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Commercial Bank Lending to Developing Countries: Supply Constraints

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Summary. - Middle-income developing countries rely heavily on commercial bank borrowing for the bulk of their financing requirements, but borrowing from this source cannot be projected with confidence. Privately owned financial institutions are subject to a number of capital and regulatory constraints which can adversely affect (will heavily influence) the level and direction of future lending to developing countries. Moreover, the volatility and short-term character of commercial bank lending suggests an urgent need to reduce the role of commercial banks in recycling the OECD and OPEC surplus, and to create new mechanisms designed to ensure more stable and longer term sources of capital to developing countries.

1. INTRODUCTION

For the purpose of external debt and capital flows analysis, the developing world is divided into 3 major groups which correspond to the World Bank’s definition of low-income, middle-income and the oil-exporting developing countries. The focus of this paper is the middle-income developing countries and their commercial creditors.

Two-thirds of the total debt of the developing world is owed by less than 40 non-oil middle-income countries. These countries also account for 75% of the debt owed to private creditors. Since 1970, the debt of the middle-income countries has grown rapidly. Also the bulk of the new borrowing has come from private commercial banks. The question has been asked, have these countries borrowed prudently? The evidence of several studies suggests that on balance the rapid increase in external borrowing in recent years has been prudent. The record for 1974–77 shows that the middle-income countries as a group have, through responsible policies and productive use of savings, maintained high rates of economic growth and at the same time managed to reduce their current account deficits. There have been some exceptions of course, but in the midst of the longest recession during the post-war period, this group of countries maintained high levels of investment and experienced real per capita income growth at about 3% per annum.

Nevertheless, the growth of the debt and the increasing reliance on private commercial sources have been cause for concern in many circles. Fears have been expressed that some countries have reached the limits of their capacity to borrow; that private commercial banks may be less willing to make new loans to developing countries, that these developing countries are likely to face serious debt servicing problems and therefore pose a threat to the solvency of the commercial banks.

There is little basis for believing that the major developing country borrowers have reached the limits of their capacity to incur new debt. Several studies by the World Bank have indicated that the non-oil middle-income countries can sustain a per capita income growth of 3% per annum over the next decade. The major uncertainties lie in the availability of capital from commercial sources and the pace of the recovery in the industrialized countries. The rest of this paper analyses the supply constraints on the growth of commercial bank lending to developing countries. Section 2 covers the outlook for lending by US commercial banks; Section 3 examines the likely growth of lending by non-US banks, and Section 4 concludes with an overview of current trends and some suggestions for policy changes aimed at increasing the level and the stability of private flows to developing countries.

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2. OUTLOOK FOR US BANKS

Commercial bank lending to developing countries is highly concentrated. As noted previously, on the borrowing side, less than 20 non-oil middle-income countries account for the bulk of the borrowing from private sources, and within these countries, the borrowing has been done mainly by the government and a few parastatals. On the lending side, US banks account for 60% of total commercial bank claims on non-oil middle-income countries, and within the US banking industry about three-fourths of the total claims are accounted for by the large money centre banks.\(^2\)

The external assets of these large banks have increased rapidly, accounting for 45% of their total assets at the end of 1976 (compared to 16% for all US banks), and about 40% of this international lending has been to the non-oil developing countries. Private commercial banks played an important role in recycling the OPEC surplus to developed and developing countries which incurred large deficits in the balance-of-payments since 1974, and thereby prevented an even deeper world recession. However, international lending is not a recent phenomenon. The growth in commercial bank lending to the developing countries can be seen as part of the broader diversification in the banking business which has been underway for well over a decade. Moreover, this diversification has been an extremely profitable avenue of business. International earnings accounted for 95% of the increase in total earnings of the 13 largest US banks during the 1970–75 period. As a group, these banks now derive almost 50% (in some cases over 80%) of their total earnings from overseas lending.

