International Financial Markets: a case of market failure

Stephany Griffith-Jones*

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I Introduction

The issue of the appropriate form, mechanism and extent of external funding of development has become crucial for Third World countries, especially in the nineteen-eighties. This paper shows the limitations of private lending to developing countries, and argues that the experience of the last two decades (as well as earlier experience) shows that private financial markets provide an important example of market failure; for this reason, the regulation of these markets, and their partial replacement by public flows in cases where they break down or work imperfectly, is necessary.

The argument that private financial markets are inefficient as intermediators of savings has been made in the past by writers such as W. Bagehot (1873) and H. Veblen (1964) and more recently by H. Minsky (1982) and C. Kindleberger (1978). These writers point to the tendency of private financial markets being characterised by successive periods of over-lending and under-lending, often resulting in financial crisis. However, their analysis is relevant to the operation of financial markets in general, rather than to the specific and difficult issues related to international private lending to developing countries, as illustrated by over-lending in the seventies and debt crises in the eighties; it is on this specific area which this paper will focus[1]. In its final part, the paper describes and evaluates the specific form of public intervention that has occurred in the nineteen-eighties to handle Third World private debt crises, and suggests lessons for future policy.

International financial markets underwent a major process of privatisation and deregulation in the nineteen-sixties and seventies. This rapid expansion of private flows, mainly via the Euro-markets was greatly welcomed by orthodox analysts. Thus, McKinnon concluded that "lack of (government) restrictions created a model of efficiency in international banking" (McKinnon 1977). Similarly, Duffy and Giddy argued that "The Euro-markets facilitate market allocation and reduce the role of government allocation...undoubtedly, no other force can, on its own, contribute in such an important way to the efficient international allocation of credit as the Euro-markets have done" (Duffy, G. and I. Giddy 1978).

During the nineteen-seventies the share of developing countries' funding provided by private sources rapidly increased and the share of international lending channelled by international banks to developing countries grew rapidly. This "privatisation" of a large proportion of development funding was strongly welcomed by orthodox analysts as representing the optimal way of financing the development of Third World countries.

This trend was also encouraged by the International Monetary Fund as a convenient mechanism for recycling funds from the surplus countries to oil-importing developing countries, whose deficits had been sharply increased as a result of large rises in the price of oil and of the slow-down in industrial economies. For example, J.J. Polak, a senior official at the I.M.F., enthusiastically welcomed the new trend: "The development of international bank credit available to a wide range of countries, including many developing countries, has reduced the difference between the U.S. and many other countries, as regards their ability to finance balance of payments deficits. At present, it is not only the U.S. that can finance deficits by issuing liabilities expressed in U.S. dollars - most other countries can do the same, by using the credit facilities of the (private) world banking system" (Polak 1980). As late as July 1982 (only one month before widespread debt crises broke out) the IMF Occasional Paper on Capital Markets (IMF 1982), though expressing some concern about the continuity of bank lending, still concluded that, "over the medium-term the rate of growth of international bank assets (on loans to LDC's) can be expected to remain high...The efficiency of the markets in allocating capital internationally is underpinned by basic commercial principles; these should remain the key stone of banks' decisions". The voices of critics urging caution in the unrestricted use of private agents for recycling funds to developing countries, a greater role for public flows, and public supervision of private flows, were drowned by the enthusiasm of the supporters of the free market (US Congress 1977), (Balogh 1980), (Griffith-Jones 1980).

The onset of widespread debt crises in the eighties, their pervasive negative effect on development in highly indebted developing countries, as well as the threat they posed to the solvency of international banks eventually led to a reassessment of the virtues of private markets as the optimal mechanism to fund developing countries. Thus, the events of the nineteen-eighties led to a strengthening of the position of those criticising the unrestricted use of the free market[2]. Even so, a hard core of defenders of private financial markets remained. In spite of its serious theoretical and empirical flaws (which we discuss below), this position still has a great influence on the thinking of the major industrial governments.

For example, in the official report of the industrial countries (G-10) submitted to the powerful Interim Committee of the IMF in September 1985 it is argued that: "improvements in the provision of international liquidity need not be sought through fundamental changes in the system .... for the foreseeable future, financial markets must be expected to continue to supply the bulk of international liquidity ...." (IMF 1985). Furthermore, some of the Deputies (including the US representative) go further in the report to argue that "the difficulties encountered by a number of countries (to obtain sufficient international liquidity) are primarily an indication <u>of their lack of creditworthiness</u> and are not related to a general shortage of liquidity". According to these Deputies, the creation of official international liquidity (via SDR allocations) is "<u>not the appropriate tool for providing finance to countries whose access to international credit markets has been jeopardized</u>" and suggests that "they might result in <u>delaying necessary adjustment</u>" (emphasis added).

