

THE INTERNATIONAL DEBT THREAT — HOW IT ALL WENT WRONG

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We have focussed on various aspects of the recession in the Western world and the ills that beset the global economy in our previous three issues. We indicated that in the complex of inter-related factors, which in part re-inforce each other, were stagnating production, slumping world trade, growing unemployment and the increasing indebtedness of the developing countries. In this discussion, by Minos Zombanakis, who draws on his long experience in banking and capital markets, we focus on a specific aspect of the crisis, namely the 'International Debt Threat'. In this paper, (re-produced from the Economist of April 30, 1983) he deals in the latter part with ways of how to avoid a crash, and suggests in concrete terms a more durable solution that might suit all concerned. Here we publish only the first part of his paper, which deals with a diagnosis of the problem and recounts how it all went wrong.

International indebtedness is probably the most pressing problem on the world economic horizon. Many developing countries are facing severe difficulties in servicing their foreign debt, which in total has climbed to over \$ 750 billion, over half of it owed to commercial banks. Already more than 25 countries, with between them bank loans of around \$ 250 billion, have been forced into reschedulings.

This huge debt load stems from the large structural imbalances in countries' external payments which began to appear in the 1970s after the first oil crisis and which continue today. These imbalances were wrongly diagnosed as 'cyclical disequilibria'; as a result, the current-account deficits of the non oil developing countries were allowed to accumulate to frightening proportions.

The correct way to deal with the problem would have been under the collective responsibility of the world community, expressed either through the International Monetary Fund (probably with an adjusted mandate) or through some other international initiative. Instead, it was left to the commercial banks to finance the

developing countries' deficits under their own credit responsibility. The banks saw in this an opportunity for profit. They rushed to inter-mediate between the savings, in the form of bank deposits, of the newly-surplus countries (mainly OPEC oil exporters) and the demand for loans of the deficit countries. And they allowed themselves a comfortable spread.

The banks' monetary authorities saw this intermediation as a function of cash flow movements in a free market place and believed that, with time, a new equilibrium would emerge in world payments. It was an attitude of complacency, not an objective view of the necessary action at the time.

The New York banks, acting as the main money-centre institutions of the world banking system, set out to secure the largest share of the so-called recycling. They ended up, as a group, as the largest single supplier of credit, both directly to country borrowers and indirectly to the inter-bank system. Surplus funds from the treasuries of the large American banks were made available to smaller banks or foreign banks unable to attract directly deposits denominated in

foreign currency. These other banks in turn used the funds to lend to the same community of borrowers. Exposure of the big American banks was thus ensured through the inter-bank markets even when loans were extended by other banks; there is no control over the end-use of funds once they are channelled through the inter-bank markets.

It was much the same for a limited number of other international banks, such as the leading British banks, the four large German banks and the Japanese banks — big banks which had the credibility to act as primary depositories of surplus funds.

The American authorities did not discourage these developments. The dogmatic American treasury could not see anything wrong with the intermediation of the market place in the supply and demand of money. It set out to kill as irrelevant any proposals to face international debt problems collectively. The Kissinger safety net, the Healey plan and other such proposals were quashed.

Paradoxically, the Federal Reserve considered the dependence on the American banks in the recycling process a tool of strength for American policy in general and felt very comfortable with the large American banks taking the leading role. The European and Japanese international banks played their part, though always as the second fiddles — except when Japan's current account was running a large surplus and the Japanese ministry of finance used the lending activities of its banks to export funds.

As for the non-American banks, in carrying out their lending operations through the Euro-markets to country borrowers (or other borrowers for that matter) they always assumed the American monetary authorities would act as lenders of last

resort if there was a shortage of liquidity in the Euro-markets. Absurd as it may be, most of the banks still believe this today. For three main reasons:

- (1) Three quarters of the outstanding international debt is denominated in dollars.
- (2) American banks have provided the bulk of the funds for the credits. It is, therefore, implied that if the foreign banks cannot meet their liabilities to the American banks the Federal Reserve will have to provide the shortfall.
- (3) The Fed adopted a policy of "neglect" during the huge expansion of international lending by the American banks. The Europeans firmly believed this neglect was a way of expressing tacit knowledge and approval.

