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International Lenders of Last Resort: Are Changes Required?

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Just over a hundred years ago 'lender of last resort' was the subject of active and heated debate in the context of national banking markets. That argument has long since been settled: the willingness and ability to act as lender of last resort are now regarded as one of the essential functions of the central bank in respect of its domestic market responsibilities.

In the present paper, Dr. Griffith-Jones and Professor Lipton argue that the time has now come for a similar debate to be engaged in with respect to the international banking market. They believe that the authorities' concern with 'moral hazard' as it relates to international lender of last resort (ILLR) facilities — namely the risk that banks will be tempted into imprudent lending if the terms and conditions for ILLR support are known in advance — has 'gone too far for the health and stability of the banking system.' Were a full-blown banking crisis to develop, uncertainty about ILLR 'must involve delay, speculation and dangers of further destabilisation.' The present background of widespread financial distress among developing country borrowers from the international banking system accordingly makes ILLR a timely and pressing issue. The authors argue, however, that the need is not one that arises only at times of potential crisis; indeed the existence of agreed ILLR arrangements in more normal times would actively contribute to the avoidance of crises by encouraging a more balanced pattern of international lending. Far from being an inducement to moral hazard, Dr. Griffith-Jones and Professor Lipton believe that lender of last resort arrangements and effective banking supervision are two sides of the same coin, both contributing to the provision of a stable, steadily growing flow of credit to sound borrowers. They would like to see a commitment to known ILLR arrangements formally accepted.

This paper was first prepared as a background paper for the Commonwealth Secretariat Study on the International Financial and Trading System, which was commissioned by Commonwealth Finance Ministers. The Study, 'Towards a New Bretton Woods', was published in 1983.

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Midland Bank International's purpose in publishing this series of Occasional Papers is to assist and stimulate public debate on issues of lasting importance to the international business community, government and the public. The intention is to provide contributors with a forum that will allow them to develop their analysis and argument at sufficient length to ensure a proper understanding of the issues involved.

The Bank does not necessarily subscribe to the views expressed in these Papers, but it does believe they represent an important contribution to their subject and that they deserve a wide audience.

Hervé de Carmoy
Chief Executive (International)
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International Lenders of Last Resort: Are Changes Required?

1 Introduction

> 'Theory suggests, and experience proves, that in a panic the holders of the ultimate Bank reserve (whether one bank or many) should lend to all that bring good securities, quickly, freely and readily. By that policy they allay a panic; by every other policy they intensify it.'
>
> (Bagehot, 1873)

As the national lender of last resort (LLR) needed clear exposition just over one hundred years ago, so international lender of last resort (ILLR) needs it now. Bank activities are much more complex, internationalised and interlocked. Not merely the welfare of depositors, but the capacity of sound firms at home and abroad to borrow — as well as the capacity of many developing countries to grow — depend on the maintenance of a liquid base for the banking system. We concur with Kindleberger (1978)*, IMF (1983) and others, that formalised, known international lender-of-last-resort arrangements are increasingly necessary not mainly to 'allay a panic', but to prevent one.

However, to construct a proper ILLR requires an improved understanding of LLR functions in two respects. First, while most observers appreciate that LLR's purpose is not 'to bail out banks' — indeed, a major problem is to prevent banks from relying on this perception — neither does LLR exist mainly to protect depositors; its main purpose is to ensure a stable, and if possible steadily growing, flow of credit to sound borrowers. Second, in this task, reliable LLR and really adequate supervision are two sides of one coin, the latter acceptable to banks only with the former; as supervision should smooth upswings, so LLR should buffer downswings of bank credit.

This paper tries to suggest ways in which ILLR arrangements can be achieved, without unacceptable increases in moral hazard,[1] by changes in supervisory arrangements and other matters. First, however, we would stress the importance of confidence in ILLR for maintaining, despite recent shocks, the flow of capital to developing countries. This applies even to low-income countries, although they seldom borrow much from commercial banks. The present operations of the system, without clear ILLR facilities, may hurt the poorest countries in two ways. First, pressures to avoid default divert official flows from low-income to middle-income countries — and, recently, towards shorter-term and less concessional official lending. Second, as we shall explain, the inadequacies of ILLR, even without crisis and especially during early recovery, exercise steady deflationary pressure on growth, trade, and hence development prospects.

The lack of an appropriate ILLR — which can take account of the enormous complexity, scale and internationalisation of commercial banking — makes two undesirable developments more likely. Firstly, there remains a possibility that widespread financial distress now characterising the world economy may turn into a major financial crisis. Secondly, and more plausibly, the combination of actual

** Detailed references will be found in the bibliography on page 19.*

reschedulings (reducing the banks' liquid base) and fear of defaults may continue to constrain private bank lending to developing countries. Ad hoc anticipatory contractions — by them or banks — are mutually deflationary, and further weaken the prospects of a sustained world economic recovery.