The position of industrial governments has become somewhat more flexible since that declaration was made, particularly as regards concessionary official flows to low-income countries in Sub-Saharan Africa. They still believe, however, that the almost exclusive provision of international private liquidity to different categories of LDC's remains a feasible and desirable option; this leads to problematic policy conclusions, from a developmental perspective, such as that SDR issues are unnecessary. Equally, it means that international liquidity for developing countries will be either provided by private financial institutions or under high conditionality lending by the public international financial institutions (IFI's). Then the premise that international liquidity should basically be market created, has far broader implications: in particular that macro-economic policies and, most seriously, development strategies should be heavily conditioned by the requirements of private bankers and IFI's. This situation gives tremendous power and influence over development to the markets and IFI's.

In the next section we will briefly examine historical evidence in order to assess the effects of private international financial flows on growth and development. We will stress those negative effects on development which have either been ignored or insufficiently treated in the orthodox literature; we shall also discuss the negative effects of excessive private international lending on the creditors themselves.

The final section of the paper suggests three broad sets of policy implications. These will cover the scale and regulation of future private lending, the role of international official funding and liquidity creation, and the future management of debt crises.

We shall argue that industrial governments should play a larger role in the future, both to regulate private financial flows to developing countries and to channel public flows towards them; somewhat paradoxically, however, we shall argue that "the markets" should be allowed to play a larger (albeit different) role in finding a solution to the debt problem than they have till now.

II The effects of development funding from private sources, with special reference to the nineteen-seventies.

One of the important issues facing the international economy, which particularly affects developing countries, relates to the appropriate levels and mechanisms for international financial intermediation. The issue arises, both nationally and internationally, mainly because those economic agents that save are not the same ones which invest. Internationally, if financial intermediation between net savers and net investors is not adequately performed, the effect will be to depress the level of output and income, particularly in countries with low net savings and possibly also in the world economy as a whole.

As regards developing countries, most authors agree that economic development normally requires some long-term external capital and short-term balance of payments assistance to help fund both long-term and short-term current account deficits. It is important to stress in the context of our evaluation that specific conditions need to be met so that such external funds contribute to development. Raul Prebisch (1979) attempted to specify these conditions as follows:

a. the net volume of financial inflows should be appropriate to development needs.

b. the outflows generated for payments of profits and interest must still allow for future net inflows; for this reason Prebisch added, that the financial terms of such flows (in relation to maturities, grace period and level of interest rate) should not be too onerous.

c. the net external financial inflows should be used for investments which will contribute to an increase in exports and/or a substitution of imports.[3]

In the discussions preceding and during Bretton Woods, it was proposed by Keynes that a very large public international institution, which he called the International Clearing Union, should channel a large proportion of flows from surplus to deficit countries. However Keynes' detailed proposals were not accepted and the institutions emerging from Bretton Woods - the IMF and the World Bank - were both smaller and less powerful than those he had envisaged.

Furthermore, the relative size of these institutions decreased in the following decades, particularly in the case of the IMF; thus, the ratio of IMF quotas to total world imports has systematically declined, from about 16 per cent in the late 1940's, to 12 per cent in 1960, to only around 5 per cent by the end of 1983, after the eighth (and most recent) General Review of quotas.

In the 1970's, the dramatically increased size of the problem of financing non-oil developing countries' current account deficits, (which according to IMF figures, grew from US $11.3 bn in 1973 to US $107.7bn in 1981), together with the limited response made by the public international financial system, implied that public institutions were able to make only a relatively marginal contribution to deficit countries' funding. It has not been sufficiently stressed in the relevant literature that in the 1973-82 period, the IMF, through all its facilities, financed a mere 3.1% of the current account deficits of non-oil developing countries[4]. Furthermore, during the 1970's, there was an almost total lack of public control or even supervision with respect to the process of expansion of private lending[5].

In 1973, around 38% of disbursed public, and publicly guaranteed external debt of all developing countries was owed to private creditors; by 1982, that percentage had risen to 55%; for Latin America and the Caribbean alone, the figures were 58% and 77%. Furthermore, the share of financial market (increasingly bank) credits vis-a-vis supplier credits increased from 65% to 91% for all LDC's in that period. The resulting rapid increase in the share of bank credit occurred in the context of a very rapid increase in the total outstanding debt of developing countries.

It is not the main purpose of this paper to attempt to explain why banks engaged in such massive lending and why bank supervisors allowed it. However, it is useful for the analysis to treat this matter briefly. The behaviour of banks and of supervisors can be explained both at macro and micro levels. At the macro-economic level, it is clear that in the early seventies, rapidly growing liquidity in the Euro-markets (due to steep increases in deposits from oil exporting countries as well as other sources) implied that international banks' deposits were growing rapidly. At this time, however, credit demand from their traditional clients was slowing down due to the recession in industrial countries, and demand for increased funding was growing in developing countries.