An orgy of credit

Such was the background against which the world's banking community embarked upon an orgy of credit. The Euro-market was seen as the main supplier of money, using net bank deposits as the monetary base. Credit expansion assumed huge proportions, as the modus operandi of the Euro-market came to resemble a Federal Reserve system without reserve requirements or central bank control. Demand, rather than supply, dictated its size.

In order to mobilise short-term deposits and credit availability in general, a system was devised whereby lenders entered into a commitment to supply money for a given term without having to match it with deposits of comparable maturities. The commitment allowed banks to revise their interest rate periodically (usually at three-or six-month intervals). As their interest rate was based on the cost of money to themselves

plus a spread, the banks could borrow for every interest period and thus refinance the amount they had originally extended to the borrower.

At the beginning some efforts were made to apply credit judgement and to justify the purpose of the loan. With time, however, competition among the banks to secure a larger share of the business encouraged them to overlook credit worthiness and even to invent theories to justify an unwise extension of credit. Otherwise cautious bankers publicly rationalised past actions in order to justify the increasing dependence of their institutions on the earnings from their international loans.

Loan maturities had little to do with the actual structure of a country's requirements and loans were put together in terms of size and maturity either to meet market preference or to fit the spread over LIBOR (London inter-bank offered rate) that borrowers were intending to pay. Though the spread represented an insignificant proportion of the total cost of the borrowing, some enterprising bankers – with the help of the press – succeeded in turning it into a credit worthiness rating. Maturities, therefore, had to be shortened in many cases to fit the spread expectations.

Another notion was that a short-term loan was safer than a long-term one, because it would allow that lender to recover his asset before other creditors. Thus, when the market place was reluctant to respond to given requirements, the maturities became shorter to fit lenders' preferences.

For all these reasons, the average life of loans became shorter. With time and attrition, big country borrowers saw their total debt concentrated in such short-term maturities that it was beyond their ability to service or repay it. Now countries began to be concerned with refinancing existing

debt due for payment, as well as securing credit for new requirements.

Refinancing at any price

When the lending spree started, both lenders and borrowers assumed that, with time and an expansion in international trade, countries would be able to increase their export earnings and repay their obligations. But something went wrong.

Doubt began to emerge when (1) the size of the obligations was inflated by the huge rise in interest rates, adding to the costs on servicing existing debt; and (2) economic growth began to diminish as the world entered its longest post-war recession. The high cost of new borrowings inevitably led to a further shortening of maturities and a further increase in the size of the loans needed to refinance maturing obligations. Suddenly the main preoccupation of the borrowers and of their bankers was to secure continuous refinancing at any maturity.

So 1982 began with international debt in a very fragile state. Western banks had outstanding loans of about \$ 180 billion to Eastern Europe (including Russia) and over \$ 180 billion to Latin America.

Equally important, the average life of the debt of the biggest borrowers among the developing countries – Mexico, Brazil, Argentina, Poland and Yugoslavia – had fallen and large chunks of debt were due in the following year or two. A number of international banks had large exposures in individual countries, especially American banks in Latin American countries. This forced them to extend still further credit to cover these countries' current needs in order to avert sovereign insolvency. In addition, they had to make up for the leakage caused by the unwillingness of American regional banks, and some other international banks, to renew maturing credits.

It became evident that the large banks were locked into these foreign loans. The withdrawal of any individual banks from any given country could bring the country's downfall and, in the process, insolvency of the bank also.

The large banks were preoccupied not only with the solvency of their assets; they were also anxious to see that other creditors, especially the smaller banks, did not abandon the borrowers. Their anxiety led their respective authorities to ask all banks to overlook creditworthiness and to stick with the loans — an absurd (and perhaps illegal ?) position for a central bank to take, but nevertheless justified under the circumstances.

Politics didn't help

The political events of 1982 did not help. The persistence of political turmoil in Poland not only weakened its own negotiating position on its outstanding debt, but it also reduced the ability of other Eastern European countries to raise funds internationally — with the exception of Hungary, which pleaded that it had nothing to do with the problems of its brothers. The rescheduling of the Polish debt met with difficulties, but in the end was done.