Following the oil crisis, private US bank lending to developing countries increased rapidly by about 30% a year. The latest estimates available indicate that there was a marked slowdown in 1977,\(^3\) and there are clear indications that the rate of growth of net US bank lending to developing countries will continue to grow slowly, at about 10–12% per annum over the next several years. An examination of the most important factors influencing the likely growth in US bank lending to developing countries indicates that the principal constraining factors are capital adequacy and portfolio considerations, investor attitudes and changes in the regulatory climate affecting US lending abroad.

(a) Capital adequacy

The prospects for a faster growth in the total assets of the large money centre banks are clouded by the capital adequacy issue. The capital (shareholders' equity and reserves) base of the large money centre banks has been deteriorating since the early 1960s and at present they are among the most thinly capitalized banks in the US.\(^4\) Market observers feel that these banks will have considerable difficulty preventing a further erosion of their capital base because the prospects for future earnings are not good, dividend payout ratios are already low, investor attitudes to bank stocks are not favourable and these banks are already highly leveraged.

Since the boom years of 1973–74 when the combined earnings of the large money centre banks increased on average by 20% a year, the growth in earnings has slowed down considerably and was only 1.6% in 1976. Partly due to lower loan-loss provisions, the growth in earnings improved during 1977 and continued in early 1978. However, profit margins have remained low. Marginal domestic spreads declined from 160 basis points at the beginning of 1977 to about 117 basis points at the end of the year. International spreads have also been under pressure; from a 150 basis points spread a year ago, spreads are now in the 75 basis points range.\(^5\) The decline in domestic spreads have been due to the weaker consumer and industrial (C and I) loan demand at most money centre banks. Internationally, the decline can be attributed to competitive pressures. Consequently, although the growth in earnings assets has been quite rapid at over 17% a year during 1971–76, and the ratio of equity to earning assets has declined, the return on equity has increased only marginally since 1973. This year, the large money centre banks are expected to continue to experience pressure on spreads domestically and overseas.\(^6\)

Lower spreads and pressure to increase dividend payouts imply a slower growth in retained earnings. The major investors in bank stocks are bank Trust Departments handling individual accounts, and bank stocks are of interest primarily for income. Banks generally have to compete with industry in dividend payouts and during 1976 high-quality industrial companies paid out 41% of their earnings as dividends as compared to 30% for banks. However, even with low dividend payout ratios,
bonds have only been generating capital internally at the rate of 5-7% a year.

The ability to raise capital through new issues of equity is also likely to be constrained. Bank stocks in general are not highly favoured at present, and within the industry, the regional banks with limited LDC exposures are highly recommended in preference to the larger banks. As of 31 December 1977, only 5 of the 30 largest bank holding companies had their stock priced above book value, Citicorp, which sold for 175% of its book value in 1973, today is selling for 95% of its book value. This trend in prices is also reflected in a declining trend in the price/earnings ratios of the money centre banks. While the Dow Jones industrial average's price/earnings ratio dropped by about 20% between December 1976 and December 1977, the multiples for some of the banks have fallen by as much as 50%. The important implication of these factors is that banks are not disposed to raise capital externally when stock prices are at or below book value. Therefore, unless market conditions improve dramatically, stock issues cannot be counted on to provide a major part of the future capital requirements of the large banks.

Banks can also raise capital by borrowing. However, the current regulatory guidelines limit debt to 50% of equity plus reserves, and many of the large money centre banks are already approaching this limit. Thus, these banks not only have very low capital to asset ratios, but the environment is not conducive to substantial new issues of stock and the banks are already highly leveraged.

It is difficult to judge just how much of a constraint considerations of capital adequacy will prove to be in the projected asset growth of the money centre banks. Equity to asset ratios have been declining for over a decade, and with Bank of America showing the lowest equity to asset ratio (3.3% in 1977), the regulatory agencies are unlikely to say that the largest US bank is under-capitalized, and almost all banks look better than Bank of America in terms of capital adequacy. However, market analysts say that the money centre banks are under-capitalized, and the Comptroller of the Currency has recently criticized Citicorp for completing a stock repurchase programme which had the effect of reducing Citicorp's equity capital. Although the Comptroller was careful not to comment specifically on the issue of capital adequacy, his remarks were carefully phrased to indicate that 'Citicorp was not over-capitalized'.