More generally, insufficient ILLR facilities give commercial banks scant reason to accept really effective supervision. This contributes to patterns of capital flows, especially of bank lending to developing countries, in which 'euphoric' over-expansion (Kindleberger, 1978) alternates with over-contraction. Such swings tend to accompany, not to stabilise, business cycles, both at country level (Griffith-Jones, 1980) and world-wide. Adequate supervision would control, diversify and, when necessary, limit 'euphoric' expansion. Moreover, such supervision relates each bank's behaviour to the total exposure, not just of that bank, but of the borrowing and lending country. It considerably transcends traditional supervision,[2] and would be acceptable to commercial banks only if backed by reliable, even if potentially costly, ILLR facilities. With supervision moderating upswings and ILLR buffering downswings, private credit flows would be more regular. The package would produce much more desirable credit patterns — not just for developing countries but for the world economy, and ultimately for the banks as well, even though some apparently profitable business would from time to time be frustrated.

This paper focuses on issues closely linked to the need, or otherwise, for ILLR. However, this problem cannot be treated in isolation from other major issues. In particular, any ILLR facility is complementary to — and by no means a substitute for — measures to make its use less likely or less necessary. This covers, in general, measures to promote sustained world economic recovery, and, in particular, the expansion of official and private flows, which may be more appropriate to finance lending in some developing countries than is current short- or medium-term bank lending with floating interest rates (ICIDI, 1983). We share doubts about the genuine appropriateness of medium-term variable-interest bank loans for the finance of some developing countries. However, such flows remain essential, particularly while alternative mechanisms — either private or official — remain only as proposals.

In Section II, we define the role of an LLR, pointing to the key issue of how 'onerous terms' for its use must deter imprudence by potential users. We then ask why a special ILLR is needed at all (Section III). Next — in the context of the central bankers' decision to make ILLR deliberately uncertain and vague, so as to create a form of 'onerous terms' — we outline existing ILLR facilities, and associated supervision procedures (Section IV). We then assess (Section V) whether they are — and are perceived to be — sufficient to contain a 'crisis' that might be caused by various sorts of non-repayment of foreign debt. In that context, we also enquire how these uncertain ILLR facilities affect the level and stability of commercial bank lending and of world flows of credit. Do these facilities encourage banks and customers to distribute credit among users in ways that favour steady and sound economic expansion, especially by developing countries? Finally, in Section VI, we review our conclusions and make our proposal — to replace damaging uncertainty about ILLR by a revival, in a form that suits today's needs, of Bagehot's original conditions for 'onerous terms'.

II Role of national LLR, and international aspects

An LLR is a central bank, group of banks, or treasury that has the power, and accepts the responsibility, to lend without limit — or to the limit of plausible requirements — but on onerous terms, to institutions in trouble or crisis. 'Institutions' were taken by Bagehot to mean 'all comers' but nowadays are confined to banks, or, at most, institutions taking financial deposits against interest for onlending.

'Trouble' has normally been taken to mean a significant risk of not being able to repay depositors and creditors on request, either because the bank is unusually illiquid, or because depositors seem likely to ask for their money in unusually large numbers (a run); if depositors are confident of LLR facilities they will, it is assumed, be prepared to restrain withdrawals. In fact, 'trouble' could be more broadly defined as incapacity by a bank, even well short of any risk of collapse, to carry on with normal lending operations. For instance, when British commercial banks recalled money from discount houses and forced them into the Bank of England at the 'penal' Bank Rate, this was often conventionally taken as a first-stage LLR operation, though nobody suggested that either commercial banks or discount houses were in danger of not meeting obligations; recourse to the central bank is had in order not to forfeit normal, profitable business. Similarly, recent 'liability management' by US banks implies that 'even borrowing from the Fed should be considered a source of funds' (Cargill, 1979).

It is crucial, in understanding the case for LLR (ILLR) as a 'social good' like health or roads to be provided by the State, to realise that this case depends not only, nor mainly, on the wish to rescue depositors. The main basis is the need to maintain the capacity of the banking system to lend: to prevent 'trouble' facing one bank, especially if it threatens to degenerate into a 'crisis' of confidence in many banks, from stifling the flow of credit to countries and enterprises. Of course, panic transfers of cash among banks by depositors, or rushes by them into cash (or foreign currency, or physical or financial assets bought with foreign currency), would make it even harder for firms to borrow, as banks became more cautious and less liquid. But the principal reason for an LLR to commercial banks is not to safeguard depositors (which can be achieved by other mechanisms — see below); it is to preserve and stabilise productive activity, by underpinning the capacity of the banking system to lend to enterprises and countries.

Before we define 'onerous terms', we should build on these points to clarify what an LLR is not. LLR is sometimes vaguely or inexactly used to describe three entirely different sorts of operation. The first is deposit insurance. This covers, for example, US deposits below $100,000 — about two-thirds of the total, but excluding almost all major foreign deposits. Since 1934, deposit insurance through FDIC has been dramatically successful in reducing US bank failures (Cargill, 1979) and since 1967 Canada, France, Germany, Japan, Netherlands, Switzerland and the UK have set up similar schemes. Coverage is usually incomplete or small (e.g. 75% of deposits up to £10,000 in Britain) and foreign-currency or company deposits are sometimes excluded (IMF, 1983). These schemes provide valuable safeguards for small depositors, but their extension would probably create larger and less predictable burdens for central banks (and ultimately taxpayers). More fundamentally, deposit insurance does not fulfil the prime function of LLR as a social good — maintenance of the commercial banks' capacity to lend in support of economic activity. Repayment of depositors by an offical deposit insurance agency normally implies the winding up of the institution in question; and while its assets may be transferred to a viable competitor its new lending activity will be lost, with no clear guarantee that other institutions will replace it, especially in a climate of impaired confidence.

