CEPAL
Review

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UNITED NATIONS
ECONOMIC COMMISSION FOR LATIN AMERICA
SANTIAGO, CHILE/ FIRST HALF OF 1978

SUMARIO

CEPAL REVIEW
First half of 1978

External finance and commercial banks

Their role in Latin America's capacity to import between 1951 and 1975

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Since the mid-1960s a radical change has come about in international financial flows which has placed commercial banks at the heart of the process. It is they that handled substantial funds deriving from the expansion of the Eurocurrency market and later recycled a considerable portion of the surpluses generated by OPEC; and for several reasons, paramount among which is the expectation of profit, they have channelled a considerable proportion of these resources towards the developing countries. The article analyses the positive and negative effects of this process on the nations in question. On the one hand, it has relieved the external bottleneck, increased the capacity to import, provided incentives to investment and economic growth, made it possible to weather the oil price crises, and afforded freedom from the constraints of official loans. But, on the other hand, it has also increased dependence upon foreign capital and debt service requirements, and has 'commercialized' development financing; this last consequence generally implies more onerous loans with variable rates of interest, shorter terms, less tolerance, 'commercial' criteria for estimating a country's creditworthiness, and intervention of banks in government policy. In face of these negative effects, the author proposes a series of remedial measures, of which the most outstanding is to augment the available funds of multilateral financial institutions with resources from the central countries and from OPEC.

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Introduction*

As can be seen in figure 1, in the mid-1960s Latin America[1] experienced the beginning of a dramatic rise in its capacity to import foreign goods and services.[2] If 1965 is used as a base, the region's ability to import, before having recourse to compensatory finance, more than doubled in 9 years, representing an annual average growth rate of 10.5 per cent in real terms. This is in sharp

*I should like to express my gratitude to Héctor Assael, Andrés Bianchi, David Hoelscher, Carlos Massad, John McDermott and Aníbal Pinto for their comments on earlier drafts of this paper. Their individual views do not, however, necessarily coincide with those presented in the paper. Also, any errors that the paper may contain are solely the responsibility of the author.

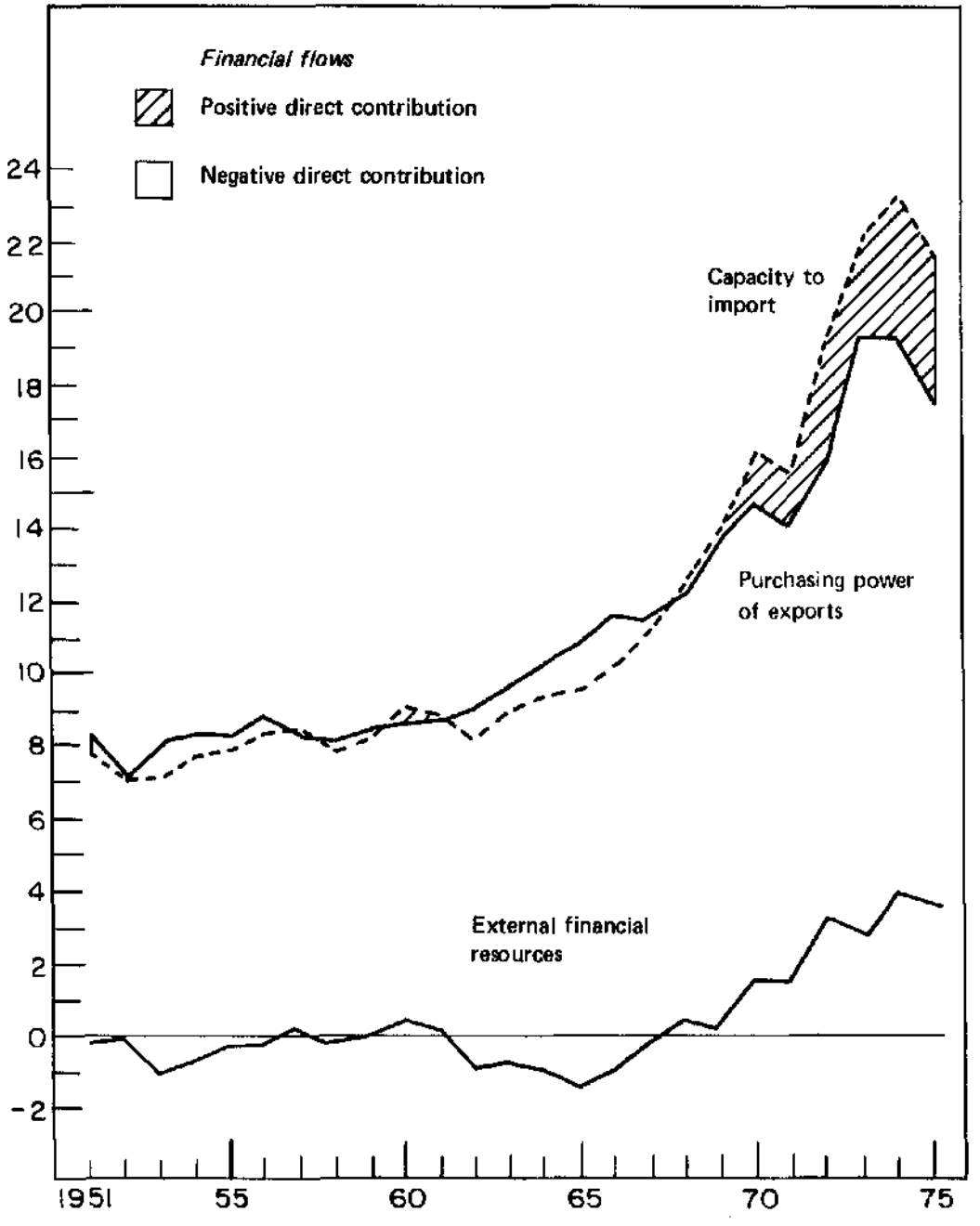
[1] Comprising Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru and Uruguay. Venezuela has been excluded because its status as a major oil producer has long set it apart from regional trends.

[2] The concept of capacity to import used here corresponds to CEPAL's traditional definition, i.e., the amount of goods and services that can be purchased with the annual net inflow of foreign exchange resources, excluding, however, inflows of resources under the heading of compensatory capital. Thus, capacity to import can be expressed as $Z = X + EF$ where Z is capacity to import, X is the purchasing power of exports and EF is the net flow of financial resources, exclusive of inflows of compensatory capital. For the sake of clarification, $EF = (AI\text{-}AO\text{-}Fa) - (CO + Fc) + (N + Fn) + E$, where AI represents foreign autonomous capital inflows; AO, foreign autonomous capital outflows; Fa, factor pay-

Figure 1

LATIN AMERICA: NET CONTRIBUTIONS OF PURCHASING POWER OF EXPORTS AND EXTERNAL FINANCIAL RESOURCES TO CAPACITY TO IMPORT, 1951-1975

(Billions of dollars at 1970 prices)



Source: CEPAL, on the basis of official data.

contrast to earlier years, as capacity grew by less than a third during the period 1951-1965, or at an annual average rate of only 1.7 per cent.

