

The Vulnerability of the International Financial System: International Lending and Liquidity Risk*

1. - Since the first oil crisis in 1973, international banking — as distinct from multinational banking (which is concerned with the activities of foreign branches and subsidiaries in the currency and with the residents of the host country) — has become one of the dominant features of the international monetary and financial system. The main factors in this development have been a) the unspent oil receipts of the low absorbers oil-exporting countries which were mainly deposited with US and European banks, and b) the increasing financial needs of non-oil LDCs which were mainly covered by loans from those banks. The role of the banks as suppliers of funds has been enhanced by the “conditionality” of the governing IMF's intervention which has been resisted by the borrowing countries for political and social reasons. On the purely technical side, the development of the market has been greatly facilitated by technological progress in the telecommunications sector.

The volume of international bank loans, as calculated by the BIS, rose from 320 billion dollars at the end of 1973 to 1070 bn. at the end of 1979. Admittedly, these amounts contain some double counting, and the bulk is constituted by interbank transactions. However, at least one quarter are direct Eurocredits to final users, to which must be added a large volume of export financing, direct bilateral credit arrangements and the amounts of bond and note issues directly absorbed by the banks. These various items have probably exceeded 100 bn. annually in the last five or six years.

* In preparing this paper, the Author has greatly benefited from and drawn extensively upon the contributions to the International Monetary Conference in New Orleans by Jean-Maxime Lévéque, David Rockefeller, Robert Lee Pemberton,, Guido Hauselmann, Wilfried Guth, Henry Wallich and Alexandre Lamfalussy.

International banking is certainly a very old business, but since 1973 it has acquired new characteristics and dimensions. *First*, the number of participants, which at the beginning of the period were mainly American banks, has considerably widened to include German, UK, Japanese, French and Italian banks operating directly or through foreign branches and subsidiaries. The share of international bank loans extended by American banks decreased between 1973 and 1979 from 38 to 32 percent, with a corresponding increase in the participation of non-American banks. *Second*, the foreign component of total assets of the big international banks has grown at a rate considerably above the average — in some cases by as much as 50 percent, so that many major banks have now more international loans outstanding than domestic ones. *Third*, nearly three quarters of the current deficit of LDCs in the period under consideration have probably been financed by commercial banks. *Fourth*, the amount of individual loans has risen considerably. A few years ago, syndicated bank loans of 100 million dollars were quite an exception; today, this sum is frequently exceeded. The risk from individual borrowers has therefore become significantly larger. *Fifth*, there has been a lengthening of maturities. As the share of international short-term bank loans to non-banks in the total has generally remained fairly constant, medium- and long-term credits have increased proportionally. Average maturities are now about 10 years. Borrowers increasingly press for longer maturities with considerable success because of the liquid conditions in the markets, on the one hand, and the stiff competition between Eurobanks, on the other. *Finally*, along with the assets (as mentioned above), international banks have diversified their sources of funds — foreign currency deposits from residents, OPEC deposits, issues of notes, interbank deposits. The share of the latter is considerable, with the result that a close network of interbank relations has gradually been established. Hence, each participant, as a provider of funds, has a vested interest in the success of the lending operations of the others.

2. - From the above remarks, it will be evident that, in the years following the first oil crisis, international banks have greatly contributed to the development of the world economy, or at least

helped to avoid a major recession. The recycling of the unspent oil surpluses has been effected mainly by the banks; in the absence of their support, demand by the non-oil LDCs would have fallen sharply, setting in motion a downward spiral in the world economy which would have taken years to reverse. Thanks to the banks, the barriers to the international mobility of capital have been lowered, especially in the relations between industrial and emerging countries, and capital has moved to the regions where it is most productive, and the development of the weak economies of LDCs has been sustained. LDCs cannot finance their growing needs with internal resources unless they accept a very slow rate of progress similar to that in industrial countries over the numerous decades of early industrialization.