Support for depositors is different from LLR. So is support for borrowers. We share the widespread fear that the recently agreed enlargement of IMF resources is insufficient. We share, too, the fear that IMF conditionality can be inappropriate; although aimed at financial realism for each borrower, it involves — when simultaneously applied to many countries — contractions of demand, including mutual export demand, that will make it harder for the borrowing community as a whole to meet its new and old obligations. Countries with repayment problems, if there are many countries and large problems, certainly need new funds conditional on their adjustment in a manner that does not induce general and mutual deflation. However — while additional provision of such funds (and new modalities for conditionality) may reduce the risk of calls upon ILLR — provision of such funds to borrowers is distinct from LLR facilities for banks.

Both depositors and borrowers, if their activities have not been speculative, may be provided with emergency facilities through some sort of safety net. Such help for customers, while it may ease the strain on an LLR, is not truly a substitute for LLR to the banking or near-banking intermediaries. Nor, third, are general open-market operations a true form of LLR in near-crisis. Generalised new liquidity will not — unless enormous — go to distressed banks, or their clients.

To advocate provision of LLR proper, as Bagehot did — and to deny the adequacy of substitutes — is not to express general lack of trust in the operation of financial markets. A series of bank troubles, leading to a crisis that feeds on itself for want of an LLR, is not a market, but a gap, a discontinuity, between two sets of situations, in each of which market forces can operate, but between which they can no more mediate than people can see round sharp corners. LLR is not a substitute for financial markets, but a necessary condition for their contribution to stable growth.

However, if an LLR is not to be transformed into a mechanism to 'bail out the banks', and if LLR facilities are not to encourage reckless lending in the belief that there is no lender's risk, then a precise content must be given to the concept of 'onerous terms'. Three different methods for applying the concept of 'onerous terms' today seem possible:

(a) Bagehot did this with a twin condition: lending had to be on 'good collateral', and there should be 'a very high rate of interest' (Fetter, 1965).

(b) Another approach is to define clearly conditions where LLR will not be available, e.g. if there is good reason to suspect fraud, or if there has been gross breach of banking practice and/or explicit supervisory conditions.

(c) A final approach is to maintain uncertainty about the nature, duration, entitlement or cost of LLR facilities.

We shall argue that current reliance on (c) in ILLR has gone too far for the health and stability of the banking system — but that (a) and (b) can be revived only with supervision, redefined, as the counterpart to a more assured ILLR.

III The internationalisation of banking and of its risks

Why cannot the requirements of ILLR facilities simply be met by national authorities? Six trends in international banking since the early 1970s have increased the need for an ILLR, and for new forms of international central-bank co-ordination and supervision. These are well known and have been analysed in depth elsewhere; we sketch them very briefly here.

1. *The growing dependence of developing countries on commercial lending:* private bank lending to oil-importing developing countries grew at 19.7% annually at constant prices between 1970 and 1980 (World Bank, 1982). Recently a very high proportion of such countries' current-account deficits has been financed by borrowing — and more recently by short term borrowing — from international banks. Of all such deficits, in 1977-81, 53% was financed on average by increases in international bank claims. (For the large borrowers, the ratios were much higher). Thus, by end-1981, the total obligations of non-oil developing countries to banks reached on average 3.56 times the level of their official international reserves and as much as 45% of this debt was due in less than one year (IMF, 1983).

2. *The rapid increase in the financing needs of the developing countries:* the current-account deficits of the non-oil less developed countries (non-oil LDCs) increased from $11.6 bn. in 1973 to $100 bn. in 1981 and $87 bn. in 1982 (IMF, 1983).

3. *The rising trend of debt service ratios:* By mid-1982, the debt service 'ratio' (DSR) to annual exports of goods and services was 38% for oil-exporting LDCs, and 24% for oil-importing LDCs as a whole (IMF, 1982). In 1965-74, when risks were smaller, difficulties arose in 38 of the 102 cases where an LDC had a DSR above 20% in a particular year, but only in 2 of the 478 cases with a DSR below 20% (Feder, 1979; Lipton, 1981). Nor, on past evidence, need 'recovery' — especially if patchy — reduce the risk; for some debtors, it could even worsen terms of trade and/or raise interest-rates. Hence there is no validity whatever in popular, and populist, claims that the internationalised threat to financial stability is somehow unreal, or no greater than before (Lal, 1983), or that urgent demands for ILLR or other action constitute some sort of 'banker's ramp'.

4. *The concentration of bank lending:* the debts — and risks — are the more alarming for being very concentrated on a few big debtors and banks. At end-June 1982, of $347.5 bn. owed by the hundred-plus developing countries to BIS reporting banks (excluding offshore centres), some 49.6% was owed by Argentina, Brazil, Mexico and Venezuela (Morgan Guaranty, 1983) all of whom in early 1983 had reported DSRs well over 100%. Exposure to the first three alone by the 10 leading US banks was $38 bn. — over 40% of the countries' bank debt, and over 140% of the banks' total equity! (Economist, April 1983).