It is clear from the figure that the major thrust behind the expansion of capacity to import was an unprecedented increase in the purchasing power of the region's exports, which came about largely because of an unusually prolonged period of favourable trade prices. But the figure also makes it evident that the rise was attributable in part to an unusually large net inflow of external financial resources. It is to the analysis of the latter phenomenon that this paper will be devoted.[3]

The format of the paper is as follows.

The first section will examine the evolution of external financial flows over the past 25 years and show their impact on the region's capacity to import. The analysis will focus on two basic subperiods, 1951-1965 and 1966-1975, because of the rather distinct behaviour of key variables in these years.

Because analysis will show that a heavy influx of foreign loan capital was the principal determinant of the increase in financial flows during 1966-1975, section II will be devoted to examining the factors underlying the movement of loans. It will be seen that much may be attributed to structural changes in world finance which encouraged banks to penetrate into the field of the external finance of developing countries.

The third and last section deals with some of the implications of recent trends in external finance. It finds that not only has external dependency and debt increased, but that with the recent emergence of banks as the major agents of external financing, the nature of the debt problem itself has been seriously complicated.

Finally, before going on to the body of the paper, the reader should be forewarned that most of the statistical analysis will be confined to the region as a whole, with little disaggregation or none to speak of. Therefore, care should be taken to remember that the statements discussed may not be equally applicable to all countries of the region. Clearly, analysis of trends at such a high level of aggregation has serious limitations. But there nevertheless is some value, however small, in looking at events with respect to the region as a whole, and it is just such a modest contribution that this paper proposes to attain.

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ments on autonomous capital; CO, outflows of foreign compensatory capital; Fc, factor payments on foreign compensatory capital; N, net movement of assets held by residents of Latin America; Fn, factor receipts on national assets; and E, the net errors and omissions entry of the balance of payments. Note: national assets include government transactions; thus there is an element of double counting in the data.

[3] An analysis of the evolution of exports and trade prices and their impact on the region's ability to import can be found in CEPAL, "The economic and social development and external relations of Latin America" (E/CEPAL/AC.70/2), Santiago, Chile, February 16, 1977.

I

The evolution of external financial flows and their impact on the region's ability to purchase foreign goods and services, 1951-1975[4]

A. *The general picture*

A glance at the bottom half of figure 1 will show that during the period 1951-1965 external financial flows behaved in a rather erratic fashion. But in spite of short-term fluctuations, it can be said that the financial resource flow tended to be negative; only in three out of the fifteen years (1957, 1960, 1961) was a positive financial resource balance recorded. Moreover, towards the end of the period there was a noticeable enlargement of the negative resource balance, as it reached 1.4 billion dollars by 1965.

The behaviour of external financial resources during this period tended to exacerbate an already serious external bottleneck; not only was the purchasing power of the region's exports showing sluggish growth (2.1 per cent per annum), but significant proportions of these resources were generally claimed by requirements to cover the deficit in the external financial balance. The gravity of the problem is revealed in the upper portion of figure 1 by the rather large gaps between the purchasing power of exports and the capacity to import; indeed, at the close of the period the capacity to import was fully 13 per cent less than the purchasing power of exports.

Faced with this situation, Latin America resorted heavily to compensatory finance in order to keep imports at acceptable levels. As seen in figure 2, there was active use of compensatory instruments in every year during the period 1951-1965, and this helped to support purchases of foreign goods and services for amounts in excess of the capacity generated by autonomous resource flows. But even so, actual imports grew by only 2.5 per cent per annum in real terms and the coefficient of imports to GDP showed a marked downward trend over the period.[5]

In the second half of the 1960s the flow of financial resources started to show a remarkable change in behaviour (see again figure 1). Over 1966-1967 the negative financial balance began to decline from the peak level of 1965. Then, in 1968 a positive balance of 0.4 billion dollars was recorded, causing capacity to import to exceed resources made available from exports for the first time in 7 years. From then on the positive financial balance underwent strong expansion, reaching a peak of 3.9 billion dollars in 1974.

As can be seen, the shift to a large and sustained positive financial resource

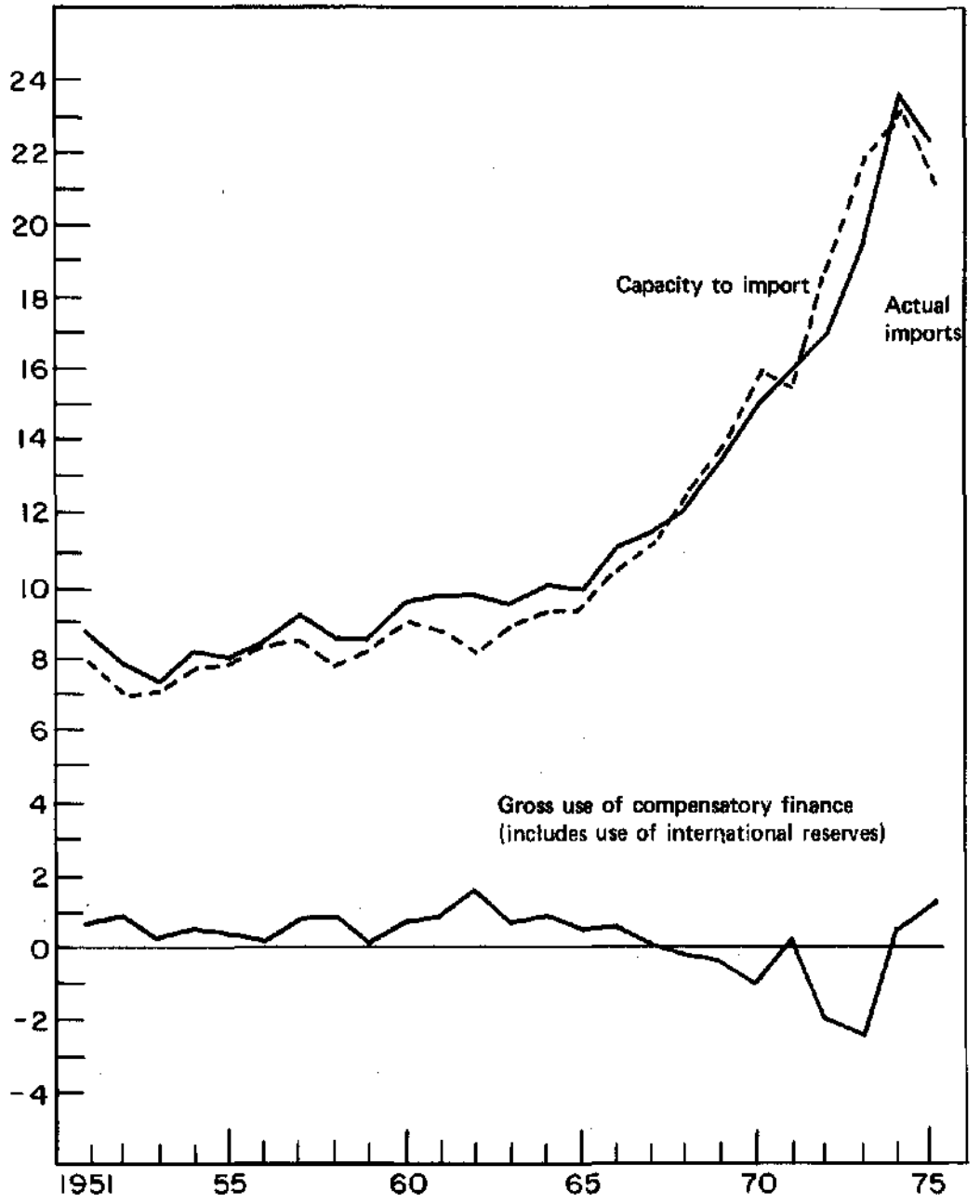
[4] In this section all data are deflated into dollars at 1970 prices.