However, the very rapid increase in banks' lending to developing countries, leading to a very high share of banks' total assets and capital represented by their exposure to some developing countries, needs also however to be explained in terms of micro-economic behaviour. An interesting approach to explain banks' behaviour, (and that of bank supervisors') stresses "disaster myopia" (Guttentag and Herring 1985). This approach is especially relevant in the context of this book, challenging, as it does, the conventional assumptions of rational expectations theory, which assumes that market discipline will ensure that successful decision-makers form expectations correctly; those who make systematic errors incur losses and go bankrupt. But this hypothesis has much less relevance for expectations concerning low-probability hazards - <u>those which occur so rarely that they can be disregarded without cost for long periods</u>. Guttentag and Herring (1985) argue that as the length of time since the last major incidence of default lengthened (and as in the post-war era, the repayment on country loans was relatively good in relation to other lending), bank decision-makers believed that the probability of a range of countries defaulting was very low, and, effectively, zero.

This "dysaster myopia" on the part of the banks seems to have been accelerated by the high mobility of decision-making staff, who were thus personally able to avoid the possible negative effects of over-lending on <u>future</u> non-payment, but whose career benefited in the short-term as personal promotion was often linked to maximising credit growth[6]. This behaviour arose largely from the very nature of the product "transaction" involved, where the moment of selling "the product" does not, by definition, coincide with the moment of payment. Extreme decentralisation of operations, geared towards attempting to maximise speed in credit decisions, also contributed to institutional "dysaster myopia". Alexander (1984) has even reported that "some bankers were so frightened of losing market shares that they even allowed their secretaries, during the banker's lunch-break, to promise US $5 million or US $10 million, as part of any package for Brazil or Mexico over US $1 billion".

This tendency to neglect low-probability hazards can however produce large or even crippling losses, in a context of decision-making under uncertainty about the future. In this specific sense, it undermines the standard assumptions of rational expectations theory. "Disaster myopia", linked to the perception that the existence of sophisticated economic management and of IFIs reduced risks of country default, seems also to have led supervisory authorities in creditor countries to be lax in the supervision and control of private bank lending. Furthermore, the fashionable belief that markets know best, further discouraged supervisors from attempting to regulate and control private bank lending.

Other factors that explained over-lending to LDC's in the nineteen-seventies include the fact that banks had access to imperfect information about the borrowing countries and even about the total level of their debt; this was particularly the case for smaller, less internationally oriented banks. This often led to smaller banks relying on information provided by larger banks (thus basing their decisions largely on the prestige of the leading banks in the loan-making process). As a result, decisions of one firm were no longer independent of those by other firms, breaking a key condition for efficient resource allocation. By consequence many decisions on loans (and their prices) were not taken purely on the basis of independent profit/risk analysis, but partly based on "herd behaviour" - the wish by all to participate in what was generally seen as profitable expansion. Furthermore it has been argued (Devlin 1985) that the comparison between the profit from, and risks associated with, a particular loan is only one element in the decision to lend; the possibility of capturing other business - such as obtaining deposits from the borrower, or even deposits from the exporters of the borrowing countries - seems to have further encouraged bank lending.

It should be stressed that the 1970's were by no means the first period in economic history in which bank lending (or other form of private flows) have had an "euphoric" over-expansion. This has happened usually in times of upward movement in the business cycle, and has often been followed by over-contraction, at times of slow-down in economic activity; Kindleberger (1978), analyses the pattern of boom-bust lending, and illustrates it with historical examples, going back as far as the South-Sea Bubble; in a more recent work, Marichal (1988) describes in some detail, the four great lending boom/debt crises that have occurred in Latin America before that of the 1970's and 1980's. These occurred in the mid 1820s, in the mid 1870s, in the early 1890s and - as is well known, in the early 1930s.

This evidence suggests that private bankers, regulators as well as government officials in developing countries suffered in the 1970's not only from disaster myopia, but also from an ignorance of history!

III <u>The effects of private bank lending in the 1970's and 1980's</u>

Initially, for several of those developing country governments that borrowed heavily in the nineteen-seventies, private international credit provided a welcome, easily obtainable, apparently cheap, and low-conditional, source of external savings to help adjust to major external shocks without sacrificing growth. The fact that growth was sustained in an large part of the developing world contributed somewhat to sustaining growth in the world economy as a whole.