5. *The concentration of bank deposits:* 'Recycling' of OPEC funds meant that, by December 1981, 16% of total deposits of private banks in the BIS reporting area originated from the oil-exporting countries; and about 38% of these banks' net external resources (deposits minus credits) came from oil-exporting countries, mainly Saudi Arabia, Kuwait and the UAE (BIS, 1981, 1983).

6. *The changing supervisory needs of the market:* the internationalisation of banking — through (a) syndicated lending, with the participation of banks from different countries to finance developing country and Comecon borrowing; (b) the rapid growth of a much larger, international interbank market; (c) a growing search by banks for legal means to avoid exposure limits and to reduce tax liability — has resulted in a great variety of foreign branches, subsidiaries, affiliates, so-called holding companies, etc., largely in offshore centres with parent banks based in other countries. As a result, a large proportion of operations and flows do not clearly fall within the purview of any national supervisory or LLR authorities.

IV Existing provisions for ILLR facilities

There is now, as we have stressed, uncertainty about LLR for foreign activities. Central bank representatives repeatedly argue that even indications of the possible provisions of their support as ILLRs, or any apparent generalisation from past cases where their services were provided, may reduce bank prudence. Governor Wallich (1978), of the US Federal Reserve Board, has stated:

> 'There are dangers in trying to define and publicise specific rules for emergency assistance to troubled banks, notably the possibility of causing undue reliance on such facilities and possible relaxation of caution...The Federal Reserve has always avoided comprehensive statements of conditions for its assistance to member banks. Emergency assistance is indirectly a process of negotiation and judgement, with a range of possible actions varying with certain circumstances and need. Therefore, a pre-determined set of conditions for emergency lending would be inappropriate.'

Bank of England Executive Director (now Deputy Governor) McMahon expressed a very similar view (1978):

> '...close consideration and cooperation among the central banks most concerned with the security of the international banking markets is essential. By the same token, however, it is not possible for them to define in advance with any precision the circumstances in which last resort finance might be forthcoming. Indeed, if they tried to do so, banks might be tempted to sail too close to the wind with the presumption that support would automatically be forthcoming if they got into difficulties. The primary purpose of agreement among central banks on the provision of last resort finance is to safeguard the international banking systems on which that is founded. The provision of such a safeguard does not — indeed cannot — entail automatic support to any bank facing difficulties regardless of the particular circumstances'.

Central bankers, therefore, deliberately do not make explicit existing ILLR arrangements. Thus the major official statement, the September 1974 Communiqué, issued by the Central Bank Governors of the Group of 10 and Switzerland, a few months after the collapse of Bankhaus Herstatt, is kept brief and unspecific (IMF, 1983):

> '...The Governors also had an exchange of views on the problem of the lender of last resort in the Euromarkets. They recognised that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means are available for that purpose and will be used if and when necessary'.[3]

Note that this leaves open the possibility that 'temporary liquidity' may be supplied to borrowers, to lenders, or through open-market operations. It is not explicitly assured to the troubled bank.

In April 1980, the same Group — in a further communiqué, mainly about supervision — referred even less explicitly to ILLR issues:

> 'In view of the present volume of international bank lending and of its prospective future role the Governors are agreed on the importance of maintaining the soundness and stability of the international banking system and of seeking to avoid any undesirable effects either worldwide or on the conduct of policy in particular countries'.

This 1980 Communiqué announced the creation of the Standing Committee on the Euromarkets. This has been interpreted (IMF, 1983) as a responsibility for 'coordination of responsibilities of lenders of last resort'. It has also been suggested that the BIS 'bridging loans' in 1982 and 1983 represented a sort of ILLR facility; and that, behind the 1974 Communiqué, there lay 'an agreed plan with respect both to the allocation of responsibilities of lender of last resort and the circumstances under which such support would be provided to banks experiencing difficulties' (IMF, 1983). However, supervisory authorities (in conversations with us) questioned all this; they suggested BIS functioned, in respect of ILLR, not independently but as a monthly meeting-place for central bank Governors of the Group of Ten and Switzerland. Moreover, as the IMF document (1983) itself points out, 'subsequent developments with respect to individual banks, as in the case of Banco Ambrosiano, have cast doubts on whether such firm commitments exist'.

Some indirect evidence on the distribution of ILLR responsibilities can be extracted from the actions of central banks following the few recent failures of individual banks with significant international operations: Bankhaus Herstatt, the Franklin National Bank, the Israel-British Bank and Banco Ambrosiano.[4] Except for Franklin, all four cases revealed important ambiguities as to final responsibilities in case of bank failures.

The ambiguities were much greater in the case of Ambrosiano, leading (so far) to the loss of money by creditors of Banco Ambrosiano Holdings of Luxembourg, though the parent bank's creditors were granted full protection. The Luxembourg authorities, and naturally the creditors of Banco Ambrosiano Holdings, objected. The issue was made more difficult by technical questions;[5] and it has also been put to us that the problem arose from open fraud, not from international over-exposure as such. However, we are unconvinced that existing ILLR-overview facilities would prevent even a perfectly 'innocent' bank from failing, if its overseas operations were overstretched.

