil imports and, at the same time, slower growth in their export markets because of reduced growth in the developed economies. The non-oil developing countries did not immediately respond to these changes. Their economies continued to grow at rates not much below what they had been previously and their import volume soon recovered from an initial reduction. The current account deficits of the non-oil developing countries rose from an average of 1.7 per cent of GNP in the 1960s to an average of over 3 per cent of GNP in 1974–79.

For a number of reasons commercial banks came to be the main providers of the funds needed to finance these deficits. First, as I have said, they were already interested and involved in lending to the developing countries, and it seemed rational for them to extend this role, particularly since the recession in the industrialised countries meant that opportunities for profitable lending at home were fewer. Second, the banks were well equipped to engage in the maturity transformation which was needed. The OPEC countries, which were now in substantial surplus, wished to keep their assets in highly liquid form. The need of the developing countries on the other hand was for medium and longer-term development finance. Using markets and instruments tailor-made for the purpose, notably syndicated loans at floating rates, the commercial banks carried out what has come to be known as the recycling of the OPEC surpluses to the deficit countries. Although nominal interest rates rose sharply, inflation kept real interest rates at modest—even negative—levels for much of the time.

(1) In remarks to a conference on the international debt crisis organised by the City University Business School.

The result was that in the years immediately after 1973 commercial bank lending was providing 60 per cent or more of the external financial needs of the developing countries, while direct investment and official finance provided 18 per cent and 19 per cent respectively in the period 1973–78. One effect of the increased part played by commercial bank lending, which was to have important consequences later, was that the interest costs of the developing countries moved closer to market rates as the proportion of their debt at concessionary rates declined. This was particularly true of the larger, middle income, newly industrialising countries in which the greater part of the commercial bank borrowing was concentrated.

Another manifestation of the greatly increased scale of international intermediation by commercial banks was the ever larger numbers of banks wishing to be represented in the major centres. In London, for example, in the mid-1960s around 100 foreign banks were represented through branches, subsidiaries, representative offices or participations in joint ventures. Between 1972 and the end of 1974 the numbers grew from 245 to 335. Today there are over 450. Included among the banks seeking overseas representation was an increasing number of banks from developing countries setting up branches abroad. These banks had a limited natural deposit base and tended to rely heavily on short-term funding from the international interbank markets. Their participation in the recycling process greatly encouraged this and they, perhaps even more than other banks engaged in matching these short-term deposits with medium and long-term assets, mostly loaned directly back to their countries of origin.

To summarise, building on developments which had taken place over a period of years in the 1960s and early 1970s, banks had by the mid-1970s come to occupy the central position in financing the needs of deficit countries. In the circumstances of the time this was vital: the scale of internal adjustment that would otherwise have been demanded of these countries would, I have no doubt, have been impossible to achieve without massive upheaval—although there is certainly room for argument that there was greater scope for adjustment than actually occurred. However, certain structural changes had taken place: channels designed for financing trade had been converted to conduits for deficit and development financing; borrowers had become more fully exposed to movements in nominal and real interest rates; the proportion of short-term borrowing by debtor countries was already rising fast; and debt service ratios, so much a preoccupation of those in the official agencies in the 1960s, had risen sharply, largely unremarked.

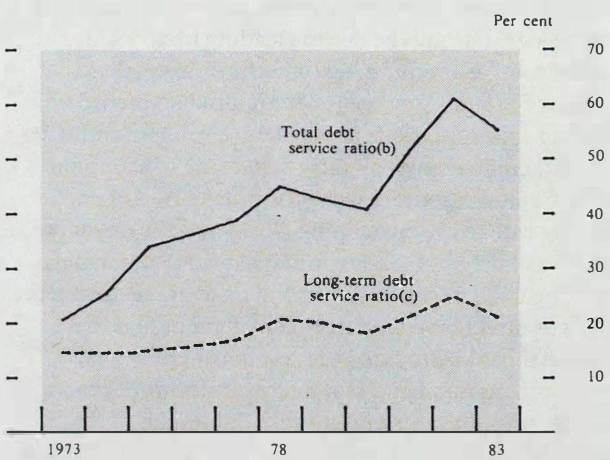
The second oil price shock in 1979–80 brought similar consequences to the first: another fall in growth in the developing countries' export markets and an increase in the cost of their imported oil. There was, however, one crucial difference. This time the policies adopted in the industrialised countries were to give the highest priority to resisting the inflationary impetus of the oil price increase, and not to seek to offset its effects on real incomes by adopting expansionary macroeconomic policies. Instead those policies were consciously and persistently anti-inflationary in their thrust, restraining demand and output, raising interest rates sharply, first in nominal terms as the policies were applied and, subsequently, in real terms as prices responded. In an associated development, the effective exchange rate of the dollar—in which perhaps 80 per cent or more of the developing countries' debt was denominated—shifted sharply upwards, greatly increasing the costs in terms of the domestic transfers of resources needed to service these debts.