[5] The coefficient declined from 16.8 per cent in 1950-1952 to 10.9 per cent in 1964-1966 (including Venezuela). See CEPAL, *op. cit.*, p. 47.

Figure 2

LATIN AMERICA: CAPACITY TO IMPORT, ACTUAL IMPORTS AND GROSS USE OF COMPENSATORY FINANCE, 1951-1975

(Billions of dollars at 1970 prices)



Source: CEPAL, on the basis of official data.

balance caused the capacity to import increasingly to exceed export earnings. By 1974, capacity exceeded export earnings by 20 per cent; this figure even rose slightly higher in 1975 because the fall in the financial balance (5 per cent) was less than the drop in the purchasing power of exports (9 per cent).

It can also be observed that the positive external resource balances after 1967 helped to push the capacity to import to levels that were for the first time in excess of actual imports. Figure 2 shows that while actual imports expanded rapidly (8.8 per cent per annum in real terms), the capacity to import exceeded the imports effected in every year except 1971 and 1974-1975, thereby indicating a substantial accumulation of foreign exchange reserves.

Figure 3 breaks down the external financial resource balance into its basic components: foreign resources, the net movement abroad of national assets and the errors and omissions entry of the balance of payments (the two last being designated as "Other" in the figure[6]). The figure reveals that the sustained positive financial balances that were recorded from the start of the late 1960s were due principally to the movement of foreign financial resources.

During 1951-1965 the foreign financial balance displayed a mixed behaviour. At the beginning of the period it was negative, modestly positive at the middle of the period, and then negative again at the end. However, in the latter half of the 1960s there was a profound change in trends. In 1966-1967 the negative balances diminished. By 1968 the balance had once again turned positive, and at 0.5 billion dollars was larger than any previous positive resource flow. But, more importantly, thereafter the positive financial balance grew very rapidly –at an extraordinary average pace of nearly 50 per cent per annum– reaching 5.5 billion dollars by 1974. In 1975 the positive foreign balance declined by 20 per cent, but nevertheless remained very large *vis-à-vis* historical experience.

The rise in the positive balance was generally less in the case of total financial resources than in that of the foreign component because of the tendency for negative balances to be recorded under "Other" financial resources. As can be seen in the figure, the negative balance was exceptionally large in 1973-1974, exceeding 1.5 billion dollars in both years. The reason behind this big deficit will be examined shortly.

The radical change in the behaviour of external financial resources can perhaps be better appreciated if averaged data for 1951-1965 and 1966-1975 are compared. Table 1 presents just such a comparison.

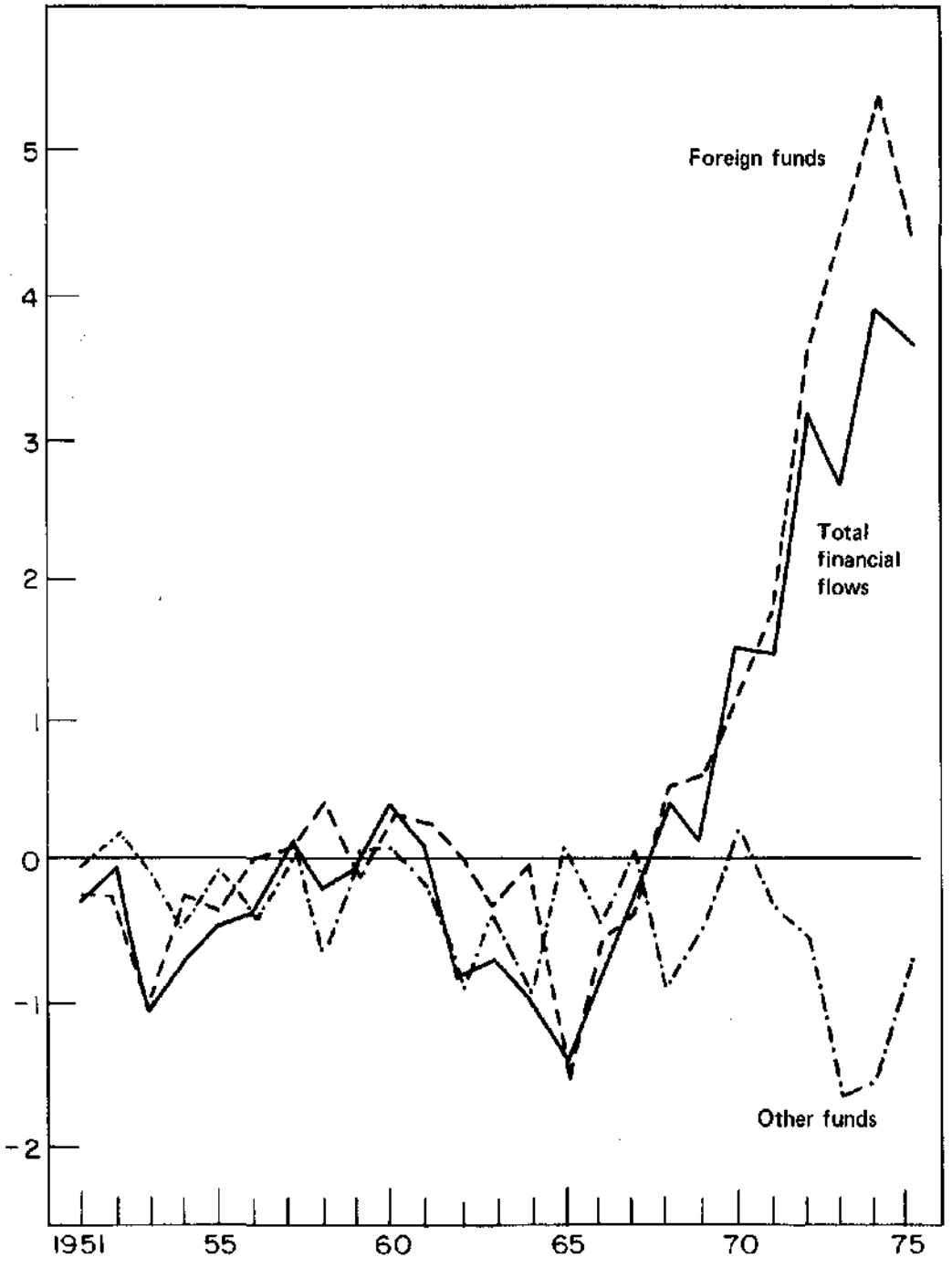
It can be seen that during the first period the region experienced an average negative balance for financial resources in the order of 0.4 billion dollars per annum, which is equivalent to 5 per cent of the average purchasing power of exports for the same period. This contrasts sharply with the behaviour pattern followed over the succeeding 10 years, as the average balance of financial resources showed a surplus of 1.6 billion dollars, representing an increase in absolute terms of 2.0 billion dollars with respect to 1951-1965, and implying that nearly one-quarter of the increase in average capacity to import between the two periods was attributable to the more favou-