The Falklands war did not help the fortunes of Latin American payments by Argentina. It also exposed the myth that Latin America is an American backyard and so, whatever happens, the United States will underwrite these countries. Under certain conditions America would take the part of "outsiders", as it did with Britain over the Falklands crisis. And America could not tell the banks or the IMF to bail out countries — contrary to the self-perpetuating, mythical assumption.

Suddenly Latin American countries met with closed doors when they approached the market for refinancing on a business-as-usual basis. The

first to try — and to fail — was Mexico, which at the end of last summer declared it could not service its debts. The IMF was consulted, the American government agreed to payments against oil, and the Bank for International Settlements put a short-term facility at Mexico's disposal. But it was soon realised that all these ad hoc arrangements were a drop in Mexico's \$ 80 billion ocean of outstanding loans. In fact the \$ 5 billion package put together for Mexico amounts to only half of the interest payments due for 1983.

Faced with this situation, neither the banks (especially the American ones which — unlike in Poland's case — had the lion's share) nor their supervisory authorities knew what to do. Many people in the last August thought the financial system would collapse. Catastrophe was averted only because: (1) people who might have panicked were on summer vacation; and (2) the Federal Reserve intervened to provide both liquidity and encouragement to the banks to "hold on". The fear was that one of the lenders might declare its loans in default which, through cross-default clauses, would put all loans to Mexico in default and make them due for payment.

Subsequently, consultations with the IMF, strong intervention with the banks by its managing director, Mr. Jacques de Larosiere, consultations among the lenders and encouragement from their respective governments helped to arrest the situation in Mexico, at least temporarily. The same procedure was later followed to deal with the problems of Brazil and other countries, as they followed in Mexico's footsteps.

The case of Brazil was especially dramatic. Just before Christmas last year the country declared "unilaterally" its inability to service and repay its loans. The banks had no choice but to concede to its requests by a certain date (March 31st), otherwise the country would declare itself insolvent. Brazil's action gave a different perspective to the whole problem of outstanding world indebtedness. Bank loans became frozen assets.

The borrower dictates

It exposed the fact that when lenders are involved with a borrower to the point where their own solvency is at stake, it is the borrower that dictates and the lender that follows. Unfortunately, this is where we are today. The table, reproduced here

Exposure of Ten American Banks

	Outstanding loans in \$ billion				
	Brazil	Mexico	Venezuela	Total of 3 countries	Total as % of banks equity
Citicorp	4.4	3.3	1.1	8.7	180
Bank America	2.3	2.5	2.0	6.8	148
Chase Manhattan	2.4	1.7	1.0	5.1	183
Man.Hanover	2.0	1.7	1.1	4.8	174
Morgan Guaranty	1.7	1.1	0.5	3.3	122
Chemical	1.3	1.5	—	2.8	143
Bankers Trust	0.9	0.9	0.5	2.2	143
Cont.Illinois	0.5	0.7	0.5	1.6	96
First Interstate	0.5	0.7	—	1.2	64
Security Pacific	0.5	0.5	—	1.0	68

from the American Banker, shows that in Brazil, Mexico and Venezuela (recently added to the casualty list) taken together, the 10 large American banks have outstanding loans which by far exceed their total equity.

It serves no purpose to blame anyone now, perhaps the banks less than most, for in a way they became the victims of circumstances. Instead, we must concentrate our efforts on relieving the system of pressures to avoid the consequences of its possible collapse. There is no way the problem will solve itself without official intervention, despite the optimism of some bankers. What else can they say if they are to maintain the confidence of the public ?

THE ZOMBANAKIS PLAN

Rescue schemes for countries which have been worked out so far with the IMF's help, calling for programmes of adjustment under agreed reschedulings, can only buy time: they cannot solve the basic problem. We must look for longer-term solutions while struggling to hold the system together through these ad hoc arrangements.

Solutions should not disrupt the international system of trade and payments. They should not require the bailing out of banks by their respective taxpayers. They must address themselves to the real problem, which is not just shortage of liquidity but, above all, the threat of insolvency both to countries and to the banks. They must fit the existing framework to the maximum extent possible, so that a new international consensus is not required — something that would be hard to obtain today, at least before the catastrophe had occurred. In a nutshell, we must look for solutions that allow Mohammed to go to the mountain rather than expect the mountain to go to Mohammed. So far, in all the plans proposed by academics and others, the latter is the case.