The contribution of banks, especially in the form of multilateral syndicated transactions, has been far greater than that from official sources — bilateral official loans, grants, and loans at concessionary interest. No doubt, the banks' recycling operations have been carried out since 1973 smoothly, intelligently and efficiently and with a degree of success which, when the first oil crisis emerged, was certainly un hoped for. At the same time, it has gradually become evident that the bank loans to LDCs could not exclusively support economic activities creating a capacity for reimbursement. This is probably a natural process if we consider that the amount of unsatisfied internal needs of the borrowing countries is so great that the export capacity, and therefore the repayment capacity to be created, was to be inevitably a residual, insufficient to service the loans. This prospect will loom larger and larger in the future, giving rise to a dilemma: *either* the LDCs concentrate on development in agriculture, the early stages of processing of agricultural products, energy, and labor-intensive manufacturing, making it more and more difficult to repay the loans granted in order to finance these activities, *or* LDCs are condemned to making very slow progress, with dire consequences for themselves and for the industrial countries who will be confronted with dwindling outlets for their manufactures.

As a matter of fact, the choice of the first horn of the dilemma is unacceptable to international banks, as country risks will inevitably materialize and insolvencies spread. The choice of the second horn of the dilemma is historically unrealistic. Whereas the average

age of our population is rising, with the prospect of a very moderate development in the future, in the Third and Fourth Worlds at the present trend the population will double every 30-35 years, making these countries the centre of future economic development. Financial resources will be steadily shifted towards them; even in the absence of current oil deficits to be financed, international banks would thus have found themselves increasingly involved.

The dilemma can therefore be avoided, in the medium term, by the transfer of "mature" industries (such as textiles, furniture, shoes, or even cars) to LDCs, accompanied by a reconversion of the industrial system of advanced countries to products with a high technological content. In the short term, insolvency can only be avoided by a significant increase in official aid in the form of outright grants and, in some cases, by the scaling down of existing debts.

3. - LDCs are at present heavily indebted, probably for a total in the region of 300-350 bn. dollars. A great part of the debt has been contracted with international commercial banks. Their external position deteriorated seriously between 1973 and 1979. Non-oil LDCs' ratio of foreign debt to GNP is at present 50 percent higher at least. The debt service ratio, which was below 10 percent, now averages 18 percent.

Eastern (Socialist) countries are in no better shape. According to the BIS statistics, net claims of the reporting banks on these countries at the end of March of this year amounted to 40 bn. dollars. Total indebtedness, which slowed down in 1977, to pick up again in 1978 before a new pause, must now be in the region of 70 bn. dollars. One third of the debt is due by the Soviet Union, and one fourth by Poland; other Socialist countries, particularly Czechoslovakia and Bulgaria, show a more prudent stance. In parallel with the increase in their debts, their position both as regards the ratio of debt to GNP and the debt service ratio has deteriorated probably to the same extent as that of the LDCs.

When faced with a more conservative attitude by international banks to extensions of new credits, both LDCs and Socialist countries run down their reserves and speed up the use of their credit lines. In the second half of last year, Latin American countries used up 25% of their existing credit lines (reducing them from 34

down to 26 bn.) and Socialist countries 28% (from 13.7 down to 9.9 bn.). As a consequence, there will probably be no increase in net lending this year.

4. - With the deterioration of LDC's and the Socialist countries' external position, the position of international banks, as a consequence of their foreign business, has equally deteriorated.

Firstly, the problem of the refinancing at maturity of their normally short-term position has become more difficult. The proportion of their medium- and long-term credits financed with funds of equal maturity tends to diminish. The increasing tendency of non-American banks to open branches and subsidiaries in New York in order to facilitate their dollar provision is proof of these difficulties.

Secondly, inflation has caused their capital ratios to decline. In the seventies, this phenomenon was more pronounced in the US and in UK for the big banks involved in international lending, and less marked, but nevertheless evident, in German banks. National authorities and the BIS view this development with increasing concern.

Thirdly, they are rapidly running up against countries' borrowing limits, legally imposed or internally set for the containment of risks. Moreover, they are becoming more aware of the increase in the concentration of loans in potentially vulnerable countries.