[6] The errors and omissions entry has been included in the financial data since it is thought to be more reflective of unregistered flows of factor income and capital than of movements of tradeable goods.

Figure 3

LATIN AMERICA: EXTERNAL FINANCIAL RESOURCE BALANCE, 1951-1975

(Billions of dollars at 1970 prices)



Source: CEPAL, on the basis of official data.

Table 1

LATIN AMERICA: NET CONTRIBUTIONS OF EXPORTS AND FINANCIAL FLOWS TO THE CAPACITY TO IMPORT

(Billions of dollars at 1970 prices)

Averages	*Purchasing power of exports*[a]	*External financial flows*					*Capacity to import (1+6)*
		Foreign[b]	*Other*			*Total (2+5)*	
			National funds	*Errors and omissions*	*Total (3+4)*		
	(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*
1951-1965	8.8	-0.2	-0.1	-0.1	-0.2	-0.4	8.4
1966-1975	15.1	2.2	-0.5	-0.1	-0.6	1.6	16.7
1966-1970	12.8	0.3	-	-0.1	-0.1	0.2	13.0
1971-1975	17.3	3.9	-0.8	-0.1	-0.9	3.0	20.3

Source: CEPAL, on the basis of official statistics.

[a]Includes private transfers.

[b]Net effect of direct foreign investment (net) less profit remittances; short- and long-term non-compensatory loans less amortization and interest payments; net official transfers and amortization of obligations stemming from compensatory financing operations.

rable behaviour of financial resources. Significantly, most of the increase occurred after 1970, the average balance being 3.0 billion dollars in 1971-1975, compared to only 0.2 billion dollars in 1966-1970.

This turnaround in the average financial resource balance was due, of course, to the behaviour of the foreign component noted above. Whereas the net balance on average was a negative 0.2 billion dollars in 1951-1965 (equivalent to roughly 2 per cent of the average purchasing power of exports), it rose to a positive figure of 2.2 billion dollars in 1966-1975, which signified an absolute increase of 2.4 billion dollars. Most of the influx took place in the latter half of the period, as reflected in the fact that the positive balance averaged 3.9 billion in 1971-1975, while in 1966-1970 financial flows behaved in such a way that the average was a rather modest 0.3 billion dollars (see again table 1).

With regard to "Other" financial resources, average balances were negative in both periods because annual dificits generally resulted from the movement of national funds combined with the errors and omissions entry of the balance of payments. However, the outflow in 1966-1975 was triple that experienced in the previous 15-year period.

The factor underlying the increased deficit was a notably higher negative balance with regard to national funds: the average rose fivefold, from 0.1 billion dollars in 1951-1965, to 0.5 billion dollars in 1966-1975. The increase, however, largely reflected events in the years 1972-1974, when the deficit averaged 1.3 billion dollars per annum; moreover, more than three-fourths of the latter fi-

gure was concentrated in Panama, which is an international banking centre.

To summarize up to this point, the behaviour of financial flows differed greatly in the two basic periods under consideration here. During 1951 to 1965 there was a significant negative balance of external funds, which, when coupled with a rather sluggish growth of the purchasing power of exports, formed a severe external bottleneck. Even with considerable recourse to compensatory capital, imports increased at a very slow pace in real terms. In contrast, the period 1966-1975 was marked by a shift to a large positive external financial balance for the region, and this conveniently coincided with a similarly sharp expansion of the purchasing power of exports. The result was a phenomenal rise in capacity to import; indeed, capacity increased to such an extent that it often exceeded actual imports, thereby facilitating an accumulation of foreign exchange reserves. The key factor behind the favourable shift in the behaviour of external financial resources was the movement of foreign funds, which entered the region on a net basis in unprecedented proportions as from 1968.

Given that the foreign financial component played such a vital role in the rise in the capacity to import during 1966-1975, it is useful to examine these flows in greater detail.

B. *The foreign financial resource component*

Before proceeding with the analysis of the behaviour of the various types of foreign resources, it will be wise to clarify just what is meant by the net contribution of foreign finance to the capacity to import.

Foreign financial flows can be said to have a direct and an indirect impact on the region's capacity to import. The direct impact refers to the accounting of resource flows, i.e., the degree to which annual inflows of new foreign funds exceed outflows stemming from service payments (income remittances, interest and amortization payments, etc.).

The indirect impact of foreign flows consists in any favourable effects that resources may have on a country's ability to generate foreign exchange: for example, new foreign investment in an export industry would tend to boost export earnings. This paper will deal only with the direct effects of foreign flows on capacity to import. As will be seen shortly, from this viewpoint some types of foreign funds have at times had a negative impact on capacity to import. However, reference to a negative net resource balance does not mean to imply that these funds have been necessarily detrimental to the region's interests; only an analysis with a more ample perspective could determine this point.