There is a tendency, in some of the simplistic Latin American literature, to argue that the long-term impact of private international lending was purely negative, particularly once the international economic environment deteriorated in the nineteen-eighties. Although this is broadly true (see below) a <u>few</u> countries that relied heavily on private capital in the nineteen-seventies were able to sustain development in the eighties. Thus, the scale and use of private external funds by the developing countries influenced how they affected development. It would seem that the lower the relative size of the external debt in relation to exports, the higher the proportion of the private loans that remained in the domestic economy (and did not leave as capital flight), the higher the proportion of those flows that were devoted to funding investment and the higher the proportion of that investment devoted to the increased production of tradeables, then the more likely were positive effects on future development, and the more likely that debt repayments would be manageable (Griffith-Jones and Harvey 1986). In this sense, it seems that the Asian countries demonstrate this more positive pattern, and have had a more favourable growth experience in the 1980's than the Latin American ones.[7] As an illustration, two extreme cases can be mentioned. On one hand, South Korea is an example of a country which borrowed relatively little (in relation to its exports), had very little capital flight, and devoted a high proportion of what it borrowed to investment in tradeables, particularly in industrial exports; at the other extreme, Venezuela provides an example of a country where the size of the increase in the external debt to private creditors coincided with the size of the increase in assets held abroad by the private sector (Alvarez 1988).

Although it is clear that the nature of economic policies influence the effect which international borrowing had on individual economies' development, the neo-liberal argument that debt crises "are primarily due to mistaken policies" (Lal 1988:3) seems too strong. It totally ignores initial structural differences amongst economies and their politics. Equally it is very narrowly based, focussing only upon trade and exchange-rate policies, rather than upon the influence, also, of terms of trade, of war, of climate and of history in determining outcomes.

For the majority of developing countries which borrowed heavily in the Euro-markets in the 1970's, development has not been sustained in the 1980's, and indeed their development record seems relatively poorer than that of other developing countries.

These negative long-term effects can be attributed mainly to the following features:

1) The modality of the variable interest rate, in the context of loans with relatively short-term maturity was particularly unsuited to fund long-term development; it was designed by actors in the private market, with the objective of passing on to the borrower the risk of interest rate fluctuation; this was undesirable from a development perspective, as the variability of interest payments added an important additional element of uncertainty to developing countries' attempts to predict and plan their balance of payments flows. This, inevitably, would have disruptive effects both on short-term macro-economic management and long-term development if interest rates rose. This they did in the early nineteen-eighties in nominal and real terms. At a more micro-economic level, variable interest rates make it impossible to decide whether the allocation of borrowed funds to any particular use was rational, because economic agents were unable to predict the whole cost of individual projects. Furthermore, even for the private lenders this mechanism was counter-

productive, as the interest rate risk was translated into credit risk, with far more threatening effects on their stability than a pure interest rate risk could have had. Thus, the variable interest rate, which was designed to reduce an important category of risk, in fact increased risks arising from unfavourable changes affecting many borrowers simultaneously such as the impact of the world recession. Private actors on the whole, are unable to foresee such risks, or to cope with them (without resorting to governments) when they occur.

This critique is not against private flows in general, but against the modality which private flows adopted in the 1970s (which, incidentally, was different to the long-term, fixed interests bonds which characterized private flows in the 19th Century). LDC governments did not have much choice in the matter. Private capital markets were not willing to lend through bond instruments in the seventies (and were even less willing to do so ten years later). If bond finance were to have been provided by the markets to LDCs, some form of guarantee from industrial governments in intermediation would probably have been essential.

2) The second problem, applicable to all private flows to developing countries is their instability and their pro-cyclical nature. As the early 1980's illustrated particularly clearly, interest rates, terms of trade and the supply of lending can interact perversely; as the international environmental deteriorates (together with both the current and perceived prospects of repayment by developing countries) private lenders become unwilling to make new loans, thus making the ultimate inability to pay far more likely.

For the developing world as a whole, rapidly increasing interest rates and counter-cyclical reduction in new private lending have implied that net resource transfers have become negative or "perverse" since 1985 (see table 1). According to World Bank estimates, for the heavily indebted countries, net resource transfers from those economies to their creditors in 1985/87 amounted to $74 billion, equivalent to about 3% of their total G.D.P.

Undoubtedly, negative resource transfers are a major constraint on developing countries' growth in the eighties. Together with the sharp deterioration in terms of trade that occurred in the eighties, it has contributed to an interruption of growth and development in large parts of the developing world, particularly in Latin America and Africa. This is because an important part of export revenues cannot be used to purchase imports, and an important part of domestic savings cannot be channelled to investment, being absorbed, instead, by debt service.