Fourthly, the profitability of international lending is declining. Total net interest earnings during the last five years have increased much less than the amount of foreign assets (probably somewhere around 50% and 150-200 percent respectively). The main reason for this contraction of earning power is to be found in the decline of spreads and in the lengthening of maturities which is due, on the part of the lenders, to the ample supply of liquidity, the moderate domestic demand for credit and the keen competition in the market elicited by the continuous appearance of newcomers; and, on the part of the borrowers, to their fierce insistence, solely for reasons of prestige, on margins which are sometimes ridiculously low in relation to LIBOR. During the last four of five years spreads for LDCs went down from 2¼% to 5/8-3/4% (for industrial coun-

tries from 1¼ to 1/2%) and maturities ranging from 5 to 7 years stretched to an average of 9, and frequently more than 10 years. Commercial banks try to compensate for the decline of earning power in their interest rate component by charging a number of fees (commitment and management fees — the latter benefiting only the managers and co-managers), and by the administration of Eurocredits through tax havens, with a lower cost supply of dollars from residents. However, these sources of profit do not compensate for the decline in interest receipts. As a consequence, although administrative costs are low owing to the wholesale nature of international banking, it becomes more and more difficult to cover the cost of provision, the cost of protection against risk, and the remuneration of equity capital.

This year, the OPEC surplus is estimated at between 110 and 120 billion dollars, the corresponding deficit of the LDCs being in the region of 65 to 70 bn. The picture in 1981 might be pretty much the same with a smaller OPEC surplus and a bigger LDC deficit, while the external position of industrial countries would be improved. Incertitudes as regards the future price of oil remain great. It is not unlikely, therefore, that imbalances of this size will continue for some years to come. In this perspective, demand for loans by LDCs may continue very strong. But industrial countries too may well remain in the red for the same reasons; an additional demand from this side is therefore also to be expected. Similarly, Socialist countries will continue to press for financial assistance.

Taking into account the heavy indebtedness of LDCs and of Socialist countries, the strained position of the lenders as regards risks, liquidity and profitability, the probable surge, or at least the maintenance, of demand for loans from every side, it appears obvious that international lending is becoming more and more difficult and complex. This year, things will have gone relatively smoothly. But there is a large question mark about developments in 1981 and in the following years.

5. - The question mark is related to the increased awareness of the international banks that foreign lending presents three main kinds of interrelated risks which are not only growing larger but are not entirely in the banks' power to lessen or to eliminate. I

refer here to the country risk, the risk of interference by Governments and the liquidity risk.

Countries, it is said, never go bankrupt. Admittedly, actual defaults up to now have been few and far between. Countries in arrears with their lenders are still an exception. However, in view of the growing tightness of the situation, past experience cannot be extrapolated. A major insolvency is a distinct possibility. For the time being, we continue to go along with different forms of hidden bankruptcy which put a heavy burden on the banks' balance-sheets. Commercial banks know from bitter experience — and this is also becoming true as far as domestic business is concerned — that they have to stretch maturities through rescheduling operations, renounce interest payments, and extend new credits in order to make reimbursements possible. The proportion of Eurocredits used to finance debts at maturity is constantly increasing. Banks are therefore becoming more cautious in their lending operations. Syndication of medium term loans, which is primarily meant to spread risks from an individual borrower, may, in case of default — hidden or open — magnify its effects in a chain reaction.

“Country risk” — i.e. the risk of lending to an organization in a foreign country in a currency other than the local one — is essentially a political concept. It materializes when a country is unable or unwilling to pay at maturity. It may materialize even when the borrower is a perfectly solvent enterprise if its Government does not allow the transfer of the amount due and paid in at the borrower's central bank (this particular risk is called “transfer risk”).