1. *Direct foreign investment*

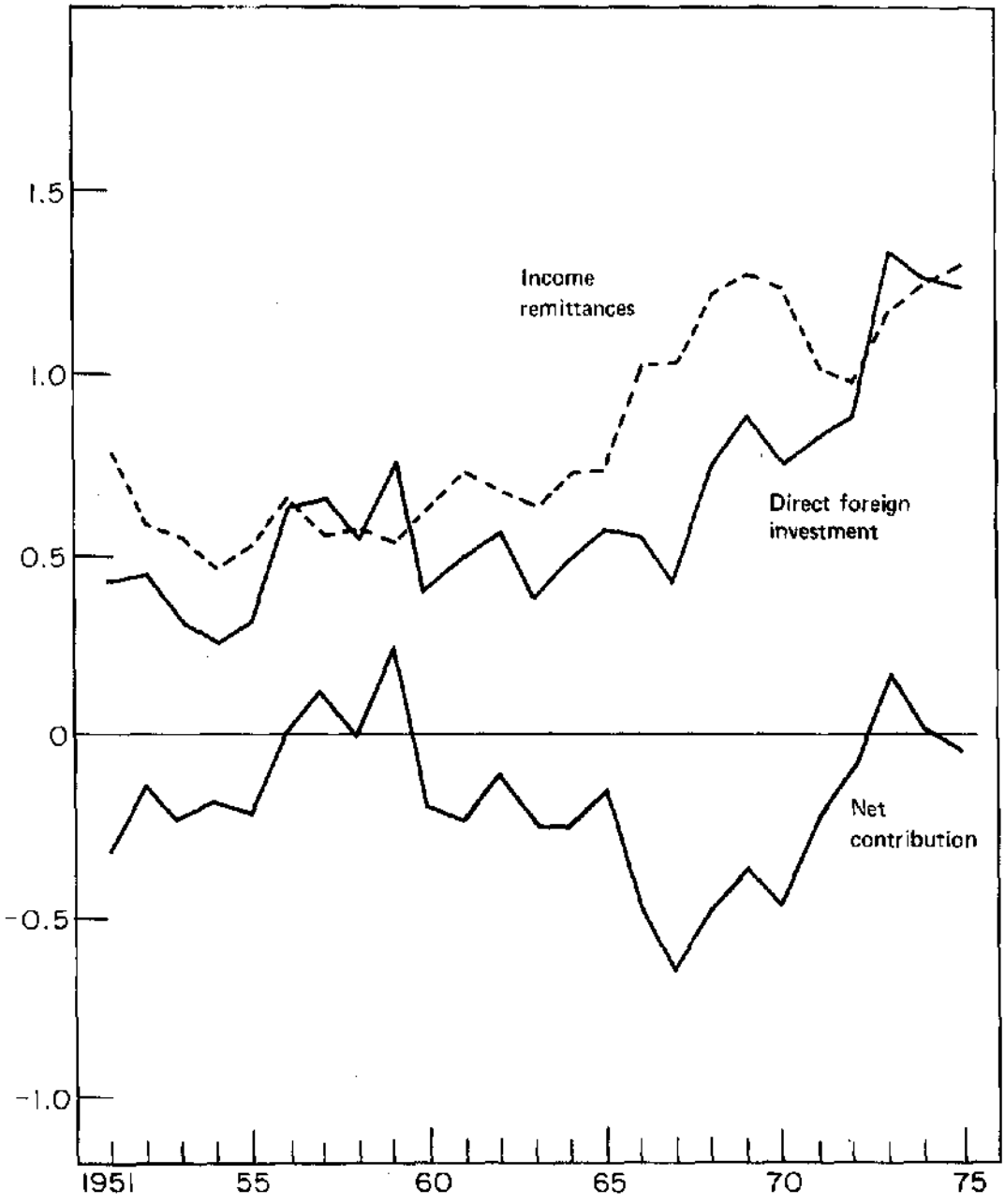
Direct foreign investment includes capital contributions to private direct investment enterprises of non-residents and reinvested earnings from these investments. But direct foreign investment carries with it a reverse flow in the form of income remittances. It is the net balance of these two flows that determines the direct impact on the region's capacity to import.

Figure 4 presents the evolution of new investment flows to the region and the outflows stemming from payments of foreign income. It is clear that there was generally a large deficit associated with foreign investment operations

Figure 4

LATIN AMERICA: NET DIRECT CONTRIBUTION OF DIRECT FOREIGN INVESTMENT TO CAPACITY TO IMPORT, 1951-1975

(Billions of dollars at 1970 prices)



Source: CEPAL, on the basis of official data.

viewed in the aggregate. During 1951-1965 the resource flow was positive for only 2 years, 1957 and 1959, while in 1966-1975 positive balances were recorded only in 1973-1974. The tendency towards a negative resource flow had the general direct effect of reducing the region's capacity to import.[7]

A notable feature is that in the late 1960s direct foreign investment flows began to show a new dynamism as compared to the rather flat growth of earlier years. However, income remittances also underwent a marked expansion, and on average the negative balance for foreign investment operations doubled between the two basic periods (see table 2). But it should be noticed that most of the increased deficit was accumulated during 1966-1970, when the negative balance averaged 0.5 billion dollars. In 1971-1975 the gap narrowed considerably and on average the resource flows were in rough balance. It can be said, then, that while not making a positive direct contribution to the capacity to import, the relative balance between investment and remittances nevertheless effectively helped to accentuate the sharp rise in capacity to import in the early 1970s.

Table 2

LATIN AMERICA: NET FOREIGN FINANCIAL FLOWS

(Billions of dollars at 1970 prices)

Averages	*Foreign investment net (1)*	*Foreign investment income (2)*	*Net balance (1-2) (3)*	*Non-compensatory loans*[a] *M-L/T (4)*	*S/T (5)*	*Total (4+5) (6)*	*Interest payments (7)*	*Net balance (6-7) (8)*	*Other flows (net)*[b] *(9)*	*Total (3+8+9) (10)*
1951-1965	0.5	−0.6	−0.1	0.5	0.2	0.7	−0.3	0.4	−0.5	−0.2
1966-1975	0.9	−1.1	−0.2	3.1	1.1	4.2	−1.6	2.6	−0.3	2.1
1966-1970	0.7	−1.2	−0.5	1.6	0.5	2.1	−0.9	1.2	−0.4	0.3
1971-1975	1.1	−1.1	–	4.5	1.7	6.2	−2.2	4.0	−0.1	3.9

Source: CEPAL, on the basis of official data.