(b) Portfolio constraints

The most operative constraint is likely to be the need to diversify the LDC loan portfolios of commercial banks. Banks generally maintain self-imposed limits on country lending set either in absolute amounts or as a ratio of their capital base. However, these ceilings can and do change along with perceived risks and considerations of marketing strategy. US banks have, on the whole, been selective in their lending to developing countries. The bulk of the outstanding claims are concentrated in a select group of non-oil middle-income countries, and within this group, two countries, Brazil and Mexico account for 40% of total US bank claims on non-oil developing countries as shown in Table 1.

Banks do not release information on their exposure in any one country. However, the data available from several sources indicate that the overseas portfolio of the major banks is highly concentrated in a few countries, and the exposure to Brazil and Mexico is very high in relation to capital. The House Committee on Banking, Finance and Urban Affairs has said that the 6 largest American banks have made loans to Brazil and Mexico in amounts equal to their combined banking capital. This is broadly consistent with the fact that the combined capital of the 20 largest US banks was estimated at $19 billion at the end of 1976 compared to total US bank claims on Brazil and Mexico of over $21 billion as of that date.

By far the most telling indication of portfolio concentration is the share of interest income due from the largest developing country borrowers to total bank earnings. As a group, the 12 largest US banks now derive almost half of their total earnings from international lending, and the bulk of these earnings come from the LDC borrowers which usually pay higher spreads. Brazil accounted for 13% (compared to 28% for the US) of Citicorp's total after-tax income in 1976, and earnings from Brazil exceeded those from the US in 1977. Similarly, Brazil ranked fourth behind Japan, the US and the UK in Chase's total earnings in 1976. Thus, whether one looks at the lending side or the earnings side, the degree of concentration of the LDC loan portfolios of the major US banks is fairly high. Citicorp's portfolio outstanding in Brazil is over $2 billion, and with a net after-tax income of $390 million in 1977, an estimated 35% of Citicorp's net income is sensitive to developments in Brazil. Market observers do not consider this degree of concentration prudent.
Table 1. **US bank claims on developing countries**
(as of 31 December 1976; in $ billion)

<table>
<thead>
<tr>
<th>Country</th>
<th>Amount</th>
<th>Percentage share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico</td>
<td>10.7</td>
<td>20.5</td>
</tr>
<tr>
<td>Brazil</td>
<td>10.4</td>
<td>20.0</td>
</tr>
<tr>
<td>Venezuela</td>
<td>5.1</td>
<td>9.7</td>
</tr>
<tr>
<td>Korea</td>
<td>3.1</td>
<td>5.9</td>
</tr>
<tr>
<td>Philippines</td>
<td>2.4</td>
<td>4.5</td>
</tr>
<tr>
<td>Indonesia</td>
<td>2.1</td>
<td>4.0</td>
</tr>
<tr>
<td>Argentina</td>
<td>1.8</td>
<td>3.5</td>
</tr>
<tr>
<td>Peru</td>
<td>1.8</td>
<td>3.5</td>
</tr>
<tr>
<td>Colombia</td>
<td>1.5</td>
<td>2.8</td>
</tr>
<tr>
<td>Iran</td>
<td>1.4</td>
<td>2.7</td>
</tr>
<tr>
<td>Turkey</td>
<td>1.3</td>
<td>2.4</td>
</tr>
<tr>
<td>Algeria</td>
<td>1.2</td>
<td>2.4</td>
</tr>
<tr>
<td><strong>Total 12 countries</strong></td>
<td><strong>42.9</strong></td>
<td><strong>82.0</strong></td>
</tr>
<tr>
<td><strong>Other 66 countries</strong></td>
<td><strong>9.4</strong></td>
<td><strong>18.0</strong></td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>52.3</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

* Data refers to 78 of the 81 countries covered in the IBRD Debt Study (Report =1595, May 1977). The three countries excluded are the off-shore banking centres, Liberia, Panama and Singapore.

from the viewpoint of risk dispersion even though the largest borrowers are among the more credit-worthy of the LDC borrowers. The sensitivity of net income of the portfolio interest rates on foreign lending, and the concern of the regulatory authorities (discussed below) has already led banks to diversify their LDC portfolios to include many less well-known borrowers, and to reduce the rate of growth of lending to some of the major borrowers.