Table 1: Net Transfers of public and publicly guaranteed debt (US$ billion)(a)

	1985		1986		1987	
	Total	Private Creditors	Total	Private Creditors	Total	Private Creditors
All developing countries of which	-12.7	-18.2	-19.1	-23.6	-28.5	-29.4
Latin America and Caribbean	-14.0	-16.1	-15.6	-17.5	-12.7	-12.5
Africa, South of Sahara	-1.6	-3.0	1.7	-0.7	2.5	-0.4
East Asia	3.4	2.5	-2.2	-1.3	-10.7	-9.8
Europe and Mediterranean	-3.1	-1.5	-5.1	-4.0	-9.1	-6.0
North Africa and M. East	0.5	-0.4	0.2	0.0	-1.2	-1.1
South Asia	2.2	0.2	1.9	0.0	2.8	0.4
memo: Highly indebted countries(b)	-18.0	-18.7	-18.6	-19.4	-15.2	-14.2

Source: World Bank, World Debt Tables 1988-89, Washington DC.

(a) The net transfer figures are far higher if private non-guaranteed debt was included.
(b) The highly indebted countries, as defined by the World Bank, are: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Côte d' Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia.

3) Thirdly, the large private lending for developing countries followed by sharp decreases in financial flows was particularly damaging because most countries had adopted development strategies and macro-economic policies that assumed a permanent large private

net transfer. Thus, patterns of consumption and production became more import intensive in the 1970s; furthermore over-valued exchange rates and large budget deficits were feasible and were even encouraged by massive private inflows. Though misguided economic policies are naturally the responsibility of national governments, the "facilitating" availability of private international liquidity played an important role in encouraging such distorting policies. As net resource transfers were drastically reversed, the recessionary cost of adjustment was greater, precisely because the pattern of development had been so import intensive, and because - in most countries - adjustment was mainly market determined (little use being made of selective policies, such as import controls). Similarly the over-valued exchange rates compatible with large trade deficits had to be rapidly and drastically reduced so as to accommodate the need for large trade surpluses; these massive real and even larger nominal devaluations contributed to sharp accelerations of inflation in most of the heavily indebted countries, and particularly those in Latin America.

We have focused, so far, on the effects which private flows had on the development of heavily indebted countries. Two other aspects need to be stressed in this context. Firstly the "privatisation" of financial flows in the seventies led to a very high concentration of external flows to the upper and middle income developing countries. It has been estimated that low-income countries obtained less than 3% of total net private lending to oil-importing developing countries, while the share of their access to other flows (e.g. aid) more dominant in the sixties, was higher. So the shift to private flows worsened the distribution of access to external finance among developing countries during the seventies; though this trend may have led to slower growth in the seventies, it may have helped some (e.g. India) sustain growth better in the 1980's. There is however evidence that debt crisis management in the eighties, has implied an increase in the share of public flows going to highly indebted mainly middle-income developing countries, thus leaving again a lower share of flows (in this case public ones) available for low-income countries. It thus has been argued that low-income countries have become the lenders of last resort, as their reduced access to public flows allows greater public flows to highly indebted countries, which in turn allow them to service their debts to private banks.[8]

Secondly, the high exposure of most of the international banks to developing countries, combined with the risk of widespread defaults or by them, has undoubtedly posed a threat to the stability of the international banking system. Though the threat significantly receded, its existence has weakened the international banks. Nevertheless, the LDC debt continues to pose a serious threat particularly to some US banks.

In the absence of intervention by industrial country government during the early 1980s, bankruptcy of some major international banks, disruption to world trade and an even higher cost to development would probably have resulted.

Thus, industrial governments have, since the early eighties, recognised in their actions (albeit partially and implicitly) that stable external financial flows to fund development and stability of the banking system are "public goods", that cannot be provided by private market agents acting individually; particularly in times of international recession, private actors are on their own incapable of dealing with the systemic risks and crises that arise. The cost of market failure is high because of its' potential systemic effect, which could drastically reduce lending to all countries and enterprises, thus further reducing their level of activity. For this reason, the provision of stable financial flows to LDC's <u>and</u> a stable international banking system are public goods, bringing benefits which the market, acting unassisted, finds it difficult or impossible to provide.

<u>Some Features of government intervention</u>

The actions taken by governments in the 1982-87 period have been both too limited and biased towards preserving only one of the "public goods" under threat from the LDC debt crisis - the stability of the international banks. Insufficient attention has been given to the other "public good" under threat, that of providing stable and positive net financial flows to developing countries to help sustain development.

Government intervention in debt crises has not been limited to action by industrial nations. Indeed, one of the most paradoxical effects of the debt crisis is that some developing country governments have assumed - or been forced to assume under pressure from the international banks - the role of borrowers of last resort (or guarantors of last resort). Indeed, even debtor governments like that of Chile strongly committed, as it was, to the operation of market forces, granted (ex-post) guarantees, on international loans previously made by international private banks to private national companies. As Ffrench-Davies (1988) shows, the Chilean government granted an ex-post guarantee to the debt of the private financial sector; Chilean, private debt with public guarantee grew from a mere US $69 million in 1981 to US $2.612 million in 1986 (about 10% of the total external debt). Furthermore, there was a more indirect mechanism of "nationalisation" of the external debt in Chile, which also often applied in the other heavily indebted countries. Here, the public sector contracted loans from private creditors to service not only its own debt but also that of the private sector. As a result of these trends, the share of public and publicly guaranteed financial debt in the total Chilean external debt rose from 35.8% in 1981 to 75.9% in 1986.