The Ambrosiano failure clearly points to gaps in the coverage of both supervisory and ILLR facilities. Luxembourg lacked an indigenous central bank, or any other LLR capacity for Euro-banks; while according to many observers Italy did not supervise adequately Ambrosiano's consolidated accounts. These elements could surely be repeated in other cases — Italy and Luxembourg are relatively sophisticated financial centres, after all.

More generally, the problems of non-banking (and other) subsidiaries, etc., without clear supervision from their parent country, particularly in centres with no LLR obligations, do reveal a more serious gap, both in supervisory and ILLR facilities. It is not clear whether this case has led to adaptations of these facilities.[6]

Our fears that major deficiencies and gaps exist in supervision and ILLR facilities are supported by the Group of Thirty report on bank supervision by Dale (1982):

> 'It is a matter for concern that lender of last resort facilities differ considerably from country to country. A few financial centres have no LLR capacity. Some national authorities can provide only temporary liquidity assistance on a secured basis, while others are able and willing to sustain even insolvent institutions in order to protect depositors. These disparities apart, there is a danger that some authorities may be prevented from extending collaterallized assistance to banks' foreign branches where national laws confer on branch depositors preferential claims to branch assets'.

International bank failures since 1973 have been at fairly long intervals, and each has been relatively small. It has been reasonable, therefore, to see the main ILLR task as being to safeguard the interests of depositors and other creditors. If a major international bank — or a closely-spaced sequence of minor banks — were to be 'in trouble' or to fail, the main issue would not be to safeguard those interests, but to sustain that bank's (and others') lending capacity. It is in this context that true ILLR — not just deposit insurance, which in essence is what was applied to these four cases — acquires fundamental importance. (Even deposit insurance may require international coordination, if it is not to cut across and destabilise ILLR operations.[7]) Reliance on ad hoc solutions, however brilliantly managed, may be acceptable for a Herstatt case, or even an Ambrosiano case, but the prospect of open default by LDC or Comecon creditors requires formal ILLR safeguards.

The inadequacy of existing safeguards is well summarised by Dale (1982). The main disparities and gaps in LLR operations at a national level, which create problems at an international level, are in his view:

i) When monetary authorities provide financial assistance to commercial banks experiencing temporary liquidity difficulties, there are varying national distinctions made between formalised routine use of the official discount window, and longer-term support operations undertaken on a discretionary basis.

ii) Although emergency assistance is typically extended directly by the central bank, there are different alternative methods of support in different countries (e.g. special joint facility of the authorities and the banks; lending below market rates to institutions prepared to acquire or assist the problem bank; general support, with or without official encouragement, by one or more large domestic banks).

iii) Crucially, several financial centres — notably Luxembourg, Hong Kong and Singapore — have no indigenous central banks. (Luxembourg has no LLR at all.) This (and other problems) would appear even more widespread and serious among financial centres not included in the Group of Thirty study (e.g. Cayman Islands, Bahamas).

iv) Frequently emergency support can be offered only on a secured basis to solvent institutions. Some countries have broader powers of intervention where insolvency is threatened; elsewhere, the deposit insurance agency has LLR powers which — for potentially insolvent institutions — may exceed those of a central bank.

v) Some central banks are permitted to act as LLR in domestic currency only, although these funds may in principle be converted. Elsewhere, the capacity to provide foreign currency assistance has specific limits.

vi) To varying degrees, countries conceal the precise scope of LLR, as a matter of policy. In general, they expect foreign parent banks to provide all necessary assistance to their local subsidiaries, although the threat of shareholders' actions could limit their commitment.

vii) Finally, where banks do fail, national liquidation proceedings sometimes favour local depositors. (US and many other deposit insurance schemes, too, leave big and/or foreign depositors virtually unprotected.) For this, several countries treat branches of foreign banks as separate entities requiring their own liquidators; such creditors may also enjoy a preferential claim to branch assets.

V ILLR and international expansion: acute and chronic problems

Are ILLR facilities — and the accompanying supervision — adequate to limit damage in times of crisis or widespread distress? Perhaps even more important, in less 'abnormal times', do existing arrangements encourage the right scale of lending; do they avoid 'euphoric' lending, followed by panicky curtailment of lending; and do they promote, without over-centralist 'hands-on' intervention (McMahon, 1983), an appropriate structure (by types of loan) and distribution (amongst developing countries) of bank lending?

A first conclusion of this study — shared by many other analysts — is that current arrangements, based on general uncertainty and attempted ex post coordination of ILLR in cases of distress, are dangerously insufficient.

There are a number of reasons — some familiar from the historical literature, others arising from the current situation — which make a reliable, predictable ILLR essential amid the complexities of international banking today.

As Kindleberger (1978, 1982) has pointed out, responsibility for international banking stability (like health and welfare) is a public good, even if public provision of it may somewhat diminish private self-reliance. The good is too risky, and fraught with externalities to be provided by one, or even several, private agents acting alone. This approach does not necessarily rest on the perception of some analysts that the U.S. and other banking systems are inherently fragile, but on the possibility that the international capital market is mostly resilient but can very occasionally break down, with huge, unpredictable, lasting and maldistributed costs.