(c) **Investor attitudes**

The concerns being expressed by investors and bank stock analysts with regard to the LDC exposure of commercial banks could also have a negative impact on the actual rate of growth of net exposure to developing countries. The principal cause for concern is the perceived weak financial position of the large money centre banks which are under-capitalized, highly leveraged and showing a decline in the rate of growth of earnings. Investors are wary of the share of bank earnings generated overseas. This concern is not limited to the developing countries; they are equally concerned about economic and political conditions in Western Europe, Spain and Portugal.

Another worry about the large banks is the maturity distribution of foreign deposits. The rate of growth of deposits of the major banks has averaged 15% per annum since 1971. However, foreign deposit growth has greatly exceeded the growth of domestic deposits. As a result, foreign deposits accounted for 45% of the total deposits for Bank of America in 1976; 61% for Citicorp and 56% for Morgan. The 1971 figures were 31%, 44% and 34% respectively. The disturbing problem is not that OPEC will withdraw these deposits from US banks for political reasons. This is considered far-fetched as an any withdrawal from one bank would be placed in another and re-lent on the inter-bank market.

Investor concerns are also influenced by an awareness that the data available on the foreign portfolios of banks are extremely poor, which in turn leads to suspicion that banks are understating the risks in their LDC portfolios. A credibility gap exists partly because of the lack of data and partly as a result of misleading statements made by various bankers in the past.
In 1976, for the first time, the BIS and the US Federal Reserve began to provide data on the external debt of developing countries owed to commercial banks, but the data are still inadequate in many respects including total exposure by country and bank, the amounts externally guaranteed, maturity distribution, etc. This reflects the absence of agreed-upon definitions and consistent guidelines as to the provision of data. The annual reports of the major US banks do include information on their LDC portfolios but the data are often not comparable and no meaningful conclusions can be drawn from the statistics provided.

The lack of comparable data creates uncertainty, and confidence is weakened when new data contradict the comforting statements of bank spokesmen. A year ago, some bankers stated publicly that 50% of their LDC exposure had some form of external guarantee. Subsequent US Federal Reserve Board Survey (FED) data show that only 67% of the claims on foreigners by US banks carry external guarantees. Consequently, market analysts feel that much of what banks say about the risks in their LDC portfolios is self-serving.

The absence of standard criteria also raises doubts about the country credit-worthiness assessment undertaken by banks. Lending decisions, it is argued, are most often made by field offices, not at headquarters where all the economists reside. Criticism has also been directed at the apparent herd instinct in banking behaviour which it is claimed led to the large Real Estate Investment Trust (REIT) losses. With hindsight, most of those loans seemed good at the time. What went wrong was that everyone else rushed into real estate investment trusts and down came the market. It is believed that this herd mentality is behind the rush to increase international lending by the smaller US and foreign banks which little financial support by third parties, etc. If the borrowing entity fails to meet either the 'means' test (capacity to repay) and a 'purpose' test (specify use of borrowed funds). In order to show that the borrower has satisfied both tests, banks are required to obtain additional information relating to the borrower's legal status, ownership, any form of direct or indirect central government control, financial statements, the bank's assessment of the borrower's means of servicing the loan, and guarantees or other financial support by third parties, etc. If the borrowing entity fails to meet either the 'means' or the 'purpose' test, the Comptroller of the Currency indicates that all such lending must be treated as part of lending to the government. Thus, in the case of lending in the UK, Shell would be treated as an independent entity, but British Leyland would be lumped with the government. Only entities, whether owned by the government or partially owned by the government, that stand on their own from the point of view of credit evaluation would be treated as separate and independent borrowers.