Both the banks and the borrowing countries were slow to see these changes coming and reacted much as they had done during the first oil shock. The developing countries continued to finance their balance of payments deficits through commercial bank borrowing, and the share of finance in this form rose to over 70 per cent.

The emergence of debt servicing problems

Given the sizable stock of debt which the banks already held, and the sharp increase in interest rates, banks began to feel uneasy about the weight of debt on their books and an anxiety emerged about the implications for the capacity of the borrowing countries to service these debts. Some banks had taken a more cautious attitude to their involvement in sovereign lending and made only marginal adjustments to their international activities. Others, more deeply engaged but, if you like, less committed reacted differently: they lent first at shorter term and then showed an increasing reluctance to lend at all. For their part, the borrowers too were reluctant to accept the need for adjustment and continued to borrow at shorter and shorter term. Before Mexico declared a moratorium in the latter part of August last year the scene was therefore set in which its difficulties could pass rapidly and dramatically to borrowers in a similar—or in some cases dissimilar—position. The channels and instruments which had proved effective in the

Chart 1
Debt service ratios[(a)]



(a) Partly estimated. Ratios express interest and amortisation payments on debt as a proportion of exports of goods and services.
(b) Short and long-term debt.
(c) Debt with an original maturity of more than one year, excluding IMF debt.

recycling exercise were also those which ensured that the problems encountered by Mexico were communicated swiftly to others.

The response of the world's monetary authorities, of the banks and of the borrowers to the threat posed to the international monetary system by last Autumn's events are well recorded and need no elaboration here. I will add only one or two observations of my own. First, a crisis was averted only because all of the parties involved were prepared to do things which went against instinct. The most responsible banks continued to lend when their conventional training would have indicated they should cease and withdraw. Central banks effectively committed part of their liquidity and foreign exchange reserves before they could be sure they would retrieve them quickly. Borrowing governments, both through the IMF and directly, took politically unpopular courses of action and embarked on domestic adjustment programmes which were probably unprecedentedly severe. Finally the IMF stepped away from its customary cautious and arms-length relationship with the banks and encouraged more explicit and formal links between Fund programmes and bank finance. Courage was required on all sides for habitual reservations to be set aside.

Second, this has been done without, in my judgement, causing fundamental damage to the operation of the international markets. Of course, certain markets have suffered a knock; and the relationships between borrowers, commercial bankers and official institutions has altered, for how long we do not yet know. But it has been a central concern of the world's monetary authorities to work through existing institutions and markets; and to avoid, where possible, fundamental changes in major institutions and markets which may be either premature or wrong in principle.

Prospects for a solution

In coming to the prospects for a longer-term solution it is, I think, natural to start by asking about the nature of the problem. It is not, however, easy to see at this stage what that is. It may, of course, differ as between cases.

A distinction that is sometimes used is between a liquidity problem and a solvency problem. I have trouble with this approach. A good deal of what we have seen this last year has certainly included problems of liquidity. But in considering solutions the concept of solvency is not really applicable to country risks. I suppose it may be possible to imagine a case where a country had incurred debts which exceeded its total assets, such as infrastructure and mineral resources; but such a calculation, even if it could be made, would ignore the people and managerial capacity of the country—which, as we all know, is what really counts. From the point of view of finding a solution, however, it is surely nonsense to talk about liquidating a country's tangible assets or distributing them to creditors. Such suggestions seem to me to be irrational since they fly in the face of political and practical realities—to say nothing of their likely effect on those whose co-operation is essential if we are to continue to work our way out of our collective difficulties.