National LLRs cannot cope with the problems of an international bank. As central banks or other national authorities represent their own national interests, they will be unlikely to take a cosmopolitan view of their responsibility in a crisis — unless, implausibly, potential loss from absence of ILLR, and potential cost of ILLR rescue, are in the same ratio for all creditor countries involved. It may be feared that as a consequence no single lender of last resort may be willing to save a given bank (whose activities transcend its frontiers) from a liquidity crisis, because the domestic effects of inaction do not seem to be larger than the cost of support, even though the world consequences may be.

Inevitable conflicts of interest will arise where parent banks, subsidiaries, holding companies, depositors and borrowers have varying nationalities. Each central bank will try to minimise its proportion of the costs of any ILLR operation. Delays and disputes about responsibility can themselves reduce confidence and deepen crisis. We repeat: the world can put up with such costs in the event of a Herstatt or an Ambrosiano; but in the event that overt default, in one or several developing countries, threatens the liquid base of major banks? We should perhaps thank the Ambrosianos for alerting us, in time, to the crucial need for a formal, transparent, swift ILLR. But are we in fact alerted?

The review of existing national LLR facilities, and more importantly the recent experience of international bank troubles — with interlocking, multiple losers and unclear responsibilities — raised concerns that the financial crises of the 1870s and 1930s may be repeated, and showed that these concerns are not merely theoretical and historical. Furthermore, even if a national LLR had — and if it was willing to commit — unlimited resources in domestic currency, the fact that international deposits and loans may be denominated in foreign currencies could cause it serious problems and lead to its unwillingness to provide foreign currency to support commercial banks' international operations.

Amongst industrial countries' central banks, this problem has so far been overcome by mutual balance-of-payments support operations. Such operations, however, could be much more clearly and swiftly handled in the framework of an ILLR. The role of the US Federal Reserve would necessarily be crucial, as such a large proportion of international banking operations are still in dollars. Therefore, the position of the US Government and of the US Federal Reserve Board in these matters will inevitably have a great influence on arrangements agreed.

Guttentag and Herring (1981) also stress special characteristics of international banking that make a transparent ILLR essential. Interbank credit lines may cause one bank's failure to damage the solvency of other banks. Furthermore, several of the largest international banks hold similar assets in their portfolios. Here, one bank's weakness may raise suspicions about other banks. On either ground, failure of one bank may result in deposit outflows from other banks. Thus uncertainties about ILLR may make uninsured depositors more prone to abrupt reassessments of the creditworthiness of banks. This creates, under current conditions, unacceptable risks to the stability of the international banks.

Such authors as Guttentag and Herring recognise the problem of moral hazard, but attempt to overcome it by mechanisms which they perceive as far more efficient (i.e. effective bank supervision). Moreover, if uncertainty is used to control moral hazard, private banks may not know what behaviour would disqualify them from support; they will therefore not know what activities they should avoid (Shafer, 1982). Most important, 'uncertainty' in time of crisis must involve delay, speculation and dangers of further destabilisation — especially if uncertainty is combined with unclear division of responsibility among central banks.

So much for the problems of ILLR in time of fear of crisis. Even in more normal times, the lack of clear ILLR protection, and of appropriate supervision, not just of the prudence of individual bank lending but of the adequacy and stability of the structure of total bank credits especially to LDCs, has serious disadvantages. Great swings of expansion and contraction, e.g. in lending by banks to Mexico or Brazil, indicate several things. First, each bank, initially lending in hope of a sound return, continues to do so to defend its previous lending, or to avoid admitting past errors. Then, when a country's balance of payments deteriorates, the withdrawal of some banks imperils the position of others, and they too withdraw. Finally, in the downswing, erosion of the cash base — and measures, by banks and borrowers, to anticipate it — reduce the volume of sound lending and delay recovery (McNamara, 1982; Lipton, 1981).

VI Towards a solution

Neither more lending nor less lending — only more appropriate lending, with better structure, distribution, steadiness and insurance (e.g. via ILLR) — can remedy this recurrent, deepening, and more and more destabilising sequence. Recovery alone cannot. If it turns out to be sustained and ideal for debtors — pushing up oil prices for Mexico, and commodity prices and general export demand (but not interest rates) for other LDC and Comecon lenders — 'men of affairs' may, as in Britain in 1858-65, conclude all is well; credit will again be blown hard into the balloon marked 'sovereign risk'. But more lending on the same pattern as before will only mean bigger problems later. As for less lending as such, that either destroys recovery or precipitates default; national and international authorities realise this, as the recent frenzied, brilliant, and largely successful attempts to ensure that large numbers of banks continue to lend to the large debtors (e.g. Brazil, Mexico) show.

What does 'more appropriate lending' mean, and how could a more clearly defined ILLR help? More appropriate lending involves three things: better information; sustained, counter-cyclical flows; and diversification.

Commercial banks considering loans to country X, which is likely to have a given production structure implying a particular set of foreign-exchange flows to and from X, would ideally know (a) what, in total, other banks and official institutions propose to lend to X, and have already lent to X — and what are the maturity structures; (b) what are the prospects for X's future trade flows, both as regards their volumes and their prices. That sounds a frightening requirement, almost a world economic model, and if taken too far would choke off all credit; but what is needed is something much more modest. Unless a loan is secured very firmly, a commercial bank needs to know — from its own sources, and from the central bank and perhaps indirectly from BIS/IMF — something about the applicant's total credit position, actual and potential, as affected by the commodities and manufactures he proposes to trade in. Surer access to ILLR could well be a 'carrot', persuading commercial banks to supply, and to seek, more such information.