An asymmetry thus arose in debtor and creditor government actions, as regards private capital flows. While industrial governments did not make explicit provision for an international lender of last resort facility to protect their banks from insolvency, governments of the borrowing nations either provided explicit or implicit guarantees to their private nationals to facilitate their borrowing internationally. The existence of an implicit borrower of last resort in debtor nations during the seventies must have encouraged over-lending to the private sector in developing countries in the "boom" years; lack of international lender of last resort facilities implied that in the eighties new international private lending was not effectively sustained. Thus, the asymmetrical actions of lender and debtor governments could be said to have accentuated, rather than moderated, the pro-cyclical nature of private flows. Furthermore, when acting as borrowers of last resort, LDC governments were to an important extent showing themselves as more concerned with the stability of international banks, than with their own economic growth.

A further feature of the intervention of industrial governments (I.G.) and the public IFIs is that it was based on the assumption that debt crises would be temporary. Based on the very influential analysis by Cline (1983), and that of others, the debt crisis was diagnosed by IGs and IFI's as a "liquidity" crises and not a "solvency" crises; this implied recognising that the markets had discontinuities related largely to international events, such as recession. But it also depended on ther notions that they were temporary and could be easily overcome by short-term action on the part of IG's and IFI's, together with drastic adjustment policy being applied in debtor developing economies themselves. The probability that new voluntary international private lending might not recover for a long period and that therefore negative net transfers could continue was not faced. If the latter assumption is correct, and if the development of debtor nations is as important a policy objective as preserving the stability of the private banks, the type of government intervention required is far more comprehensive and radical than that implied by the "liquidity" diagnosis.

A fiction has been created that markets still exist to provide private international lending to the highly indebted developing world; in fact net new lending has declined (and has even in certain years been negative). Furthermore it has been involuntary (obtained by pressure from industrial governments and central banks, as well as from some of the most heavily exposed commercial banks). Equally, it has often had direct or indirect guarantees from IFI's (implying again a "disguised" role for governments). In fact, a market for private lending to heavily indebted countries does not exist any more, and will not do so again unless major changes occur in the world economy.

Paradoxically the fictitious promise of new private lending (a market in the future) increases the incentive to continue servicing the debt <u>not</u> at its market value but at its far higher face value! Thus, the elaborate machinery of debt crises management (in which industrial governments and to a lesser extent, debtor governments have played such a large role) is de facto artificially preserving the value of the debt (and of debt servicing) at a level well above its market value.

Finally, the type of new lending which has been encouraged or channelled by governments is on the whole inappropriate to meet the needs of long-term development of the debtor nations. It is:

a. <u>insufficient</u>, as it results in large negative net resource transfers (see Table 1).

b. consists mainly of (i) <u>involuntary private lending</u>, still at variable (and currently fairly high) interest rates and (ii) <u>highly conditional public flows</u> from IFI's, with somewhat more appropriate financial terms (e.g. maturity and interest rates), but with very controversial and pervasive policy conditionality.

c. Practically no use has been made by governments of existing instruments to provide <u>low-conditional or unconditional counter-cyclical liquidity via the IMF</u>: since the debt crises arose, conditionality associates with the Compensatory Financing Facility has been tightened and there have been no new issues of SDR's (Special Drawing Rights).

To summarise, the governments' interventions in the debt crises have been asymmetrical by preserving far more carefully the stability of international banks' than the sustained growth of debtor economies; it is noteworthy that many debtor governments have had a similar bias, by granting ex-post guarantees to previously un-guaranteed borrowing by private debtors. The key issue since 1982 has not been whether governments should intervene or not to manage the debt crisis but to what extent, via which mechanisms and (particularly) in whose favour they should intervene.

III <u>Conclusions and policy implications for the future debt crises management</u>

Since 1982, public flows to developing countries and government intervention have been used to defend not only the stability of the international private capital markets but also the profitability of private international banks, by helping to maintain a fictitious face value of their assets in the Third World. This public intervention was successful in terms of achieving the main objectives of creditor countries and institutions.

The main challenge has now become to restore growth and development in the indebted LDC countries. To meet this new objective, a set of different actions is required. As before, this will require both government and market action focussed not on generating new private-lending, but upon debt and debt service reduction.