An alternative approach and one which avoids the need to fit our thinking into established accounting definitions, is to try to assess the time scale over which a country's debt servicing problems will last. This could help answer the question which I find great difficulty in answering—namely, has the country over-borrowed in some fundamental sense? Using this approach, the gauge of a country's return to financial health would be its ability to return to normal market financing, without recourse to special packages or co-ordinated loans, within a reasonable period. I acknowledge that this does not depend on some fixed and measurable event, but on the subjective judgements of banks and investors. However, we would be wrong to think decisions about lending will ever be reduced to complete reliance on objective criteria. Judgement will always play a central part.

Given these uncertainties it is very hard to judge how long the current difficulties are going to be with us; but there are indications that at least in some cases the problem is not transitional, in the sense I have indicated. For such countries the question arises whether the transfers of resources which would be necessary for them to meet their obligations without some kind of ameliorating arrangements are such that they would have difficulty in obtaining access to normal market finance for some considerable time.

If you assume, as I do, that the current debt difficulties are not purely transitory, but may persist for some little time, what then should be done about it? Looking around at the range of opinions on offer, I think there are three possible classes of action which have been suggested: to do nothing; to look for a single 'big' solution to all the problems; or to continue with ad hoc management. The first option, to do nothing, has two variants: the first of these is to allow a collapse to take place which will teach banks and borrowers the discipline necessary to avoid a recurrence for many years ahead, and puts the burdens where they belong. There are no points for guessing that I find this solution unacceptable. I believe the lessons are capable of being learned short of such puritanical treatment; that there are lively and serious risks that the collapse would spread and create unmeasurable difficulties; and that the burdens would almost certainly not be distributed equitably—whatever that might mean.

The second variant of the first option to do nothing rests on an assumption that, so to speak, a rising economic tide will be able to float the vessel off the rocks. It cannot be denied that this is a possibility: economic recovery may arrive sooner and be stronger than we now expect, bringing lower interest rates and expanding export markets for the developing countries, a reduction in the effective rate of the US dollar, and allowing them to service their debts and return to the market with restored confidence. First there is a real risk that we may wait for an economic upsurge, and it may not arrive. Economic forecasting has scarcely become a more confident occupation in this last decade. Second, and much more important, what may be true for the generality of debtor countries may not apply to some crucial cases. I have reservations about an approach which reduces the solution to a required rate of growth for the OECD or any other group of countries. I do not know whether growth of 2%, 3% or any other percentage will suffice to solve the problems of some of the largest debtor countries; and it is no solution if a way forward cannot be found which assures that these borrowers' problems will be taken care of.

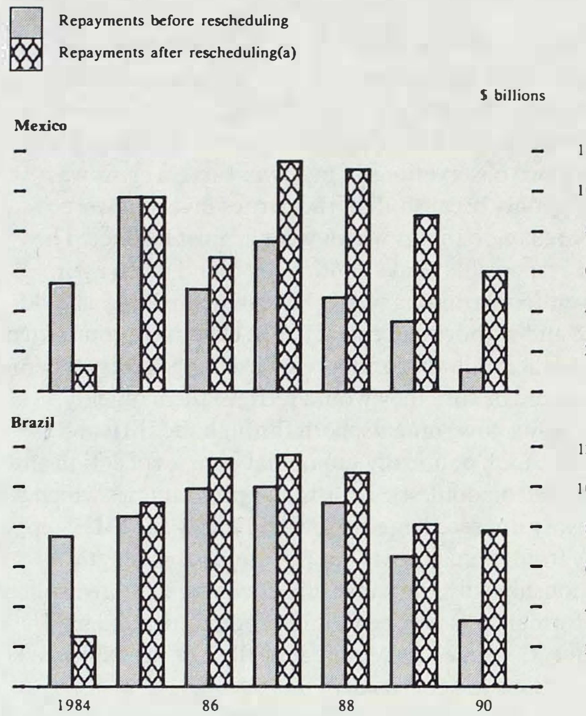
Unless we look to more radical solutions, such countries will therefore be obliged to continue to make their contribution by continuing adjustment. But a sustained period of adjustment is only possible in my view if there is a continued flow of bank finance. Such finance could only be forthcoming if it were managed in something like the way it has been recently, and this negates the principle of the do nothing option which we are considering. I have to conclude, therefore, that the odds against such a solution are too high for it to be wise to rely on it.

