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SM/85/61

February 20, 1985

To: Members of the Executive Board

From: The Acting Secretary

Subject: Developing Countries' External Indebtedness to Commercial Banks

Attached for consideration by the Executive Directors is a paper on developing countries' external indebtedness to commercial banks, which has been scheduled for discussion on Wednesday, March 20, 1985. A supplement containing background material will be issued shortly.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Watson (ext. 7350) or Mr. Kincaid (ext. 7356).

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INTERNATIONAL MONETARY FUND

Developing Countries' External Indebtedness to Commercial Banks

Prepared by the Exchange and Trade Relations Department

(In consultation with other departments)

Approved by C. David Finch

February 20, 1985

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I. Introduction

In response to requests made by the Interim and Development Committees in September 1984, this background paper discusses recent developments in, and prospects for, external indebtedness of developing countries to commercial banks. 1/ The last general review by the Executive Board of issues relating to bank lending, bank debt restructuring, and other developments in international capital markets was its discussion of "International Capital Markets--Developments and Prospects, 1984" (SM/84/134, 6/13/84; EBM/84/105, 7/13/84). Prior to that discussion, Executive Directors commented on recent experience with bank debt restructurings based on "Payments Difficulties Involving Debt to Commercial Banks" (SM/83/47, 3/9/83; EBM/83/57, 4/6/83).

Section II of the present staff paper reviews developments in lending to developing countries since 1974 and discusses the sources of debt servicing difficulties experienced by many countries since 1982. Section III reviews the approach to resolving countries' difficulties in servicing their bank debt. Section IV describes the factors influencing the medium-term outlook for bank lending to developing countries. Some major policy issues are set forth in Section V.

II. Sources of Debt-Servicing Difficulties

1. Overview of developments in lending, 1974-1984 2/

External debt of non-oil developing countries increased more than fourfold between 1973 and 1981--the years prior to the emergence of widespread debt-servicing difficulties. Relative to GDP, external debt of these countries also increased rapidly; this ratio rose from 22 percent in 1973 to 29 percent in 1981. Over the same period the ratio of these countries' external debt to their exports of goods and services rose from 115 percent to 128 percent. Developments varied widely amongst countries; for example, the major borrowers experienced an increase in their debt

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1/ Companion background papers prepared for the Interim Committee in April 1985 are: "Export Credit Cover Policies and Payments Difficulties" (SM/84/272, 12/18/84); "Developing Countries' Indebtedness to Official Creditors" (SM/85/62); "Trade Policy Issues and Developments" (SM/85/60, 2/19/85); "Enhancing the Effectiveness of Surveillance: The 1985 Annual Review of the Implementation of Surveillance" (to be issued shortly); and "The World Economy to 1990--Prospects and Key Policy Issues," "World Economic Outlook: Current Situation and Short-Term Prospects," and "World Economic Outlook: Medium-Term Scenarios" (all to be issued shortly).

2/ Statistical data is provided in a supplement to this paper (forthcoming). Country classifications used in this paper do not reflect the recently decided revision of classification because necessary historical data were not available on that basis at the time this paper was prepared.

export ratio from 160 percent to 187 percent during these years. 1/ The external debt of oil exporting countries grew at roughly the same pace as that recorded by non-oil developing countries, but the faster increase in exports of oil exporting countries was reflected in a lower ratio of external debt to exports of goods and services at the end of 1981.

During this period, the share of capital flows from private financial institutions in the net external financing of non-oil developing countries rose from about 40 percent in 1973 to an average of 53 percent during 1980-81. There also was a significant change in the terms of private flows, reflecting the move toward syndicated bank loans at variable interest rates and away from more traditional types of private finance such as bonds, suppliers' credits, and direct investment. In addition, increased integration of banks in non-oil developing countries with the global interbank market facilitated in some instances a rapid expansion in the short-term debt of these countries. This expansion was accompanied by a sharp decline in the protection provided by gross international reserves, which fell from 2 1/4 times short-term debt at the end of 1973 to only 85 percent of such debt at the end of 1981.

Debt service payments of non-oil developing countries increased five-fold from 1973 to 1981. 2/ The higher volume of external debt accounted for two thirds of the increase. The larger share of total debt contracted at variable interest rates, combined with the steep rise in international nominal interest rates late in the 1970s, was responsible for the remaining increase. The ratio of debt service payments to exports of goods and services for non-oil developing countries rose from 16 percent in 1973 to 22 percent in 1981. The debt service ratio for major borrowers rose even faster, reaching 35 percent in 1981.

Differences in external debt developments across regional groupings of non-oil developing countries provide useful insights into the incidence of debt-servicing difficulties, even though developments varied considerably amongst countries in these groupings. External debt expanded more rapidly in Africa, excluding South Africa, during 1973-1981 than in any other region. Foreign borrowing by these countries was heavily concentrated in loans from official sources contracted on concessional terms. Consequently, these countries' debt service payments rose more slowly than in any other region. Nevertheless, the debt service ratio of African countries increased more sharply than in any other region, reflecting these countries' markedly weaker export performance. Asian countries, unlike other non-oil developing countries, recorded a faster growth of exports than external debt from 1973 to 1981. The debt service ratio of these countries was 9 percent in 1981, the same level as in 1973.

1/ Major borrowers comprise Argentina, Brazil, Indonesia, Korea, Mexico, the Philippines, and Venezuela.

2/ Debt service payments consist of interest payments on all external debt and amortization payments on long-term external debt.

Western Hemisphere countries began and ended this period with the highest debt indicators of any region. In 1981, short-term debt of Western Hemisphere countries was equivalent to 57 percent of imports, compared to only 15 percent for Asian countries. International reserves of Western Hemisphere countries covered about 60 percent of their short-term debt, compared to 155 percent for Asian countries. External debt of Western Hemisphere countries was equivalent to about 224 percent of exports in 1981, while their debt service ratio was 45 percent.