Market mechanisms (e.g. the secondary market in debt) will be increasingly influenced by governments defending the development prospects of LDC economies. At the risk of simplifying, one could argue that markets should become the servants of development objectives, rather than that development objectives be subordinated to the needs of the market.

At the time of writing some action along these lines has been taken, but it has been timid and patchy: Bolivia and Mexico have taken the most important initiatives for debt buy backs, with several countries pursuing exit bond options. The major Latin American Governments, meeting in Acapulco late in 1987, signalled their preference for solutions that would allow debtor governments to "capture the market discount" on the value of the debt. Important industrial governments (such as the Japanese and French ones) in 1988 produced schemes that would move in a similar direction. A major change occurred in March 1989, when the U.S. Treasury announced its support for measures - including actions to be taken by governments and IFI's - to reduce debt and debt service burdens.[9]

New Flows: suggested guidelines for the future

Private Flows An important lesson from recent debt crises is that if international private flows represent a very large proportion of developing countries' GDP or (particularly) exports, their long-term impact on borrowers and lenders may well become negative. This conclusion is particularly true in the case of variable interest medium-term sovereign bank lending, which is especially ill-suited to fund long-term development. It would however seem that there is now enough historical evidence to show that very large inflows of foreign private savings under any mechanism can be harmful to the long-term interests of both private lenders and developing country borrowers. This is especially so in the context of unpredictable and large changes in key international variables, including the ability and willingness of foreign banks and/or investors to continue to promote sustained flows for long periods.

It can be concluded that for the medium-term future (once the debt crisis is resolved) it will be better for developing countries to err on the side of excessive prudence, realising that low private external borrowing, particularly in relation to exports, is desirable from the point of view of long-term development. Not only will such a policy make developing countries less vulnerable to unanticipated changes in the international environment; it will also hopefully encourage a style of development, that is more reliant on domestic savings and less reliant on import-intensive patterns of production and consumption. Furthermore, distortions in macro-economic policies - such as the large over-valuations of exchange rates, that characterised many of the Latin American countries in the late seventies - would become less pervasive and less likely.

To ensure that future private lending to developing countries is not allowed to become excessive, there is need for far greater regulation and supervision of private flows by industrial governments than happened in the seventies.

In parallel, developing country governments need to exert more self-discipline and greater control on private agents to curb excessive borrowing. Furthermore, contrary to current fashionable views, historical evidence reviewed here and elsewhere indicates the benefits of <u>some</u> controls by LDC governments on <u>capital outflows</u>, so as to avoid international borrowing being used as a source of capital flight.

A final issue regarding future private flows is that of selecting appropriate mechanisms and agents for development finance. Clearly some lending by banks will be required, particularly for specific production or commercial purposes, especially relating to trade and project finance. The relative share (within private flows) of direct, portfolio and quasi-equity investment needs to be increased;

such flows have the virtue of allowing greater correspondence between countries' and companies' repayment obligations and their capacity to pay; thus the risk variability of the income stream is shared by the foreign investor or lender and the LDC borrower.

Public Flows Given the discontinuities and market failures in the system of private international financial intermediation (some of which are short-term and others more pervasive) there is a need for an explicit recognition of the desirability of public financial flows, in particular in three areas where the market mechanism cannot operate appropriately. These are, firstly, the funding of low-income countries' development, on concessionary terms; secondly, counter-cyclical funding; and thirdly, the public role in creating international liquidity.

There is little debate about the merits of the first point, and we shall not elaborate upon them here. However as regards public counter-cyclical funding and the public role for the creation of international liquidity, there is at present far more debate.

The rationale for counter-cyclical flows seems clear. Because of the inevitability of business cycles, and their unexpected and disruptive impact on growth and on financial institutions, public counter-cyclical liquidity and credit mechanisms are desirable both to counteract the effect of the trade cycle and the pro-cyclical nature of private flows.

Based on this concept the IMF created in the early 1960's, the Compensatory Financing Facility, to compensate for the instability in countries' export earnings caused by external factors; this facility has been broadened to include (in 1988) international interest rates. However, the maximum size of the CFF credit drawing is not just determined by the externally conditioned export shortfall or interest rate excess, but by a certain proportion of the country's quota. As a result, the size of countries' access to CFF lending is limited, and its positive counter-cyclical effect - on the country and the world economy - is restricted. A second problem, which has emerged in the eighties, is that CFF lending is increasingly linked to highly conditional (upper credit tranche) lending by the IMF in contrast with its previously low-conditional character.

To improve the role of the CFF in providing counter-cyclical funding, its size needs to be increased (or even better de-linked completely from countries' quotas) and its conditionality should either be lowered to previous (pre-1983) levels, or even perhaps eliminated completely.