The second possible course of action is the radical approach, usually taking the form of a scheme which tackles, within a coherent framework, all the problems of both debtors and commercial banks. This proceeds on the assumption that, in broad terms, the balance sheets of borrowers and lenders have become so seriously out of balance that a piecemeal solution provides no lasting benefit, and early action to restructure these balance sheets offers the only hope of avoiding a further marked and possibly terminal deterioration of the situation. There are a number of schemes available, some involving the establishment of new institutions, some building upon existing institutions.

To be successful, it seems to me that there are a number of things which a well-constructed scheme could do: it could ensure a contribution from the borrowing country, probably through a continuing formal link with an IMF programme; it could ease the burden of existing debt at the same time as stimulating a flow of new finance; it could also, by transferring some risks away from the banks, reduce the fears of a bank collapse and so make them less vulnerable to a loss of confidence. But I have yet to see a scheme which deals with the cost of these transfers in a way that finds unanimous acceptance from those who would have to bear any significant part of it.

You may think such an observation is a counsel of perfection; a case of the best being the enemy of the good. However, we cannot wish the problem away; nor should we. Any scheme which fails to recognise realities fails to meet a crucial test. Even if the technical problems of such a scheme are overcome, I have to say I judge that the present time does not seem opportune for launching initiatives of this kind. No doubt some will wish to argue otherwise; but they will have to spell out how to deal with this central issue.

Chart 2
Effect on maturity profiles of commercial bank debt rescheduling and 'new money'



(a) Figures for Mexico do not include new money being negotiated for 1984; those for Brazil include rescheduling of 1984 maturities and new money being negotiated for 1984.

This leaves only the final course of action: continued management on something like the present lines for some time to come. I recognise that this suggestion lacks appeal on a number of counts. In the first case, it may be argued that it does not seem to deal with my definition of the underlying problem, but it merely pushes it back in time. For although in the short term the financial position of the borrowing countries may improve as the result of current measures, further ahead maturities are starting to bunch from loans which have been rescheduled, and the new loans which have been granted.

This approach also seems rather precarious, vulnerable to accidents, and to changes in what the lawyers call material adverse circumstances—and very hard on the nerves. It would be a course of action which would require constant fine judgements on the balance to be struck between the interests of debtors and creditors. From the creditors there would be repeated calls for new money, and from the debtors there would be the need for continued adjustment. There would be the ever-present danger of stalemate. The scarce time of senior officials and government ministers could be taken up by a never ending round of negotiations. For the tidy minded it all seems rather 'seat of the pants' and lacking in coherence.

I do not find these criticisms as damning as others do. For example, I am not persuaded that the market mechanisms, supplemented by IMF programmes and official support, could not themselves develop and adjust, given time, ingenuity and the will to succeed. Already the bankers are showing awareness of the problem created by the bunching of maturities; and spreads and fees are being reconsidered, not only because of political pressures.

The new relationships which have emerged between commercial banks, borrowers and the IMF are also capable of development. There is no doubt at all in my mind that the leadership provided by M de Larosiere was absolutely right in the circumstances, although it may have come as something of a shock to both commercial bankers and borrowers at the time. If these initiatives should lead to a more systematic management of the problem I would expect to see the Fund naturally retire somewhat from the position of prominence which it occupies at present—although I would not necessarily expect a return to the status quo ante.

Exactly how it comes out is a matter for the banks as well as the Fund and I am sure both parties will be giving active consideration to the question of their relations in the period ahead. But there is, I am confident, no desire to interfere with the market mechanism for a moment longer than necessary.

I think the fears of a continuous period of agony, absorbing the energies of Ministers and officials for years ahead, may also be exaggerated. If the initial rescue efforts go reasonably well and if one or two crucial successes are recorded I can easily imagine that the form and content of these negotiations could alter covering, for example, needs for two or more years ahead. Indeed it is the very flexibility of the current approach that appeals to me most—its capacity for adaptation to particular cases. I have little shame in confessing that I can see ahead very imperfectly, and that my vision has become weaker rather than stronger in the last decade. I therefore shrink a little from global schemes that solve the problem for years ahead; the problem itself may change.

You will see that of the three courses of action I have described my leaning is towards the process of continued management. I do not rule out the possibility that at some time in the future the time may be right for a substantial reshaping of debts. In the meantime I feel we must continue to pick our way carefully forward. If all the parties continue to show goodwill and commitment I think there is a good chance that we will make it.