[a]Short-, medium- and long-term loan disbursements less amortization payments.

[b]The net balance of official transfers and compensatory capital outflows other than use of reserves.

2) *Short-, medium- and long-term loans (including portfolio investment)*

These resources include funds lent by private and official foreign sources to Latin American governments and private enterprises. Short-term loans are understood to carry a maturity of up to one year, while medium- and long-term loans are characterized by a more extended maturity. The net direct impact of these funds on capacity to import is determined by the balance of net loan disbursements (gross disbursements less amortization) and interest payments on outstanding loan balances.

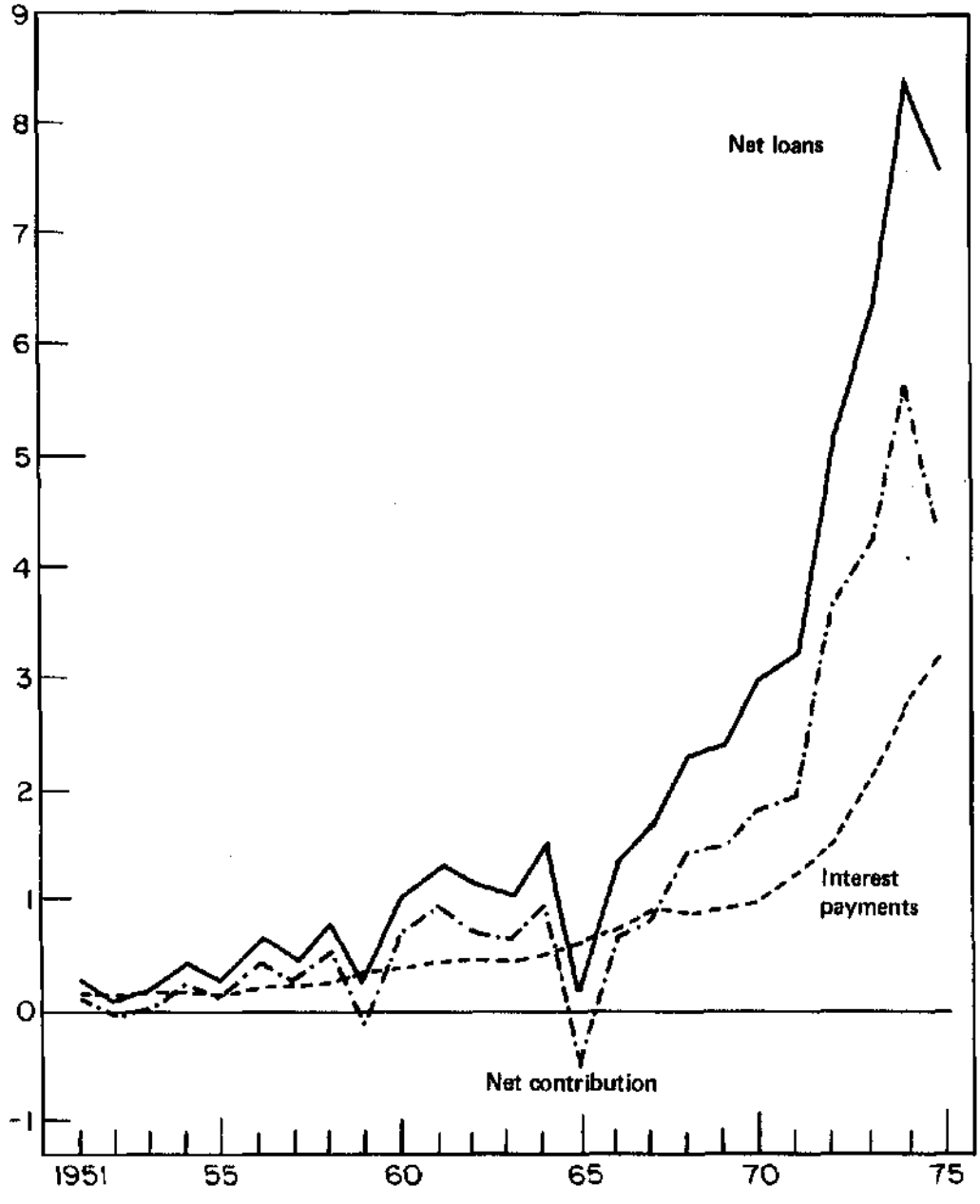
Figure 5 shows that during the 25

[7]It is worth emphasizing that this measurement does not include any other benefits such as those derived from exports, tax revenue generated from exports, transfer of technology, etc.

Figure 5

LATIN AMERICA: NET CONTRIBUTION OF FOREIGN LOANS TO CAPACITY TO IMPORT, 1951-1975

(Billions of dollars at 1970 prices)



Source: CEPAL, on the basis of official data.

years under consideration, transactions related to foreign borrowing operations generally resulted in a positive net resource balance for the region; indeed, only in three years (1952, 1959 and 1965) was the net balance negative. What is striking, however, is that after 1967 the net balance on loan operations reached unprecedented proportions and was the principal factor behind the strong contribution of foreign financial resources to the accelerated growth of capacity to import.

The main reason underlying the rise in transfers deriving from foreign borrowing operations was a rapid and remarkably sustained expansion (average growth of roughly 50 per cent per annum) in net loan disbursements, as loans were contracted at a much faster pace than they were repaid. Thus, the net disbursement from foreign loan capital rose from 0.2 billion dollars in 1965 to a peak of 8.5 billion in 1974.

Notwithstanding sharply increasing interest payments –their average growth rate rose from 11.9 per cent in 1951-1965 to 17.3 per cent in 1966-1975– the resource transfer closely paralleled the movement in net disbursements. By 1974 the net balance reached 5.6 billion dollars, or more than the cumulative net balance for the whole of 1951-1965 (5.2 billion dollars). In 1975 a 10-per cent fall in net disbursements, coupled with a 13-per cent rise in interest payments, caused the positive balance from loan operations to show a decline (21 per cent) for the first time in 10 years. Nevertheless, at 4.5 billion dollars the positive resource flow remained higher than that recorded for any year prior to 1974.

The unprecedented influx of loan capital after 1965 becomes all the more striking when averaged data are examined. This procedure can also shed light on the relative importance of short- and longer-term maturities.