Secondly, stricter supervision and surer ILLR, respectively, should stabilise the growth of lending in the 'euphoric' stage and minimise its contraction during more critical times. Sustained, possibly counter-cyclical flows would seem to be one of the most crucial likely achievements of those mechanisms — if they can be properly specified. However, an ILLR with 'uncertainty' cannot be relied on to stabilise credit flows.

The third aspect of better lending, diversification, is also intimately linked to the availability of ILLR. We have pointed to the extreme concentration of bank credit expansion to developing countries in the 1970s on a handful of Latin American and Far Eastern countries. At the time, this concentration on a few apparently credit-worthy middle-income lenders, plus neglect of almost all really poor countries, seemed prudent to each bank and each syndicate. Each, however, by its own prudent concentration of extra lending, produced a somewhat imprudent concentration of the rapidly expanded volume of total lending. Prolonged recession, high interest and oil price gyrations then turned what was sound for each lender, and mildly imprudent for all lenders ex ante, into what seemed like disastrous imprudence after the event.

However almost nobody was in 1973-74, or even 1978-80, pressing the banks not to recycle, or urging them to diversify their portfolios towards, say, Bangladesh or Mali. Probably it was felt that absolute risk (and lack of banking information) about low-income countries was so high, and their reliance on official flows (especially aid) so well-established, that the dangers and doubts about bank lending to these countries — not all of whom wanted bank money anyway — outweighed any possible gains from a better spread of risks.

Nevertheless, in retrospect (and for future reference!), greater diversity of customers among LDCs, to take in some low income countries (LICs), could have improved the safety of many banks' asset structures. So, perhaps, would a larger share of project lending, as against balance-of-payments lending. However, the gains from such shifts are available to bankers as a whole, if they move together; for any one bank, the shifts in some cases could increase risks, and would certainly increase information costs. In such circumstances, how can the authorities nudge banks in these directions? If ILLR obligations were made explicit by some group of central bankers, they could include — in the supervisory package that must be (as it is nationally) part of the quid pro quo for LLR support — appropriate pressures to induce all banks, participating in an assured ILLR facility, to move gradually towards such restructurings, as well as to obtain better information about creditor countries' total debt position and prospects, and to stabilise credit (including interbank) flows towards each borrowing country over time.

All this — even the last proposal — should not amount to pressure on individual banks to support particular countries. This 'interference with the market', indeed, has come, in practice, not from a carefully conceived ILLR/supervision package, but from the hasty cobbling together of rescheduling and new loan packages to specific countries, half-forced on numerous reluctant banks since late 1982 precisely because ILLR was and is inadequate.

How could improvements be brought about? In abandoning uncertainty as a way to raise costs of ILLR — because it defeats ILLR's very purposes — authorities can and should, we believe, replace it by adapting to the needs of today Bagehot's original concept of 'onerous terms': good collateral and the penal rate.

At first glance, this seems difficult. The only 'collateral' for sovereign debt is the willingness and ability of the governments to repay and service it, or to guarantee that the private sector does so. This collateral is by definition not very 'good' in hard times. Thus, if net capital inflows become severely negative alongside large trade deficits — as in much of Eastern Europe and Latin America since 1982 — the need to reschedule, even to go into arrears, merges imperceptibly into a temptation to default outright, as has reportedly been actively discussed in countries such as Brazil and Mexico (The Economist, May 1983; Whitley, 1983). Indeed, leading bankers argue that 'Poland, Mexico, Argentina, Brazil and now Romania have all unilaterally defaulted on their debts already' (Rohatyn, 1982).

What, then, can 'quality collateral' mean? And how high (and how self-defeating) would 'penal rates' be? There is not, as yet, a clear consensus among bankers about proposals for 'debt restructuring' (Avramovic, 1983; Guth, 1983; Rohatyn, 1982; ICIDI, 1983; compare, however, Lal, 1983; Taylor, 1983; McMahon, 1983).

Our suggestion is that such proposals be prepared in the form of a contingency plan, for use as part of an ILLR call when needed by a bank. Then, and only then, the ILLR would purchase some or all of the bank's claims upon sovereign debt at a substantial discount. This would impose a de facto 'penal rate', and turn large but doubtful claims on now insecure 'sovereign debt' into a smaller amount of 'good collateral' à la Bagehot. The private bank would thus suffer 'onerous terms' for using ILLR; but the private bank, its deposits, above all its capacity to lend, would survive.

Afterwards, the ILLR would negotiate with borrowers (e.g. developing countries) to recover the debt — presumably at a considerablly lengthened maturity — at a rate above that implicit in the discount price paid to the commercial bank for the claim, but somewhat below the original rate due. The better maturity, and perhaps rate, would reduce constraints on the borrowing country's development; this would be 'traded in' by the new owner of the claim — the ILLR — against a firmer commitment by the borrowing country to ensure repayment. The more favourable conditions for LDCs would imply a less severe constraint on their future growth as well as a greater willingness by their governments to repay the debts.