The main international banks have tried individually to evaluate country risks through the joint efforts of experts in their foreign departments, economists and regional directors. The evaluation has in some cases reached a high degree of sophistication relying on complex mathematical techniques — GNP ratio of foreign debt, debt service ratio, sources of export earnings of the borrowing country and their vulnerability in world markets, oil dependence, balance-of-payments evolution, coverage of imports by export earnings and by foreign exchange reserves, gross financial requirements, and so on. Apart from the fact that available data are not always up to date and may be overtaken by sudden events, the most important component of the country risk — the evaluation

of the political and social stability of the borrowing country — is essentially a subjective and qualitative judgement. In other words, however precious the help of political experts in this field may be, it cannot be fed into a computer.

Some country risks have always been evident (Turkey), some have exploded suddenly (South Korea); others were for long in the pipe line, but warnings about them went unheeded (Iran), or they were latent because of wrong economic policies pursued over a long period (Zaire). Risks in Poland, Brazil and the Philippines are appearing on the horizon. What can be said about countries which are economically sound, such as South Africa?

What would happen in the case of a major insolvency in which, directly or in syndication, many international banks were involved? A chain reaction could be set in motion through a double mechanism: the first provoked by the direct impact of the default on the lenders, the second — if official help were not immediately available — through the network of interbank deposits collected by the lenders to finance the loans extended to the defaulting country. This second wave of reactions would hit a number of banks not involved in the financing but present in the Euro-deposits market. If the default is substantial, the whole process could have unforeseen consequences and shatter the foundations of the international financial system.

6. - A second important risk connected with international lending, which came to the fore during the Iranian crisis, is the risk of Government interference in the market mechanism.

President Carter blocked the Iranian assets in retaliation for the inhuman and illegal detention of the hostages by the Khomeini regime. The sovereign right of a Government to protect its citizens and interests is not open to criticism. On the other hand, it is indisputable that actions of this kind have grave consequences on banking relations and market confidence. These actions create problems going beyond the original participants and compel many banks to face difficult decisions. It is of course unrealistic to ask Governments which are about to decide on retaliatory steps of this kind to see that other interested Governments are previously consulted. The action would lose its effectiveness. On the other hand,

such a move has the same effects as the materialization of a country risk or a liquidity risk, with the sole difference that it cannot be foreseen or provided against.

7. - Contrary to the practice followed in domestic markets, Euro-banks normally borrow short and lend long. This entails potential dangers of illiquidity at the maturity of the deposits collected in order to finance the loans. To be sure, one aspect of the liquidity risk is covered by the roll-over mechanism, through which the rate of interest on the lending operations is mechanically connected with the LIBOR, so that the extra price for money is transferred to the borrower. The Euromarket is very extensive and relies on a multiplicity of sources of provision. It is therefore expected that the demand and supply of funds will always balance through the interest rate mechanism. The probability that the sources of funds will dry up is very small indeed. But the risk should not be neglected, particularly for small and medium banks and for those banks which are not directly or indirectly connected with the American money market — the biggest supplier of dollars. The difficulties of a number of these banks may affect leading institutions.

8. - Country risks, risks from Government action and liquidity risks proper, as outlined above, may all end in a liquidity crisis with unforeseen consequences for the stability of the international monetary system. A liquidity crisis of this type may be accompanied by an exchange crisis caused by a massive switch of funds from one currency to another.

International banks should be prepared to deal with a crisis well in advance of the actual event, because in an emergency relief measures are very difficult to organize, the time factor being of crucial importance for success. Steps which could be taken in preparation for an emergency fall into three main categories: those to be undertaken

a) by the international monetary authorities and by the Governments;

b) by the international banks individually; and

c) by the international banks collectively, in collaboration with the IMF and the BIS.

9. - As for the steps in the first category, the IMF and the main industrial countries should insist on the direct involvement of OPEC countries in the recycling process. There is a solidarity of interest in maintaining the stability of the international monetary and financial system between industrial countries and OPEC. OPEC countries have placed the bulk of their unspent receipts with the major banks, and have taken up equity capital in some industrial enterprises of the West; they have therefore a vested interest in the continuation of the prosperity of the industrial world. Disorder and instability will affect them as much as us.