Returning to table 2, it can be seen that the average net contribution of loans to the region's capacity to import rose from 0.4 billion dollars in 1951-1965 to 2.6 billion in 1966-1975 – an increase of over 500 per cent. This reflects the fact that average net disbursements of loan capital rose by 3.5 billion dollars and average interest payments by 1.3 billion. Both figure 5 and table 2 make it clear that it was after 1970 when the transfer was most significant; the average net flow in 1971-1975 was over 3 times larger than the average for the previous 5 years and 10 times larger than the annual average balance for 1951-1965.

It is also notable that the influx of loan capital came mostly in the form of medium- and long-term funds as opposed to short-term funds; fully 74 per cent of the increase in average disbursements between the two basic periods reflected loans with a maturity of more than one year. This is an important distinction, since, all other things being equal, longer maturities are more advantageous to development strategy because repayment is less of a burden on a country's 'cash flow'.

3. *Other foreign resources*

This last group of foreign financial data incorporates the net effect of official transfers and debt service payments on compensatory finance operations. Although the combined impact of these flows on the capacity to import was negative in both the major periods under consideration (see again table 2), the

average net outflow declined by 40 per cent and this in itself tended to enhance capacity to import.

The reduction for the most part reflects the behaviour of amortization payments on obligations related to compensatory finance (since the impact of these flows tends to dominate the group). During 1951-1965 Latin America's balance of payments was generally in disequilibrium, necessitating relatively active use of compensatory loan instruments. This generated a sizeable reverse flow because of the need to amortize obligations. But after 1965 the inflow of autonomous capital tended to be sufficient to meet external financing requirements, thus permitting Latin America to resort less to compensatory finance, which in turn resulted in reduced service payments.

It is clear from the analysis in this section that there was a radical change in the behaviour of financial flows after 1965 and that it was due basically to a heavy influx of foreign loan capital. Since loans played such a key role, it will be useful to examine the factors underlying events. This will be the task of the next section of the present paper.

II
Dynamics behind growth of foreign loans: private international bank capital

The preceding section has shown that a major reason behind the dramatic growth of Latin America's capacity to import after 1967 was an unusually sharp rise in net inflows of foreign loan capital. This surge of foreign loans was largely attributable to the activities of international commercial banks.

Prior to 1965, Latin America traditionally relied on direct foreign investment, suppliers' credits and official bilateral and/or multilateral loans for the bulk of its external finance. As for banks, they played an important, but restricted role, generally confining themselves to short-term trade finance and occasional project loans that carried an external guaranty such as that of an official export credit agency. However, in the late 1960s, some countries –notably Brazil and Mexico– began to tap foreign commercial banks for sums that would not have been considered feasible in earlier years. Once more, much of the lending was of a medium- to long-term nature. By the early 1970s these two countries were already heavily reliant on private bank finance, and many other countries –for example, Peru, Colombia and Panama– were able to secure sizeable loans from such banks as well. Then, with the advent of the oil crisis in 1974, most countries experienced severe external disequilibrium, and it was private commercial banks that extended most of the funds to cover external deficits.

But why the change in access to bank credit? Evidence suggests that some special forces came into play.

A. *Structural transformation of banking*

It appears that to a large extent Latin America's increased access to bank credit was the result of its being caught up in the centrifugal forces created by a profound structural change in banking. Of major importance to the process was the expansion of the Eurocurrency market, which was first formed in the mid-1950s out of dollars generated by United States balance-of-payments deficits. The market was largely unregulated and proved to be highly profitable to banks. Using this market as a springboard, in the 1960s many banks attempted to break out of national frontiers and into the international arena, where profit growth was much more dynamic than at home. American banks led the parade, but soon European, Japanese and Canadian banks hopped on the bandwagon.

The unregulated nature of the Eurocurrency market, together with a newly-placed emphasis on the growth of earnings, caused banks to abandon their traditionally conservative posture and display unwonted boldness. A major innovation in this period was the regular extension of longer-term loans. Banks had been in the habit of restricting themselves largely to shorter-term lending because of the current nature of their deposit base. But they found that on the Eurocurrency market they could regularly "buy" 6-month deposits, and then by continuously rolling them over at interest-fixing dates, use these deposits to fund much longer-term loans, typically going up to 5 years.

During most of the 1960s the Eurocurrency market catered primarily to the industrialized countries. But as the pool of Eurocurrency expanded, and more and more banks, attracted by the high yields of international lending, entered the market, competition for customers became very keen. By the late 1960s, the forces of competition and the desire to maintain the growth of earnings were prompting a search for new customers in developing areas.

Latin America (more specifically Brazil and Mexico) became a prime candidate for loans because of the relatively higher level of growth and development to be found there. Banks were also attracted by the fact that developing countries were willing to pay risk premiums in excess of 2 per cent over base interest rates in order to secure loans.

In the early 1970s competitive pressures became so hectic that banks —many of them new entrants into the international scene— saw their lending spill over into the smaller, less-developed countries of the region; countries traditionally accustomed to obtaining capital from official sources thus found the Eurocurrency market to be a more than willing supplier of funds.[8] Indeed, by 1972 countries had discovered it to be a borrower's paradise; not only was there easy access to credit, but competition caused margins to be drastically reduced and maturities to reach unprecedented lengths. By way of example, Brazil, which was a leading borrower within the developing world, found that it could regularly secure credits with a 10-15-year maturity. As for spreads, they declined from 2 1/4 per cent in 1971 to 1 1/2 per cent by mid-1972 and to 3/4-1 per cent in 1973. At the same time lending was so

[8] Most lending in absolute terms went to countries like Mexico and Brazil, but Argentina, Colombia, Peru and smaller countries like Nicaragua, Costa Rica and Panama were also able to secure sizeable loans from the Eurocurrency market.

voluminous that the country even found it necessary to introduce policies to discourage foreign bank loans.[9]

With the advent of the oil crisis in late 1973, the forces behind lending changed somewhat. In consequence of the lack of international mechanisms for dealing with the oil crisis, OPEC countries placed more than 50 per cent of their surplus receipts in private bank deposits.[10] This left international banks awash with funds and needing to find an outlet for loans. Thus, the so-called recycling process began.

If the euphoria surrounding international lending waned a trifle on account of the uncertainties associated with the oil crisis, it was a series of major bank failures —the most publicized being the Herrstatt bankruptcy of mid-1974— that called a halt to the "go-go" expansionary phase of banking. The failures gave bankers the jitters, and many of the smaller institutions were pushed out of the market by "tiering" of money rates and the perceived higher risks of international lending. Big established banks also became cautious and revaluated their international portfolios.

The bankers' uneasiness was reflected in a radical change in lending behaviour. Loans suddenly became more difficult to secure. As is shown in table 3, the volume of lending to Latin America fell by more than 50 per cent in the third quarter of 1974.[11] Lending recovered somewhat in the last quarter (probably because of roll-over requirements), only to go flat again in early 1975.