Following the emergence of debt-servicing difficulties among major borrowers in the second half of 1982, growth in the external debt of non-oil developing countries slowed to about 8 percent during 1982-84 from about 20 percent per annum during the preceding eight years. The growth in debt owed to official creditors decelerated to 11 percent during 1982-84 from an annual average of 17 percent during 1973-1981, but the growth in external debt owed to private creditors during 1982-84 fell more sharply to an annual average rate of 7 percent, only one third of that experienced during 1973-1981. This deceleration reflected the decline in spontaneous lending by banks and the smaller financing needs of developing countries, as the result of adjustment policies.

The share of the net financing requirement of non-oil developing countries covered by private sources during 1983-84 was about one quarter, approximately half the proportion recorded in 1980-81. Nonetheless, through a combination of adjustment, debt restructuring, 1/ and official flows, these countries financed their reduced current account deficits and recorded the largest accumulation of international reserves during any two-year period since 1978-79 (US$29 billion).

The growth in bank claims during 1983-84 included US$23 billion of concerted lending 2/ to a number of Western Hemisphere countries and to Yugoslavia. Almost all increases in banks' exposure to countries in the Western Hemisphere in these two years took the form of concerted lending, although a very modest amount of spontaneous trade financing to countries in the Western Hemisphere appears to have resumed recently.

Since late 1982, spontaneous lending, albeit diminished, has continued to those borrowers among non-oil developing countries, including major borrowers, that have undertaken effective adjustment policies

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1/ The term "restructuring" covers rescheduling, and also refinancing when undertaken to ease countries' external payments difficulties. Rescheduling changes existing contracts formally in order to extend the maturity of payments due to lenders, while refinancing achieves changes to countries' debt service schedules by arranging loans to cover the timely payment of the original debts.

2/ The term "concerted lending" refers to equiproportional increases in exposure to a restructuring country coordinated by bank advisory committees; approval of a country's economic adjustment program by the Fund's Executive Board was dependent on the prior commitment of a high proportion of this lending (the "critical mass").

and continued to service regularly their debt obligations. Thus, with some exceptions, countries in Asia and Europe have continued to enjoy access to spontaneous bank lending, frequently on very favorable terms. A number of these countries had reduced their need for bank credit, as a result both of continuing adjustment efforts and of greater recourse to the international bond market. In some cases, banks have preferred to extend additional credits only after the country had adopted an economic program supported by the Fund. The group of African countries, other than South Africa, has experienced a small decline in bank exposure since the end of 1981. Bank lending to oil exporting countries slowed during 1982-84 and was very unevenly distributed, reflecting the unresolved debt-servicing problems of some major countries in the group.

2. Sources of debt problems 1/

The number of countries approaching their bank creditors for a debt restructuring reached a record level during 1982-83. Most of the countries experiencing difficulties have been non-oil developing countries, including a number of middle-income countries, but debt-servicing problems have also been encountered by several oil exporting countries and by certain non-Fund members that have centrally planned economies. In most countries, the emergence of debt-servicing problems reflected a combination of factors: inappropriate domestic policies, poor external debt management, overlending by commercial banks (which was followed by a sharp fall in lending), and adverse external conditions. The onset of countries' debt-servicing difficulties was precipitated in some cases by regional events.

Expansionary fiscal policies were frequently a major cause of excessive demand that led to a deterioration in countries' current account position, while foreign savings were utilized in projects that had rates of return below their opportunity cost. Large fiscal deficits were financed by substantial external borrowing and a rapid increase in net domestic credit to the central government. Domestic bank credit was also increased to support inappropriate policies of parastatals. As a result, total domestic credit expansion was often excessive. Restructuring countries experienced much faster growth in domestic credit during the 3-5 years prior to the restructuring than did nonrestructuring countries.

Distortions in relative prices, such as exchange rates, interest rates, and producer prices, were factors that depressed domestic savings

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1/ For a further discussion of the causes of debt-servicing problems, see International Monetary Fund, External Indebtedness of Developing Countries, Occasional Paper No. 3 (Washington: May 1981), Sec. IV, pp. 17-20; "Recent Experience with Multilateral Debt Restructurings with Official Creditors and with International Banks" (SM/83/227, 11/7/83) Sec. II, pp. 11-13; and "The Sources of Current External Debt Servicing Difficulties: Some Empirical Evidence," (DM/84/15, 3/5/84).

rates and misallocated resources. The real effective exchange rate of restructuring countries typically rose significantly during the two years prior to a request for debt restructuring, compared to virtually no appreciation by nonrestructuring countries as a group. This development contributed to a deterioration in the trade account and, in conjunction with depressed real interest rates in domestic money markets, also induced capital outflows. For countries in the Western Hemisphere, negative errors and omissions--frequently an indicator of such outflows--rose from 4 percent of exports during 1977-79 to 19 percent during 1980-82, equivalent to 37 percent of these countries' net external borrowing during 1980-82.

In addition to the impact on external borrowing of the macroeconomic policies cited above, countries' weak external debt and international reserve management policies also contributed to debt-servicing difficulties. Although restructuring countries in 1981 had on average a smaller share of their total bank debt falling due in the coming year than nonrestructuring countries, the ratio of such short-term bank debt to assets with banks was four times higher for restructuring countries than for nonrestructuring countries. The ratio of undrawn credit lines to outstanding bank debt for restructuring countries was half the ratio prevailing for nonrestructuring countries. Thus, restructuring countries were generally more vulnerable to unexpected contingencies.

Enhanced access to international capital markets increased countries' ability to finance external imbalances including those resulting from inappropriate domestic policies. Banks continued to expand their lending to countries pursuing inappropriate policies, for several reasons. In particular, they underestimated the risk associated with sovereign lending and were not sufficiently forward-looking in their creditworthiness evaluation. Banks' balance sheets deteriorated substantially during these years.