Many major US banks currently have portfolios outstanding in Brazil and Mexico equivalent to more than 50% of their capital. Considering the fact that a large proportion of

### (d) Regulatory environment

The large build-up in US commercial bank lending to LDCs has led to a number of Congressional enquiries over the past 2 years. From these enquiries have emerged veiled threats of Congressional action, and the gradual strengthening in the oversight of the foreign operations of US banks by the regulatory agencies. Recently the Comptroller of the Currency issued a rule clarifying the century-old Banking Act which in effect stated that the rule which limits bank lending to any one domestic borrower to no more than 10% of capital, is also applicable to foreign governments, their agencies and instrumentalities. This ruling may pose a severe limitation on banks to increase their exposure in some of the most heavily indebted developing countries.

Under the new ruling all borrowers in developing countries will have to meet both a 'means' test (capacity to repay) and a 'purpose' test (specify use of borrowed funds). In order to show that the borrower has satisfied both tests, banks are required to obtain additional information relating to the borrower's legal status, ownership, any form of direct or indirect central government control, financial statements, the bank's assessment of the borrower's means of servicing the loan, and guarantees or other financial support by third parties, etc. If the borrowing entity fails to meet either the 'means' or the 'purpose' test, the Comptroller of the Currency indicates that all such lending must be treated as part of lending to the government. Thus, in the case of lending in the UK, Shell would be treated as an independent entity, but British Leyland would be lumped with the government. Only entities, whether owned by the government or partially owned by the government, that stand on their own from the point of view of credit evaluation would be treated as separate and independent borrowers.

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Concerns are also expressed about the bunching of LDC debt obligations over the next 2 to 3 years, and about the potentially adverse impact that a string of debt renegotiations could have on the foreign exchange and inter-bank deposit segment of international money markets. It is argued that debt renegotiations can either lead to a decline in the willingness of foreign savers to deposit funds in US banks and/or to an increase in the cost of inter-bank deposits because of the large proportion of 'non-performing' or 'watch' loans in the portfolio. Either would lead to a decline in earnings growth. Investors feel that there is a lot of good business at home, and in general they have greater confidence in the US economy. These negative attitudes are strengthened by the wide publicity given to the Pertamina affair, the recent debt rescheduling of Zaire, and the current problems of Peru and Turkey. Although renegotiations or extensions of debt are not at all uncommon in banking, they have onerous connotations when they occur internationally.
Some Banking Committee members have balance-of-payments position have provided.

The distribution to Witteveen Facility has been delayed. Weak domestic loan (lemon) and a strong debt service ratio is one of the constraints.

Foreign economic policy. This is one of the less rapidly because of political and strategic interests. If banks are to become instruments of US foreign policy, the responsibility for the foreign loans of banks would grow more rapidly than the US banks. The US banks suggested that German and Swiss banks, Japanese banks, etc., have significantly expanded their lending relationships with developing countries.

Congress is also concerned that if a crisis develops in an LDC where US national interests are at risk, the Government will almost inevitably become involved. In the case of Indonesia in 1974, the US Government had to step in and hold things together until the banks could be repaid and a general collapse averted. The State Department feared that the collapse of Pertamina would seriously damage the Indonesian economy, create a political crisis for the Suharto Government, threaten vital US political and strategic interests, and cause turmoil in the already volatile international capital markets. US banks and Pertamina had circumvented IMF-imposed ceilings and in the process the banks had over-extended themselves.

Various Congressional interests would therefore prefer to have some mechanism created whereby the Government would be in a position to restrain the banks before a crisis develops as a consequence of their lending activities. Congress thus wants a re-examination of the relationship between the Government and the banks if the US Government is to bear ultimate responsibility for the foreign loans of banks and if banks are to become instruments of US foreign economic policy. This is one of the reasons why a final vote on the US contribution to Witteveen Facility has been delayed. Some Banking Committee members have argued that the proposed facility will only foster more US bank loans to questionable foreign borrowers.