The IMF should insist on the borrowers pursuing correct economic policies. This means more adjustment. However, the maintenance of the principle of conditionality should go along with the lengthening of maturities and the establishment of special facilities for LDCs. But, for this support to be effective, the World Bank should intensify the action of its affiliate, IDA, in granting long-term loans at a concessionary rate of interest, and Governments should increase the volume of direct aid, because it is impossible, given the LDCs' vast domestic needs, that their balance-of-payment and project financing should generate a corresponding capacity to repay.

Control of the Euromarkets is generally opposed by the commercial banks on the ground that they already exert an adequate degree of self-discipline through a stringent analysis and evaluation of projects and the maintenance of reasonable limits to commitments. On the other hand, the BIS already monitors the markets at six-months interval, or more often if necessary. A general consensus on stricter control is very difficult to achieve at the moment in view also of the fact that the increased need for recycling has polarized attention on the availability of credit rather than on the dangers of over-expansion. The view that the market has an autonomous capacity for creating deposits through the extension of credit is still a minority one. I believe that the need for reserve requirements and/or for credit ceilings will gradually be realized.

Finally, Governments of industrial countries should gradually realize that concessionary credits to Socialist countries are unwarranted. Socialist countries are not — or are not all — developing countries. Some progress in this direction could be achieved if the

industrial countries participating in the Consensus decided to link the concessionary rates to market rates with a floor represented by the present Consensus rates.

10. - Individually, international banks can take a number of steps designed to stave off country risks and ultimately the dangers of a liquidity crisis.

In the first place, they should endeavour to enlarge the equity base of their business, which has constantly deteriorated in the last few years.

Secondly, spreads on LIBOR are generally recognized to be insufficient, both as regards the aim of improving the profitability of foreign lending and the necessity of making adequate provision for risks. This necessity varies from bank to bank and is less acute for those which have been present in the market since the beginning, when large profits made possible the constitution of ample reserves. An agreement between the major banks on minimum margins, which should be facilitated by the general awareness of the seriousness of the situation, is the only way out in the presence of ample liquidity.

Thirdly, protection against country risks could be rendered more effective by strict adherence to the principle of a certain percentage of individual loans in total exposure and by their limitation in relation to the capital.

Fourthly, individual beneficiaries of loans need more advice and surveillance by the banks, which, in cooperation with the IMF, should try to impose the same rules of conditionality applied by the Fund and insist on the pursuance of the right economic policies. After all, the banks follow these rules in their relations with domestic customers. This attitude would be facilitated by closer contact between international banks and Governments, and between central banks and international institutions, as well as by better co-ordination of lending as regards the volume and timing of official and private credit. In this context, the development of cofinancing with international bodies, such as the IMF and the IBRD, should be encouraged.

11. - As regards steps to be taken by international banks collectively, the idea has been put forward — in the first place, as far as I know, by Wilfried Guth — of a "jointly organized private

safety net, to which individual banks could resort in case of an emergency in terms of liquidity." The aim of the safety net was not, in his opinion, to rescue individual participants, since a bank which has disregarded sound banking principles does not deserve to be bailed out, but to ensure the stability of the system by an injection of liquidity if, for some reason, deposits were to dry up.

The idea was picked up by Chancellor Schmidt, who at the Venice summit suggested the possibility of a safety net for private banks operating in the international market as a sort of insurance against large scale defaults by borrowers. Chancellor Schmidt's warning is reflected in the *communiqué* of the Summit, which — after endorsing the efforts of the BIS to supervise international banking — said that "the private banks could usefully supplement these efforts." This statement was made after the acknowledgment of the role of international capital market in rechannelling the substantial oil surplus funds in accordance with sound lending standards.

The contrary view was voiced by a high official of the World Bank, Mr. Eugene Rotberg, who contended that talk of the safety net to underpin Third World lending could scare some private banks away from the market and would anyway be unwarranted by the facts. These facts are presumably the still modest net exposure of LDCs to banks (70 bn. dollars resulting from loans amounting to 160 bn. and deposits totalling about 90 bn.), the willingness of commercial banks to continue their lending and their intention not to increase spreads abruptly (which would reflect anxiety and uneasiness), and finally the likelihood that, in a real emergency, international institutions and central banks would step in, and solidarity among banks would not be lacking.