During 1979-82, non-oil developing countries were confronted with a variety of adverse exogenous developments. Higher prices for petroleum and a decline in prices of other primary commodities led to a marked deterioration in the terms of trade. The prolonged recession in industrial countries, as well as the intensification of protectionism in these countries, affected adversely the demand for exports from non-oil developing countries. The sharp rise in real international interest rates in 1979 also contributed to the debt-servicing difficulties of these countries. While these developments affected countries to differing degrees, they do not appear in general to have been more severe for restructuring countries than for other developing countries. 1/ There were, however, significant differences in the policy response of developing countries to adverse external developments. Some countries implemented adjustment policies only after a delay, or on a scale

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1/ This conclusion is based largely on analysis contained in "The Sources of Current External Debt Servicing Difficulties: Some Empirical Evidence," (DM/84/14, 3/5/84).

insufficient to restore a sustainable external position. Moreover, in an environment where bank lending was both abundant and highly competitive, countries' pursuit of inappropriate policies was not constrained by the availability of external financing.

In sum, inappropriate economic policies increased the vulnerability of restructuring countries to the external shocks which occurred in the early 1980s. Weaknesses in economic policies were seriously compounded by inadequate country risk assessment on the part of commercial banks. Therefore, actions to redress these difficulties encompass adjustment policies by debtor countries, policies by industrial countries to foster more stable financial markets and a sustained growth in world trade, efforts to restore the soundness of the international banking system, and a strengthening of the Fund's surveillance procedures.

III. The Approach to Resolving Debt-Servicing Difficulties

The spread of serious debt-servicing difficulties posed a threat to the international financial system. To resolve these difficulties, a coordinated effort by the borrowing countries, official and bank creditors, and international financial institutions was required. Three principal concerns needed to be addressed: how to link financial support effectively to appropriate economic policies that would restore countries' creditworthiness over a period commensurate with countries' ability to adjust; how to provide payments relief in ways that would sustain and rebuild debtor-creditor relations; and how to coordinate support among large and diverse creditor groups. These concerns guided the approach adopted by member countries and banks in providing new money and in implementing bank debt restructurings within the context of Fund-supported adjustment programs. Authorities in financial market countries and the Bank for International Settlements (BIS) were instrumental in providing immediate temporary financial support. Bank supervisors in major financial centers responded quickly and flexibly to the problems raised by restructurings and new money packages, while the BIS provided a forum for bank supervisors to coordinate their efforts.

1. Coverage of bank debt restructurings 1/

Two objectives have guided determination of the coverage of bank debt restructurings. One objective was equitable burden-sharing among banks to prevent uneven reduction in exposure by some banks which would undermine the cohesiveness of the bank-creditor groups and aggravate a country's debt servicing problems. Consequently, bank advisory committees attempted to make the coverage of bank debt for restructuring agreements as broad as practical. As a minimum, all uncollateralized medium-term credits, including credits cofinanced with the World Bank,

1/ An overview of the terms of bank debt restructurings is provided in the supplement to this paper.

have normally been subjected to formal rescheduling. Increases in exposure--both in terms of amounts and distribution among banks--have depended on banks' exposure as of a given date (i.e., the cutoff date); maintenance of an unchanged cutoff date for successive financial packages has been adopted so as not to penalize subsequent spontaneous lending. Burden sharing between bank creditors and official creditors has been a concern to both classes of creditors. 1/ At times, agreements for bank debt restructurings have required that a certain amount of official commitments be amassed before the agreement was finalized, while the Paris Club has made rescheduling contingent on countries securing comparable debt relief from other creditors.

For developing countries, a second objective was to minimize damage to their prospects of regaining access to international capital markets. For that reason, interest payments falling due or in arrears have been excluded from reschedulings. 2/ Formal restructuring of trade credits and interbank deposits has also been avoided wherever feasible, on the grounds that a medium-term restructuring could severely damage a country's future recourse to such instruments and also threaten the stability of those markets. However, the magnitude of these short-term credits has often made their maintenance essential to a viable adjustment program. Therefore, in a number of cases, access to trade credits was protected by instituting a maintenance of exposure facility. For the interbank market, agreements were reached that deposits be rolled over. Bonds and floating rate notes owned by nonbanks also have not been rescheduled to protect countries' prospects of future access to international bond markets.

In addition to restructuring debt owed or guaranteed by the debtor government, a number of debtor countries encouraged the restructuring of nonguaranteed debt owed by their private sector in order to regularize the private sector's relations with creditor banks and to secure additional balance of payments support. To encourage these restructurings and to soften the impact of sharp currency depreciations on private sector external debt service payments, a preferential exchange rate scheme was instituted in connection with the restructuring in several cases. To limit the budgetary cost of such schemes, some countries introduced complex eligibility criteria, which occasionally caused lengthy administrative delays and delayed restructuring of both private and public sector debt. In some cases, banks pressed countries' authorities to assume or mitigate the commercial risk of their loans to the private sector.

1/ The issue of burden sharing between official and bank creditors is examined in "Developing Countries' Indebtedness to Official Creditors," (SM/85/62).

2/ The two known cases of interest rescheduling arose in countries (Nicaragua and Sudan) that had limited prospects for access to international capital markets.

During the initial stages of countries' payments difficulties, the consolidation period was generally limited to about one year (in addition to restructuring arrears of principal). Restructurings focused attention on identifying, with the Fund's assistance, the appropriate balance between adjustment and financing for the coming year. Due to considerable uncertainties about developments in the external environment and the adjustment that debtor countries would achieve, bank advisory committees generally did not establish medium-term plans for debt service payments, and the terms of reschedulings contributed to a bunching of countries' amortization payments. For countries implementing adjustment policies successfully, banks have agreed to more favorable terms in subsequent restructurings including longer consolidation periods, finer margins, lower fees, and longer maturities.