3. OUTLOOK FOR NON-US BANKS

Unlike the US banks which make some information available in their annual reports, those of the European and Japanese banks contain very little information about their overseas exposure. In addition, while the Federal Reserve Board collects and publishes information about US banks’ overseas lending, no such information is made public by the governments of Japan and Western European countries. At present, the only available source of information about the activities of non-US banks is the data collected and published by the BIS. According to the special BIS survey, non-US banks had a combined exposure of $26 billion or 40% of the total commercial bank claims on non-oil middle-income countries as of 31 December 1976. However, the BIS data are not very complete. Apart from the problems of coverage and definitions, the data do not permit further disaggregation of non-US bank claims on LDCs between German banks, Swiss banks, Japanese banks, etc. This makes it all the more difficult to gauge the lending intentions and interpret the meaning of a certain growth rate in the future for non-US banks, or to say with confidence that the external capital needs of the LDCs can in fact be met.

The expected downturn in the rate of growth of lending by the US banks in the next few years would shift credit demand toward European and Japanese banks. The great liquidity that has distinguished US corporations and banks now also characterizes the commercial banks of Western Europe and Japan which have greatly expanded their LDC portfolio. The pressure to place funds has obviously been a factor in the narrowing of international spreads. According to the BIS, banks in the 8 reporting European countries accounted for 74% of the total increase in the external claims of all reporting banks (in 1977) whereas in 1976 their share amounted to only 53%. Discussions held last spring with the European banks suggested that German and Swiss banks would grow more rapidly than the US and Canadian banks, and French and British banks less rapidly because of political and capital constraints.

Weak domestic loan demand and a strong balance-of-payments position have provided
German banks with sizeable loanable funds. Their participation in the medium-term credit market has been traditionally strong and has increased considerably over the past two years. International lending until recently has been dominated by the big three, Deutsche Bank, Commerzbank and Dresdner Bank plus the West Deutsche Landesbank. Since the early 1970s, these banks have built up a large network of foreign branches and representative offices, and now may be deriving as much as one-third of their total earnings from international operations. Thus, the large German banks are already deeply involved in overseas lending and could be expected to increase their LDC exposure. In addition, in the last few years a number of second-tier banks have reported a rise in their international activities, and the cooperative banks are also becoming more active in the field of international lending, both in export financing and in the syndication of loans.

Like the German banks, the overseas activities of the Swiss banks have also been concentrated in the big three, Swiss Banking Corporation, Union Bank of Switzerland and Credit Suisse. Unlike the US banks, the LDC exposure of Swiss banks constitutes a much smaller proportion of total international assets. In addition, only a very small proportion (less than 5%) represents medium- and long-term claims, as the bulk of Swiss banks' LDC exposure is made up of export credits. This is why Swiss banks' claims have grown much more slowly over the last two or three years than has been the case in the US and Germany. The attitude towards the LDC lending of the major Swiss banks contacted last spring was found to be positive, with portfolios expected to expand by 10-15% per annum.

The overseas lending of Japanese banks has in the past been to a large extent controlled by the government. Japanese banks were quite active in the early 1970s but then stayed out of the eurocurrency credit markets after 1974 and have only just begun to expand their overseas lending again. The improvements in Japan's external accounts has prompted the government to remove certain restrictions on Japanese banks' overseas lending imposed earlier. Japanese banks are now free to lend without any limits, so long as loans are funded on a medium-term basis (more than one year). Their overseas exposure accounts for a very small proportion of the total assets of Japanese banks; consequently the share of international earnings in total earnings is only in the range of 10-15%. Bankers feel that while domestic business will continue to dominate, the share of overseas earnings in total earnings can be doubled in the future. If this target is actively pursued, Japanese banks' overseas lending can be expected to increase rapidly in the future.