Thus — 110 years later — Bagehot's proposals would again come into their own. Their two components for onerous terms — penal interest and good (in a sense) collateral — would have merged into one.

This proposal obviously raises problems too complex to consider in detail here. Valuing the discounted collateral could be difficult, where no markets are functioning at the time. Other holders of sovereign debt, who are not in need of LLR facilities, must be considered (though presumably they would, on balance, welcome a valuation). Terms must encourage neither debtor countries to seek them, nor banks to seek ILLR facilities. International arrangements — the role of IMF and BIS, the extent to which commercial banks pay a fee or contribute funds for ILLR access — need to be specified. The question of funding the operations of such an ILLR is of course crucial. However, we believe that these problems though difficult, are soluble; and that the proposal provides, by reviving truly 'onerous terms', a much better way than 'uncertainty' to overcome the moral hazard created by existing inadequate and crisis-prone ILLR arrangements.

This proposal would be complementary to the strengthening of international supervisory functions. Although much progress has been made, particularly since the 1975 Concordat, it is difficult to establish complementary and tightly coordinated international supervision. How can one resolve problems about differences in supervision procedures amongst industrialised countries, and — even more — problems with supervising banks in developing countries and offshore centres? Even if such 'piecemeal' difficulties can be overcome, what does an ILLR system with a supervision quid pro quo do about countries that opt out and allow international banks to operate from their territory? Such countries and banks may hope that the authorities will allow them to free-ride on the ILLR facility, and will regard the cost of not doing so, in an interlocked financial system, as socially unacceptable? Finally, how does one strike a balance which assures adequate supervision and control, but which does not imply excessive centralised overview or impose unacceptable quasi-governmental controls on private lending? In any case, the existence of a clearer ILLR must increase the leverage of existing supervisory authorities, allowing them more timely and appropriate control of lending, insofar as a condition for access to ILLR functions would be to have respected the rules agreed with the supervisory authorities.

We feel that our proposal does not create the problems; it merely makes them explicit. In fact they have become serious partly because — in the interests of using 'uncertainty' to police commercial bank lending and to reduce moral hazard — the authorities have never clearly outlined and divided ILLR and supervisory responsibility, nor acquired the leverage to enforce what provisions do exist. Fundamentally such problems are always latent because of the complexity and internationalisation which now characterise banking.

As for the problem of 'free riders', if closer supervision accompanies clear-cut ILLR arrangements, each will reinforce the other. Rigorous supervision should become more acceptable to commercial banks, especially big international lenders, if accompanied by an explicit ILLR facility. On the other hand, an ILLR can work without excessive costs — whether from imprudent lending, or from the use of uncertainty to deter it — only with previous effective supervision. Both sides of the coin are currently somewhat tarnished, they need to be etched clearly — and simultaneously.

As we have discussed, the establishment (or otherwise) of an ILLR — together with more stringent supervision of bank lending — would affect the nature, level and distribution of private credit flows to different categories of developing countries. We have for example argued that the supervisory component could be used to improve the distribution, among LDCs, of commercial bank lending; it could be linked to achieving a more appropriate balance of different types of private loans (e.g. different maturities; project vs. country loans; fixed vs. variable interest) to LDCs.

Such matters inevitably have a major impact on the prospects of growth and development of the so-called Third World countries, who would borrow — or wish to do so — from the private capital markets; it would naturally also have a large impact on the interests of those developing-countries' governments who are major depositors in the private capital markets, such as the capital surplus oil-exporters. It would therefore seem appropriate that LDC governments should somehow be represented in the debate on the establishment of an ILLR and appropriate supervision. We are by no means suggesting incorporation of all or even many LDCs, as this would make any agreement infinitely more difficult; merely that the interests and concerns of the middle income and the poorest borrowers from — as well as the capital surplus lenders to — the international capital markets be clearly represented and considered.

Notes

1 Grubel (1971) derived the concept of 'moral hazard' from the economics of commerce, where it initially referred to the danger that persons would take greater risks because they were insured. Now it has acquired the more general definition used here and elsewhere (see IMF, 1983).

2 Viz. control of each bank: for fraud; for overall lending, relative to cash and to capital; and for exposure to particular borrowers, or in particular countries or sectors.

3 The 1975 Concordat — sometimes wrongly thought to apply to ILLR — deals only with the separate, though linked, issue of bank supervision. In 1983 this Concordat was updated, again without explicit reference to International Lender of Last Resort.

4 Such cases have been examined in some detail (e.g. Spero, 1980).

5 Banco Ambrosiano Holdings was technically a holding company and not a bank, for whom neither authorities had accepted supervision or LLR responsibilities.

6 Ambrosiano's failure, however, was one of the main factors leading to a revision of the Basle Concordat on banking supervision (Hughes, 1983).

7 'Not all countries have deposit insurance schemes and those that do offer widely differing coverage with respect to the size, type, currency denomination and status of deposits. In order to avert the danger that perceived differences in national protective arrangements could provoke destabilising capital movements in times of uncertainty, greater co-ordination in this area is desirable' (Dale, 1982, and IMF, 1983).

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