In order to provide enhanced liquidity for the international economy, we believe that SDR's should again be used. Such a proposal, now controversial, would not have been so in the late nineteen-sixties or early seventies. The decision to create Special Drawing Rights was originally seen as a major step in the history of the international monetary system. It gave the International Monetary Fund the power to increase the stock of international reserves through a simple book keeping device.

The role for the S.D.R. has changed since its' original creation. On the one hand, developing countries have - particularly in the last decade - had a growing need for but a declining availability of international liquidity. The debt crisis has made developing countries' governments more conscious of the need to hold higher average reserve levels to insulate themselves against severe adverse shocks. High levels of debt and the dramatic decline of private lending by international banks to developing countries in the nineteen-eighties has implied that private lenders have for many developing countries made negative contributions to their balance of payments. To defend their reserve levels, developing countries have therefore been forced to improve their trade position dramatically, either by expanding exports or - more frequently - by reducing imports. Such measures have been extremely costly in terms of growth and development. Therefore, in the eighties, the unsatisfied demand for international liquidity by a large proportion of developing countries dramatically increased, as did the cost to those countries' economies and peoples of the fact that this demand was not met by international creation of liquidity via the I.M.F.

A major asymmetry has emerged in the international financial system. Practically, for all industrial countries, the supply of international reserves has become extremely elastic; the total stock of their reserves is basically demand determined. Industrial governments - by having access to very large and integrated private international capital markets - can borrow as much as they wish from private financial institutions. As a result, industrial countries' needs for officially created reserves seem at least temporarily to have entirely disappeared. The relevant distinction is no longer between reserve currency countries and the rest of the world (as it was during the gold standard years or the Bretton Woods era) but between creditworthy countries and those that are not.

Opposition to any issue of SDR's since 1981 has arisen from some large industrial governments. This opposition seems to be based increasingly on the argument given above (for example in the quoted Report of Deputies of the Group of Ten) that "the difficulties encountered by a number of countries are primarily an indication of their lack of creditworthiness and are not related to a general shortage of liquidity". The implication is that SDR allocations are not the solution for those who are "uncreditworthy"; those who are not in the state of grace of creditworthiness must make extreme efforts - via adjustment of their economies - to attain it.

This argument is weak, as we have seen from the historical evidence above. The Managing Director of the I.M.F. gave a lucid summary of its' inaccuracy: "The argument that the international financial institutions and the markets are able to provide adequate exchange reserves to heavily indebted countries .. is far from being confirmed by our day-to-day experience. Since 1981-82, impressive adjustment, equivalent to 8 percentage points of G.D.P., has been achieved on average by the heavily indebted middle-income countries, but still leaves a situation of perhaps greater vulnerability for these countries in their adjustment efforts, because of the general withdrawal of commercial banks from voluntary lending (to developing countries). This is a structural change in the international financial system which makes it more difficult for many countries to finance reserve additions" (Camdessus 1988). Recent events have shown that even if countries are willing to make major sacrifices to make adjustment and substantially improve their trade balance, the private capital markets may not respond with an increase in their supply of lending to them, for a number of reasons largely or completely beyond the control of the developing countries themselves. There is here a clear case of market discontinuity and a need for action by the I.M.F, which contributes to the "public good" of sustaining the provision of liquidity to LDC's.

The lending activities of the World Bank also need to be strongly informed by the need for public institutions to fill gaps, and compensate for the discontinuities and limitations of private international financial markets.

Footnotes

1. For an interesting contribution in this field, see R. Devlin (1986).

2. It is interesting to point out that in another major international financial market-trading foreign exchange of developed countries and determining exchange rates amongst them - a similar disillusion with purely free market operation has occurred in the mid eighties; a gradual, but clear, move has resulted towards more managed (by governments) exchange rates, via greater agreement between governments on desirable exchange rate reference zones and by greater intervention by these governments to influence movements of exchange rates in desired directions.

3 As we shall see in section III, the experience of the 1980's adds other conditions that need to be met, such as that the financial terms should be either fixed (as regards interest rates) or related to indicators of capacity to repay (such as the country's main exports' prices).

4. Data based on IMF, World Economic Outlook, several issues.

5. See, Griffith-Jones and Lipton (1984) for a fairly brief discussion of this point. A very detailed analysis of the extent to which bank supervision lagged behind the internationalisation of bank lending can be found in Dale (1982)

6. Based on personal experience and interviews with bankers; see, also Devlin R. (1986), op.cit.

7. For a useful review of the evidence, see Hughes and Singh (1987).

8. I thank Michael Lipton for very valuable comments on this issue.

9. The Brady Plan is based on the assumption that industrial governments and international financial institutions should support debt/debt service reduction. This is an important step forward, in the context of our analysis here. However, doubts remain whether debt/debt service reduction will be sufficient to contribute to the restoration of development in different highly indebted countries.

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