While admitting that, in a real crisis, such as that initiated by a large debtor in difficulties or by a substantial withdrawal of funds from the market by banks, which would feel safer turning them into their central bank, relief would be forthcoming from these sources, I believe that the safety net is a not a fanciful idea and that it should be seriously explored. The same operation has taken place in the past, when, in troubled times, central banks organized a "swap network" centred in the Federal Reserve of New York, and the Governments of the Group of Ten decided on the "general arrangements to borrow" in order to supplement IMF's

resources in case of need. Two other ideas of the safety net type were discussed at length, unfortunately to no purpose — the official safety net among the Governments of the Group of Ten and the Substitution Account. These examples show that the international community is sensitive to the need for preparing for an emergency ahead of time.

Experience also shows that, when an emergency materializes, relief is difficult to organize. Packages of credit lines have been set up with some success in the past over a week-end in favour of countries in need, but have always left an aftertaste of suspense and improvisation.

I therefore think that the idea of a safety net should not be abandoned lightheartedly, but elaborated now in anticipation of actual needs on the initiative of the main international banks, in cooperation with the IMF and the BIS. The former has ample reserves and, under the terms of the present or of modified Articles of Agreement, could borrow and lend to market institutions. The latter collects funds from central and commercial banks and lends funds to them.

12. - A safety net could be organized along the following lines:

a) the IMF and the BIS, on an equal basis or in a proportion to be agreed between themselves, enter into stand-by swap agreements with each of the twenty or so major banks engaged in international lending and Euromarket activity;

b) the total amount of the stand-by swap network could be related to the total of net claims of commercial banks on countries having more debts than deposits and be linked to a fraction of this total;

c) individual amounts of the stand-by swaps could be fixed in proportion to the net foreign lending of each bank. The amount thus fixed would represent the limit up to which each bank would be entitled to draw or to be called upon in an emergency;

d) the stand-by swap with an individual bank should be activated in an emergency liquidity situation arising from defaults, rescheduling or Government action on the request of the interested

bank. However, the IMF and the BIS should be the sole judges whether an emergency exists and warrants the activation;

e) the IMF and the BIS could refinance themselves, at the moment of the activation, by drawing on the other participant banks which are not affected by the emergency. The drawing on the latter would normally take place in proportion to their commitments;

f) the duration of the stand-by swap could be one year, renewable; the maturity of the outstanding credit could be fixed at three or six months, twice renewable;

g) the interest could be fixed at the market or market-related rate;

b) the transactions should be denominated in dollars.

Participant banks should satisfy the standards set by the IMF and the BIS jointly as regards equity capital, proportion to capital of individual risk, proportion to total of individual risks, reserve provision against risks and so on, or commit themselves to approach those standards gradually. Participants might be asked to collateralize their drawings; if the credit to the borrowing country were insured, they might be asked to pledge the indemnification in favour of the IMF or the BIS.

Banks might feel more encouraged to lend or might become more permissive in view of the security offered through the safety net. It should therefore be made clear that the safety net will only cover the liquidity needs of a temporary character which an individual bank will experience during a crisis. The final risk of repayment remains with the lending bank.

The IMF/BIS — international banks' swap network could be made safer if supplemented by a swap network between the two international institutions and the central banks of the industrial countries.

It may be argued that an international safety net is unnecessary in a liquidity crisis, because a bank in difficulty could always resort to its own central bank. This might be true. However, taking into account the fact that a liquidity crisis could very probably be accompanied by an exchange crisis and that many banks

of different nationalities might be involved, an international swap network offers a greater degree of security.

This is of course a schematic outline of a safety net, which has no claim to finality. The setting up of the system is a very complex and long-term task requiring imagination and patience, both as regards the aim to be attained, which should sound convincing, and the preparation of the technical instruments.

Rome

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