2. New financing agreements

Prior to 1982, spontaneous bank lending frequently resumed once countries had implemented firm adjustment measures and had regularized relations with creditor banks. When widespread payments difficulties emerged in 1982-83, however, countries engaging in debt restructurings and adjustment programs were unable to obtain new spontaneous financing. The potential relief provided by bank and official debt restructurings was insufficient to close the ex ante financing gap confronting a number of debtor countries. Although additional adjustment measures by countries could have been envisaged to close such financing gaps, there was serious concern about the consequences of more rapid adjustment. Consequently, a need for additional financing arose and with the encouragement of the Fund the concerted lending approach evolved.

Concerted bank lending offered a number of advantages. It was multilateral in nature and was based on a dialogue between creditor banks and debtor countries. The balance between adjustment and financing was tailored to the country's circumstances and outlook. Furthermore, concerted lending appeared to minimize the damage to a country's prospects of regaining more normal access to international capital markets. Other approaches, such as the deferral (or even forgiveness) of interest payments, could have produced the same cash flow relief, but were viewed as substantially less compatible with a return to normal market access. Moreover, if debtor countries as a group had become unable to meet scheduled interest payments, the international banking system would have been jeopardized and future bank lending to developing countries severely limited.

The new money approach resulted in bank creditors performing a forward-looking analysis of a country's prospective payments situation and linking new lending to appropriate adjustment policies. Thus, notwithstanding the difficulties in assembling "new money" packages, reflecting the different business interests of banks and their varying regulatory, tax, and accounting environments, concerted lending has remained the common approach adopted by creditor banks.

3. Linkage with economic adjustment programs

To strengthen debtor countries' ability to service both existing and new debt, banks have made almost all restructurings conditional on approval of a Fund-supported program and have linked their disbursements of concerted lending to purchases under Fund arrangements. Non-observance of performance criteria under a Fund arrangement has delayed disbursements under new money packages until such time as the country has had its drawing rights under the Fund arrangement restored. While banks have sometimes formally halted debt restructuring when a country has been unable to make purchases under a Fund arrangement, they have nevertheless informally continued to defer amortization payments.

At the request of the debtor country's authorities, Fund staff have exchanged factual information and discussed the implications of alternative levels of financing with creditor banks. Where appropriate, the exchange of information also included a description of the policy measures undertaken and the broad policies pursued under the Fund-supported programs.

The magnitude of external financing to be provided by official and bank creditors and uncertainties regarding its availability frequently required the Fund to seek formal assurances that the external financing assumptions of the program would be met, in order to ensure that the program would be fully financed and properly designed. In such cases, Fund-supported programs were only submitted to the Executive Board when adequate progress in assembling a critical mass of bank commitments gave a reasonable assurance that the financing assumptions of the program were realistic.

4. Multiyear bank debt restructurings

For countries that have demonstrated the ability to restore their creditworthiness and diminished their reliance on concerted financing, the attention of bank creditors has turned to fashioning a viable medium-term amortization schedule. In September 1984, Mexico and Venezuela reached agreements in principle with their bank advisory groups on multiyear restructuring arrangements (MYRAs) with extended maturities. 1/ In recent months, negotiations for MYRAs have advanced with a number of other countries.

A key objective of a MYRA is to remove a "hump" in future amortization payments that would be an obstacle to normalizing debtor-creditor relationships in international credit markets. A totally normal debtor-creditor relationship would imply that borrowers could satisfy their gross financing requirements through spontaneous bank

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1/ In connection with this process of normalization, banks made clear that signature of the Venezuelan agreement would not be recommended until private sector arrears had been reduced substantially.

lending, and individual banks could increase or decrease their exposures as they chose. The question of interbank equity and burden sharing would no longer be relevant, as competitive conditions would obtain. Under currently prevailing conditions, the technique of multiyear restructuring responds to a need for progress toward these objectives.

Banks' readiness to enter into MYRAs has reflected several considerations. First, countries in question have made significant progress in correcting their external imbalances. Second, these countries were perceived to be committed on a lasting basis to appropriate adjustment policies. Third, they were viewed to have demonstrated an ability to forego concerted lending, thus setting the stage for restoring in the not too distant future a normal debtor-creditor relationship.

As discussions of multiyear restructurings have proceeded, banks have sought economic monitoring procedures for the period when these countries would no longer be using Fund resources. Uncertainties regarding the future evolution of domestic economic policies and the external environment caused creditor banks to seek more timely and comprehensive information on a country's economic developments and policy plans, and a continuing linkage between restructuring and the Fund's evaluation of a country's economic developments and policies. In this connection, Mexico agreed with commercial banks that it would not only make more economic information directly available to creditor banks, but also would request the Fund to enhance arrangements for Article IV surveillance of its economy and proposed to make copies of the Fund staff's consultation reports available to the banks. The desire on the part of external creditors for more timely information and analysis has been facilitated by the implementation of monitoring procedures which improve the availability of economic information to domestic policymakers. The general features of this approach were followed by Venezuela and are being explored by certain other member countries.

The arrangements requested by the Mexican authorities foresee that the Fund would conduct semiannual consultations. The annual consultation reports would review and appraise the adequacy of a quantified financial program prepared by the country's authorities, commenting specifically on the internal consistency of its objectives and targets and addressing their compatibility with sustained growth and a viable external payments position. Interim consultations would address the progress achieved in implementing the financial program and evaluate the country's economic performance on the same basis as annual consultations. While the Fund staff would make an assessment of the country's program and review actual developments, creditors would need to weigh that information, together with other available information, before arriving at their own judgment about the economic performance of the country and before making their independent lending decisions.