**4. AN OVERVIEW OF CURRENT TRENDS**

The changes that have taken place in the international economy over the past 4 years are irreversible. The external debt of the developing countries which doubled in 5 years between 1970 and 1975 will quadruple between 1975 and 1985, and the share of private sources in this debt is projected to stay at present levels. Since commercial lending is a more unpredictable and potentially volatile source of finance than official lending, doubts have been expressed about whether the actual rate of growth of commercial lending will be consistent with the financial requirements of the middle-income developing countries.

The examination in Section 2 which focused on the outlook for the large US money centre banks indicated that US bank lending to non-oil developing countries is likely to slow down measurably to about 10% per annum in line with projected asset growth. Some of the larger regional banks (like Wells Fargo, Republic National Bank of Dallas, etc.) may increase their LDC lending but overall, regional banks also face capital constraints to increasing their LDC exposure and they have a preference for domestic loan activities. Future growth from this source is therefore not likely to alter the projections for US bank lending.

While comparable and reliable data for individual bank lending to developing countries are not available, it is estimated that about two-thirds of total commercial bank lending to these countries is done by just 30 major banks around the world. For these banks, lending to the principal developing country borrowers is not a sideline interest to be pursued in periods of slack domestic demand. It is on the contrary a central element of their business. The examination in Section 3 of non-US banks is, however, sketchy reflecting our limited knowledge of and lack of information on non-US bank lending to developing countries. Although the growth of lending from this source can be expected to increase rapidly, there is no firm basis for projecting a rate of growth of European bank lending to developing countries at much greater than 15% per annum. This range estimate was obtained after discussion with several major European banks. The outlook for Japanese
banks, Arab banks and various consortium banks is unknown.

In looking ahead, it is imperative that commercial sources increase their lending to the developing countries to assure the continued growth of the borrowing countries and to permit prudent debt management. As World Bank projections indicate, non-oil middle-income countries need to borrow about $101 billion in 1985, out of which $53 billion would go in repayment of principal and $30 billion in interest payments. Thus, for every dollar borrowed in 1985, net transfers would amount to less than 19 cents. The ease with which these borrowers will be able to refinance maturing obligations falling due over the next several years is of crucial importance to maintaining stability in international credit markets.

As long as OPEC and OECD countries run a surplus in the order of magnitude currently projected, the mechanics of the international financial system (i.e. recycling) means that the banking system would have the means available to meet the external capital requirements of the developing countries. The only uncertainties relate to: (a) the willingness of banks to continue to assume the risks entailed in lending large amounts for refinancing debt and/or for financing balance-of-payments deficits. The experience of the past 4 years has been quite reassuring in this respect. More and more banks increased their LDC exposure because of higher profits and lower loan losses in international operations. However, profitability has declined and even some of the large banks expect more losses on the international side in the next few years; (b) the pace of recovery in the industrialized countries and increasing protectionism. These two factors which tend to go hand-in-hand constitute the most serious risks to the successful management of the external debt of developing countries.

So long as lenders have confidence in the borrower's capacity to manage its economy and in the borrower's willingness to make hard choices when required, there is confidence that commercial banks will not limit or withdraw their support precipitously because of the long-term character of the relationship between commercial banks and the major developing country borrowers. However, confidence can easily be weakened by 'bad news' in the form of publicity about the risks of lending to developing countries, occasioned for example by a major default or bank failure, disappointing economic performance and changes in regulations in the borrowing country, more stringent application of capital adequacy tests and portfolio limits by bank examiners and a host of other factors all of which could have the effect of reducing the actual growth rates of commercial bank lending to developing countries below the levels required or planned. There is also no guarantee that international capital markets will be less volatile in the future or the problems of borrowers like Indonesia, Argentina, Peru, Zaire, Zambia, Turkey, etc., will not be repeated.