During recent months, banks have entered into discussions about future restructuring terms with a number of other countries. The objective is to secure arrangements that link debt relief and adjustment, while providing a predictable planning horizon for policymakers, for creditor banks, and for the private sector. Since these countries' adjustment and financing circumstances differ, banks have indicated that they prefer to shape arrangements according to each circumstance, but taking into account precedents and implications for other arrangements. Banks and debtor countries have agreed, or are currently discussing, MYRAs that differ in respect of the length of the consolidation period, subperiods for immediate restructuring, monitoring procedures, and covenants regarding responses to a deterioration in a country's economic situation or prospects.

A wide range of possible monitoring procedures could be applied to consolidation periods of differing lengths and adapted to a country's situation. Within a multiyear consolidation period, creditors may make only subperiods immediately eligible for restructuring, with the restructuring of the remaining subperiods subject to the country's economic performance and prospects. In some cases, creditors have insisted that a country commit itself to seek a Fund arrangement for one or more years of a multiyear consolidation period.

Banks have also agreed with debtor countries on differing covenants and events of default relating to a deterioration in the country's economic performance or prospects. The objective is to secure as far as possible prompt changes in policies to respond to such developments, supported by a Fund arrangement where appropriate.

5. Other current developments

In recent months other important developments in bank debt restructurings have taken place. First, under several recent restructuring agreements, banks have been permitted at their option to redenominate, over time, a portion of existing loans into their domestic currencies or the ECU. Redenomination may reduce funding risks for nondollar-based banks, both in terms of market financing and liquidity support from central banks, and would reduce the effect of future exchange rate movements on the banks' exposure relative to domestic currency capital.

For the debtor country, diversification into currencies for which market interest rates are below U.S. dollar interest rates would reduce current interest costs. On the other hand, depreciation of the U.S. dollar would reduce this gain, as would a narrowing, or reversal, of interest rate differentials. In light of these uncertainties, redenomination may be scheduled over an extended period (e.g., 42 months in the case of Mexico). For these reasons, the advantages of currency diversification for the debtor country are difficult to estimate. Nevertheless, currency diversification, by providing banks with claims in a preferred form, can facilitate banks' participation in these agreements and lay the basis for a resumption in spontaneous lending.

A second development in some recent financial packages has been a preference on the part of banks to extend fresh funds in the form of (or convertible into) trade- or project-related loans, rather than purely financial credits to the government. Such loans enable banks to support the export activities of their customers and to some degree monitor more closely the use of these funds. However, in the context of covering an external financing gap, such lending cannot substitute fully for balance of payments lending.

Banks have also been expressing interest in greater involvement of the World Bank in assessing sectoral policies and in evaluating projects. The advantage of cofinancing with the World Bank lies in its potential to associate commercial bank lending with productive projects, rather than in providing protection of a legal nature against future rescheduling. The World Bank's sectoral expertise and techniques for project evaluation are viewed by banks as potentially making an important contribution to unlocking future bank lending.

IV. Developing Countries' Future Access to Capital Markets

1. Factors influencing countries' creditworthiness

The key factor that will influence future access to commercial bank financing and other private capital flows is the economic policies of developing countries. Progress toward a viable external payments position will be a prerequisite for improving these countries' creditworthiness. Continued implementation of adjustment policies will be crucial to consolidate the gains already achieved and will need to be matched by vigorous efforts to remove domestic constraints to real growth. Policies to increase the flexibility of developing countries' economies will play an important role in fostering greater spontaneous bank lending and in improving the composition of private capital flows by increasing the share of direct investment. Effective adjustment policies should also restore confidence, inducing a return of flight capital.

Appropriate policies in major industrial countries, by their impact on world trade and financial market conditions, can exert a major influence on the resolution of developing countries' external payments difficulties. Sound fiscal policies in industrial countries would contribute to lowering real interest rates, which would reduce developing countries' debt service burden, while rolling back protectionism in industrial countries would permit developing countries to earn the necessary foreign exchange to service their external obligations. Policies in industrial countries that foster greater efficiency and structural flexibility would help restrain pressures for protectionism and permit greater economic growth.

In a companion paper, "World Economic Outlook: Medium-Term Scenarios," the staff has analyzed the macroeconomic policies that would facilitate resolution of present debt-servicing difficulties. In that paper, the implications of various combinations of policies in both developing and industrial countries are presented. One principal conclusion of that analysis is that, provided appropriate policies are pursued in both developing and industrial countries, the ratios of external debt to exports of goods and services of the major borrowers could fall very substantially by the end of the decade. This outlook suggests that the magnitude of the debt problem in aggregate terms is being reduced, but that its resolution depends crucially on policies in debtor and creditor countries.

2. The banking environment

The banking environment is undergoing rapid change as a result of technological advances, innovations in financial techniques, deregulation, and institutional change. Competition for financial savings in a number of major capital markets has intensified in recent years, as the demarcation between various types of financial institutions and instruments has become more blurred. New instruments in securities markets have enabled many sovereign borrowers and nonfinancial corporations to obtain financial savings directly. Recent innovations, such as note issuance facilities, have unbundled certain characteristics of floating rate loans and tapped nonbank savings to an increased extent. These innovations may enable borrowers, including certain developing countries, to diversify their sources of funding, although the underlying credit risk appears to remain with the underwriting banks. New techniques, such as interest rate swaps, enable borrowers to hedge against fluctuations in interest rates on variable interest rate loans. Recent developments have increased the scope for nonbank borrowers to obtain funds on terms more favorable than those available to major banks.

In an environment of increased uncertainty and competition, banks are re-evaluating the risks inherent in their loan portfolios. These portfolios have, for many reasons, proved to be less well diversified than previously thought. First, by extending domestic and foreign loans at variable interest rates, banks reduced their exposure to interest rate risk, but, to some degree, have transformed that risk into greater credit risk as their customers have experienced directly the impact of interest rate fluctuations. Second, banks underestimated the significance of sovereign or transfer risk and the covariance of risks in lending to public and private sector borrowers in developing countries. Third, countries' efforts to restore their external payments position, while over time reducing transfer risk, frequently have resulted in a temporary deterioration in the ability of the private sector to service debts, thus increasing commercial risk.

In addition to higher risks in loan portfolios, banks' funding risks have increased over recent years. Banks have become more dependent on the wholesale money market for their funding, and wholesale market depositors' perceptions of banks' creditworthiness have become a significant consideration. These perceptions are related to the quality of a bank's assets. Concerns about the stability of their funding base have reinforced banks' desire to upgrade their assets and to reduce disclosed exposures to borrowers that have experienced payments difficulties.

Capital of banks in industrial countries increased on average from 1977 to 1981 at nearly the pace of nominal GNP growth of those countries. Banks' assets however grew more rapidly than their capital, resulting in a deterioration in capital asset ratios. During this period, banks' international claims rose more rapidly than their domestic claims, while the growth in claims on non-oil developing countries outpaced the expansion in other international assets.

In an environment with greater risk, banks' demand for capital has increased. However, two factors have combined to raise banks' costs of new capital. Concerns about the quality of banks' portfolios have led to share prices of some major international banks trading significantly below book value and to a downgrading of bank bonds by rating agencies. Greater competition has made it more difficult to generate capital internally.

Bank supervisors also have become concerned in recent years with the implications for the stability of the international banking system of the decline in capital asset ratios and the deterioration in the quality of banks' assets. To reinforce the soundness of the international banking system and assure the medium-term prospects for lending, concerted efforts are under way to secure a strengthening of banks' balance sheets. Supervisory authorities in major financial centers have sought increases in capital asset ratios and in a number of cases have encouraged banks to allocate greater reserves against lending risks.

Since 1981, banks in industrial countries have strengthened their capital asset ratios; thus far, a very high proportion of this improvement appears to have been achieved by a more rapid accumulation of capital. The ratios of capital to both total foreign claims and claims on non-oil developing countries were raised from 1981 to 1984. However, available evidence suggests that the shares of foreign claims in total assets, and of claims on non-oil developing countries in total foreign claims, were little changed over that period.

Thus, during this period, the slowdown in lending may not have fallen disproportionately on non-oil developing countries. Indeed, the competition for lending to some highly rated developing countries has proved quite intense. However, in response to efforts to raise capital ratios, some major banks have reduced substantially their general interbank business, resulting in some reduction in the liquidity available to international funding markets. 1/ As supervisors are aware, the resulting reduction in the depth of international funding markets may make banks more anxious about their vulnerability to deposit withdrawals.

The efforts to strengthen banks' balance sheets may have moderated bank lending to some degree. However, these efforts generally have been pursued in a judicious manner, as bank supervisors have balanced the need to move expeditiously against the risk that excessive speed could prove counterproductive.

3. Implications for capital flows to developing countries

Developing countries' borrowing from commercial banks is projected to increase only moderately over the medium term. A number of countries that have avoided debt restructurings can still obtain spontaneous bank credits on extremely favorable terms, and certain of these countries have maintained their access to international bond markets, but these countries' demand for bank credit has been scaled down by strong adjustment policies. Most developing countries, including major borrowers, have indicated that they expect their bank debt to increase less rapidly than the anticipated inflation rate for the medium term, partly as a result of their efforts to restore, or maintain, their creditworthiness, and partly because of limited availability of bank finance. High real interest rates in international capital markets may also temper developing countries' demand for bank funds.

As indicated in the World Economic Outlook papers, a low level of bank lending is expected in 1985-86. Indeed, in 1985 the group of thirty five "market borrowers," whose liabilities represent 70 percent of the developing countries' total debt, are anticipated to experience a very small increase in gross liabilities to private creditors. A slow pace of bank lending during the period immediately ahead would not necessarily be a source of major concern. Of course, within any overall level of bank lending, it is possible that flows may not match some individual countries' financing requirements or reflect the appropriateness of their adjustment policies.

Stronger balance sheets will diminish banks' vulnerability to both credit and funding risks and will, over time, underpin future spontaneous bank lending. While projections of future exposure must be viewed with caution, the projections of bank lending to non-oil developing countries contained in the World Economic Outlook are consistent with a reduction in the ratio of claims on these countries to banks' capital, a process

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1/ Incentives to reduce interbank deposits are greater under regulatory systems which, by employing a simple capital to assets ratio, implicitly accord interbank business the same capital cover requirement as commercial lending. Capital cover considerations have been one factor encouraging the growth of off-balance sheet activities, including swaps and note issuance facilities.

which is already underway. This ratio could return to the level prevailing before the sharp increase in lending to non-oil developing countries during 1979-82, provided that bank capital continues to increase somewhat more rapidly than nominal income growth and that increases in bank lending are modest, coinciding with the desire of many such countries, especially major borrowers, to restrain the growth in their bank indebtedness.

For non-U.S. banks, developments in the U.S. dollar exchange rate, and the pace of currency diversification, will have an important impact on the speed at which their exposure relative to capital is reduced. The real depreciation of the U.S. dollar assumed in the WEO of 5 percent per annum from 1986 to 1990 would increase the capital asset ratio for non-U.S. dollar-based banks by about 15 percent, based on existing currency composition of lending. Although currency diversification by restructuring countries will limit the impact of the depreciation in the U.S. dollar, banks' exposure to non-oil developing countries relative to capital would nevertheless be diminished to some degree.