Thus, the growth rate of commercial bank lending to developing countries, currently projected at around 15% per annum in line with estimated requirements, is not an assured figure. Much will depend on the climate for lending in international credit markets. This whole situation therefore seems to place on the banks a level of international economic responsibility that is unprecedented, especially if one bears in mind that there is no formal framework for the orderly reorganization or refinancing of commercial debt and no lender of last resort. The question arises whether shifting the burden of recycling the OPEC surplus to non-US banks does more than postpone debt problems. Disquiet on this issue of the continued role of commercial banks as the principal intermediaries has been aired not only in the creditor countries but also in developing countries as it is as much in their interest that the stability of the system be maintained.

The solution may well lie in a better understanding between the surplus and the deficit countries, with the former taking on more of the role of direct investors, rather than going through intermediaries. It may also be timely to consider a longer-term mechanism for recycling. At the time of Bretton Woods, Lord Keynes conceived the role of the IMF as that of a clearing union for the orderly financing of surpluses and deficits. He also articulated the view that adjustment to payments imbalances is a problem which must be shared equally by the surplus and the deficit countries. These thoughts naturally lead to the subject of reform of the international monetary system. Falling short of monetary reform, there are several intermediate or complementary measures which can be taken to ensure the level and the stability of the required flows of capital to the developing countries. It must be accepted that developing countries need longer-term sources of finance than are available through commercial banks. Refinancing is not really a credible alternative as it places an undue burden on the initial years of borrowing, and as examined in this paper the initial lenders may for a variety of good reasons not be able to roll-over
the amounts required. There is a need for new market instruments or perhaps a totally new market, for long-term funds. One possibility that has been raised is the idea of pooling together credits from various sources under a joint guarantee scheme, maybe under the auspices of the World Bank or the IMF. The question of activating the guarantee authority of the international financial institutions has also been raised, and a third possibility is significantly expanding the scope of co-financing activities between the international financial institutions and the commercial banks. Finally, increased bilateral and multilateral lending, and greater LDC access to international bond markets are obvious vehicles for lengthening the maturities and increasing the stability of private flows.

NOTES

1. Within this group, 12 countries account for more than half of the total debt of the developing countries. These are: Argentina, Brazil, Chile, Colombia, Egypt, Korea, Mexico, Peru, Philippines, Turkey, Yugoslavia, and Indonesia.

2. Citicorp, Bank of America, Chase Manhattan, Manufacturers Hanover, Bankers Trust, Chemical, Morgan, First Chicago and Continental Illinois.

3. According to the Bank for International Settle-
ments' (BIS) Annual Report of June 1978, 'the 1977 slowdown in new lending to non-oil developing countries was fully accounted for by banks in the US'. (p. 92).

4. The capital to asset ratio of the largest money market banks is roughly one-half of that for all commercial banks in the US.

5. These are publicized spreads. The effective spread, which allows for fees and the fact that some banks raise funds at a cost below LIBOR, is higher. Fees appear to have narrowed over the past year as well. There is no readily available information on the departure from LIBOR for the major banks.

6. Mortgage lending and consumer installment debt (mainly automobiles), which is important for some of the large banks, has expanded rapidly in recent months but is expected to grow more slowly in the latter half of 1978.

7. This is partly explained by special circumstances, e.g. the sale of a subsidiary. Also certain tax advantages associated with lending in Brazil have recently been challenged by the Internal Revenue Service.

8. Loans to Foreign Government, etc., Notice of Proposed Rulemaking, Office of the Comptroller of the Currency, 9 January 1978. Under existing law (12 USC 84) US banks are restricted from investing more than 10% of their capital to any one borrower.

9. Reference is made to the staff report of the Church Committee and the report of the Committee on Foreign Relations.

10. This information was made available in late 1977 before a Congressional hearing in the course of the discussion on the Witteveen Facility.

11. BIS, Annual Report (June 1978).

12. The Economist of 10 June 1978 (p. 87) expressed concern that international banking has grown faster than the abilities of central banks to supervise it.

13. In this regard, I am reminded of a recent statement by the Prime Minister of the UK, 'We cannot dignify the present arrangements with the name of an international monetary system. They are more like a series of ad hoc makeshifts in which the world stumbles blindly from one currency to another'.