Once banks have reduced exposures relative to capital, especially for major borrowers, and developing countries have reduced their debt ratios, there are a number of reasons to expect significant spontaneous lending to be available. While banks may now view lending to developing countries as more risky than they judged in the 1970s, domestic lending has proved at least as risky in terms of realized losses. By pursuing successful adjustment policies, developing countries can improve their creditworthiness, lowering the risk on existing and new loans.

Banks' desire to reduce their risk-adjusted exposure relative to capital will influence the form of lending to developing countries. Banks have indicated a desire to increase significantly the share of trade finance and project-related loans in total lending to developing countries, because banks perceive such loans to have lower risk than general medium- and long-term loans. Greater emphasis on trade- and project-related loans means that bank lending will be more closely associated with developments in imports. As countries continue to move away from the import compression phase of their adjustment efforts, the scope for bank lending will thus increase. Such lending will no doubt serve as a cornerstone for the return to a more normal debtor-creditor relationship for these countries. Over time, greater medium-term lending is expected, although not on the scale of earlier years. As bank lending for projects resumes, the World Bank can play a valuable role through its appraisal of projects and sector policies, and in helping to attract bank financing to productive endeavors, both through cofinancing and through general collaboration with commercial banks.

Banks also desire a greater synergy between their foreign and domestic lending operations. Consequently, banks' lending to developing countries will tend to support the export activities of their customers in industrial countries. Related business with these customers is viewed as increasing the rate of return on such lending, while in some cases the risk will be shared with the domestic customer or export credit agencies. In this regard, the policies of export credit agencies will play an important role in influencing future bank lending for trade and projects. Export guarantees can help restructuring countries that have pursued successful adjustment policies ease back into international capital markets. The impact of these policies on bank lending to developing countries is analyzed in a companion paper, "Export Credit Cover Policies and Payments Difficulties" (SM/84/272, 12/18/84).

On drawing together the various influences on lending to developing countries a number of implications emerge. First, a changed and uncertain environment is likely to make banks and bank regulators more cautious in judging appropriate concentrations of exposure relative to banks' capital. Second, in such an environment, countries are likely to reduce their reliance on bank lending. Third, in increasingly competitive financial markets, bank lending to any country will depend crucially upon its expected risk-adjusted rate of return. Fourth, bank lending will be influenced strongly by the economic policies pursued by a country and the successful restoration of a viable external payments position. Fifth, surveillance by the Fund over member countries' economic policies and continuing efforts by bank regulators to assure a strengthening of banks' forward-looking risk assessment will be essential to ensure that, over time, past problems associated with commercial bank lending do not re-emerge.

V. Key Policy Issues

Four key policy issues regarding developing countries' access to credit markets are discussed in this section.

1. Economic policies

Sound macroeconomic policies and effective external debt management by developing countries are essential for a resumption of sustained economic growth and progress toward viable external positions. A return to more normal access to bank credit and other private flows can be facilitated by prompt implementation of policies affecting both the demand and the supply side of developing countries' economies. In this connection, project, sectoral, and structural adjustment loans from the World Bank offer an important complement to Fund-supported programs. Effective economic policies should result in a more diversified inflow of external capital to developing countries than in recent years, including a higher proportion of nondebt creating flows. Countries' ability to reduce their dependence on banking flows is likely to influence strongly banks' willingness to offer favorable lending terms.

A continuing improvement in developing countries' external finances also depends crucially on the pursuit of policies by industrial countries that will result in expanding, and more open, markets for developing countries' exports and in lower real interest rates in financial markets. A fuller assessment of the implications of economic policies of both developing and industrial countries is contained in the staff papers on the World Economic Outlook.

A strengthening of the Fund's surveillance procedures can play an important role in supporting a continuing improvement in countries' policies and in securing greater international coordination of policies. The Fund's surveillance procedures are discussed in "Enhancing the Effectiveness of Surveillance: The 1985 Annual Review of the Implementation of Surveillance" (to be issued shortly).

2. Normalizing debtor-creditor relations

A normalization of member countries' relations with commercial banks can be facilitated in a number of ways, which may vary to some degree according to the countries' external payments situation.

For certain countries that have made progress in adjusting their economies and have established their ability to dispense with concerted lending packages, banks have shown a readiness to negotiate multiyear debt restructurings with extended maturities, where these are necessary to facilitate the countries' return to more normal access to international capital markets. Banks are seeking to protect the quality of their assets by devising, on a case-by-case basis, arrangements to monitor developments in countries' economic prospects and policies during the period of multiyear restructurings. In this connection, a number of member countries have proposed to make staff consultation reports available to their bank creditors as one element in the monitoring of their economies by these creditors. These countries have indicated that they will request the Fund to conduct semiannual consultations to review their financial programs and to evaluate their progress toward viable external payments positions.

The Fund's evaluations of countries' policies would assist banks in the transition toward taking credit decisions on a market basis. A return to more normal debtor-creditor relationships would be characterized by creditors making independent lending decisions based on information from a range of sources. It would be incompatible with progress in that direction for the Fund to provide "on/off" signals about the appropriateness of further bank lending or of continuing restructuring. Moreover, it is important that enhancement of the Fund's surveillance of a particular country's economy should not be misunderstood by commercial banks to be a signal that their own monitoring can be relaxed.

In cases where multiyear restructurings are being negotiated, some banks apparently wish to move quickly to decentralized credit decisions by disbanding bank advisory committees and their economic subcommittees. Other banks would be more comfortable for the time being with continued collective monitoring by a bank committee or possibly by the Institute of International Finance.

For countries that have begun to adjust their economies but are still at an early stage in resolving their payments difficulties, bank creditors may generally seek to maintain a link, on a year-by-year basis, between debt relief or new financing agreements and arrangements to use Fund resources. Where adjustment has been delayed, and debt service difficulties are more pronounced, comprehensive and vigorous adjustment measures will be required.

For countries that continue to experience protracted debt service difficulties, whether because of severe structural problems, continuing depressed foreign markets, or inadequate domestic policies, appropriate and comprehensive measures to redress the sources of a country's problems are likely to remain a prerequisite for assistance by creditor groups. Where severe difficulties persist over an extended period, creditors may decide, on a case-by-case basis, to provide substantial and continuing debt relief. Creditor banks may need to show flexibility in dealing with the problems of such countries, including those whose export earnings are highly dependent on developments in markets for primary commodities. In the case of low-income countries, the situation will require that sustained adjustment efforts be supported by debt relief and concessional flows continuing over a number of years.

A general issue, applicable to all countries seeking to resolve their payments difficulties, is the role that official resources can play in providing debt relief and in catalyzing a resumption of spontaneous bank lending to countries through such channels as cofinancing with multilateral development banks or the provision export credit guarantees. The contribution of official creditors to a normalization of countries' payments positions is discussed further in "Developing Countries' Indebtedness to Official Creditors" (SM/85/62), and in "Export Credit Cover Policies and Payments Difficulties" (SM/84/272, 12/18/84).

3. Responses to adverse external developments

One threat to resolution of the debt-servicing difficulties of developing countries would be adverse developments in the world economy. Developments in industrial countries' growth, in interest rates or in the prices of commodities, including petroleum, would have a widely varying impact on different countries. Responses would therefore need to be based on a country-by-country analysis of the situation. Only such analysis could tailor the mix between adjustment and financing to countries' circumstances and prospects. The response to countries' difficulties would continue to require the coordinated support of official and private creditors to be linked to countries' adjustment efforts. Allowing countries to accumulate debt without improving their prospects for servicing that debt would delay their ability to establish more normal debtor-creditor relationships, while placing additional burdens on their debt-servicing capacity.

A key objective of any response to adverse external developments is likely to remain a return by countries, over time, to more normal market access. In this regard, debt restructuring by official and bank creditors, and concerted lending by creditor banks, where necessary, would appear to be an appropriate approach to securing additional financing on a scale tailored to countries' debt-servicing capacity. While the assembling of financial packages is an arduous process, experience has underscored the advantages of concerted lending in bringing debtors and creditors into a dialogue, and in focusing attention on achieving a proper balance between financing and adjustment.

Concerted lending links debtor countries' adjustment policies, which restore creditworthiness, to banks' lending decisions, which are made after judging the economic position and prospect of the country. Alternative approaches, such as capitalization of bank interest payments, have been rejected by bank advisory committees and do not seem favored by those debtor countries that desire to return to international credit markets, on the grounds that to cease current payment of interest or to introduce more compulsion or automaticity in bank lending would severely damage countries' prospects for future access to bank credit. Similarly, policies that would allow a substantial accumulation of arrears, or a partial payment of bank interest, would seriously impair the outlook for countries' access to external capital and trade financing.

In assessing techniques to provide additional financing, an important consideration would be their impact on the soundness of the international banking system. Techniques that seriously impair the strength of international banks could weaken further the banking system's capacity to intermediate flows to developing countries over the medium term. In this regard, it would appear logical to maintain extension of credit to developing countries on terms as close as possible to those in the market. A sound banking system, as well as a correction of imbalances in countries' economies, is an essential element in achieving sustained growth in world trade and in member countries' economies.

4. Strengthening the international banking system

A progressive strengthening of the international banking system appears indispensable if banks are to play a full role in intermediating international capital flows, including flows to developing countries. In the period since the onset of widespread debt service difficulties, bank supervisors have balanced judiciously the need for such a strengthening against the danger that too sharp a reaction by banks could result in a counterproductive effort to curtail their exposure to developing countries. Supervisors have accommodated new money packages by allowing dilution of banks' exposure to be gradual.

Supervisors in major countries are currently engaged in a concerted strengthening of banks' capital ratios and in a number of countries have indicated to banks that more substantial reserves or provisions against lending risks are desirable. The issue arises to what degree these efforts to strengthen banks' balance sheets may restrain bank lending during the transition period.

Available evidence suggests that banks' capital asset ratios, thus far, have been increased mainly by raising new capital. Of course, efforts to secure a strengthening of banks' balance sheets may have varying impacts on lending depending on the specific modalities adopted and the degree of certainty about ultimate targets for capital ratios.

Provisioning against lending risks is another technique employed to strengthen banks' balance sheets. In some countries, tax considerations have encouraged voluntary provisioning against country risk. Where bank supervisors or auditors have deemed provisioning inadequate, they have pressed banks to make greater loan loss provisions. The sound valuation of bank assets is an essential element of maintaining confidence in, and ensuring the safety of, the international banking system. Where countries have implemented comprehensive adjustment measures, the lifting of provisioning requirements could facilitate a resumption of spontaneous lending.

At the present time, commercial banks generally desire a very modest growth in exposure to developing countries, at least in the near term, with a particular view to reducing their exposure to some major borrowers relative to their capital. This desire for modest lending coincides to a considerable extent with a desire on the part of many developing countries, especially major borrowers, to restrain the growth in their indebtedness to banks, in light of high real interest rates and changed perceptions of risk in the international environment.

While banks may have become more forward-looking in their risk assessment as a result of experience during the last two years, there remains a concern that their risk assessment may be slow to reflect current economic policies of borrowing countries. Banks also need to translate risk assessments into graduated lending decisions, and to reflect countries' creditworthiness in the scale and terms of lending, if future cycles of feast and famine in bank lending to individual countries are to be avoided. It will be important that banks weigh creditworthiness evaluations more heavily in their lending decisions. The effectiveness of commercial banks' risk assessments will be a crucial factor in supporting countries' return to more normal market access and in avoiding a recurrence of widespread debt-servicing difficulties.