Table 3

PUBLICIZED EUROCURRENCY CREDITS FOR LATIN AMERICA

(Billions of dollars)

1973	*1974*				*1975*			
	I	II	III	IV	I	II	III	IV
3.2	1.0	1.3	0.6	1.1	0.7	1.1	1.5	2.1

Source: IBRD, *Borrowing in international capital markets*, various issues.

This cautiousness was accompanied by a severe hardening of terms. Interest rates skyrocketed (6-month deposit rates reached over 14 per cent in August 1974) and spreads rose to the neighbourhood of 1 1/2-1 3/4 per cent. Moreover, maturities showed a sharp contraction. As can be seen in table 4, in the second half of 1974 long-term loans became much less plentiful; by the first half of

[9] For additional information on Brazil's experience with foreign bank loans see the study on Brazil in CEPAL, *Economic Survey of Latin America, 1975.*

[10] Morgan Guaranty Trust Company, *World Financial Markets*, October 20, 1975, p. 4.

[11] Data in table 3 are for authorizations and therefore are not necessarily in conformity with the trends for loans indicated in section I, which are based on actual disbursements.

Table 4

PUBLICIZED EUROCURRENCY CREDITS, BY MATURITY, FOR ALL DEVELOPING COUNTRIES

(Percentages)

	1973	*1974*				*1975*			
		I	*II*	*III*	*IV*	*I*	*II*	*III*	*IV*
1-6 years	8.1	20.6	12.5	12.5	25.9	65.6	74.7	76.1	78.2
7-10 years	47.7	58.8	67.9	74.1	52.8	24.8	16.5	16.8	18.1
Over 10 years	36.2	14.6	14.6	5.4	13.9	5.7	4.5	–	–
Unknown	8.0	6.0	5.0	8.0	7.4	3.8	4.3	7.1	3.7
	100.0	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: IBRD, *Borrowing in international capital markets*, various issues.

1975 only 31 per cent of all publicized Eurocurrency credits to developing countries had a maturity in excess of 6 years, as against 73 per cent for the corresponding period of 1974.

As 1975 progressed, bankers found that they had to relax somewhat their restrictive attitude towards lending to LDCs. In the first place, demand for loans in the industrialized countries was slack because of the recession there, so banks, still flooded with OPEC receipts, were in need of an outlet, and therefore had to lend to the only area where demand remained strong –the developing world. Secondly, by that time some developing countries –for example, Brazil– had become important clients of the banks, and if their loans were not rolled over, the banks themselves would face the possibility of serious losses.

While banks resumed their lending to Latin America, conditions at the close of 1975 were dramatically different from those prevailing in the expansionary period. Banks remained very cautious about lending and tended to favour larger borrowers who had established themselves as clients; smaller borrowers in the developing world were often marginalized. Of greater importance was the fact that lending terms became even more onerous. Although the London Interbank Offer Rate (LIBOR) subsided from the high levels of 1974, spreads rose to 2 per cent or more and, as seen in table 4, longer-term maturities all but disappeared from the market.

B. *Other factors*

The above remarks suggest that the increased access to foreign loan capital after 1967 was to some extent supply-led, reflecting first the forces of a dramatic restructuring of the world banking industry, and then later on the financial upheaval created by the oil crisis. But there were other important factors in play as well.

The cyclical export boom that was experienced by many countries in the late 1960s and early 1970s –and is evidenced in figure 1 by the rise in the purchasing power of Latin America's exports– made them appear more creditworthy, from the banks' point of view, precisely at the time when these institutions were vigorously competing for secondary markets in developing areas. And there was considerable demand for such loans.

Many governments had found the growth of official financing inadequate with respect to their ambitions for increased investment and economic growth. The Eurocurrency market was therefore a welcome source of new finance. Moreover, conditions were attractive. In 1971-1973, when Latin America's borrowing from banks began its real take-off, premiums on interest rates were declining and the margins between commercial rates and official rates were significantly reduced.[12] And while commercial maturities of 10-15 years were shorter than those of 20-30 years usually offered by official institutions, some compensation was afforded by the availability of credit and the quickness with which banks habitually authorized and disbursed funds.

Another factor in the initiation of bank loans was the enormous penetration of transnational corporations into the countries of the region (particularly Brazil and Mexico). For various reasons, including a desire to enhance earnings growth and security, these corporations often followed an investment strategy that minimized equity contributions in favour of debt financing. Being intimately associated with private banks, transnationals naturally sought to finance the hard currency costs of their expansion with international bank capital.

Finally, the oil crisis greatly increased the current-account deficits of most countries in the region. In order to forestall drastic reductions in economic growth and avert socio-political stress, they were compelled to borrow. Since adequate assistance was not forthcoming from official institutions, the countries turned to banks. As noted earlier, banks had their own vested reasons for wanting to respond to this need.

[12] The average Eurodollar rate for the period 1967-1971 was 7.34 per cent. Brazil and Mexico were able to contract spreads hovering around 1.1/2 and 1 per cent in 1972 and 1973, respectively, suggesting a historical rate of 8.34-8.84 per cent. The World Bank lending rate at the time was 7.25 per cent. (The difference between the two rates would have been somewhat greater for other countries in the region.) For short-sighted borrowers, Eurodollar credits could have proved extremely attractive. In 1972 the Eurodollar rate averaged 5.46 per cent, and even with a spread as high as 2.1/2 per cent, the margin over the World Bank rate would have been less than 3/4 per cent.

III
Some implications of the enlarged influx of foreign financial resources to Latin America

It is clear from the preceding considerations that the marked increase in flows of loan capital from private banks brought with it some very tangible benefits.

First, it initially helped Latin America to overcome an external bottleneck and achieve a very sharp rise in its capacity to import goods and services, which in turn stimulated an expansion of investment and economic growth. Then, with the advent of the oil crisis, bank capital was of particular benefit in helping to insulate the region from the full impact of oil-induced deficits, thereby warding off a jarring adjustment process.

Secondly, while banks had long played an important, if restricted, role in the finance of developing countries, the expansion of their lending activities at the beginning of the late 1960s introduced a refreshing plurality into development finance. Many countries found that they could break out of the straitjacket of official finance, which was available only in limited quantities and was often tied up in an excessive amount of red tape and politico-economic conditionality. Moreover, in the expansive phase of lending to developing countries (1971-1973), borrowers even found that there was a high degree of independence with regard to selection of banks because, as noted earlier, these institutions were competing keenly among themselves for new customers.

While bringing many tangible benefits, the increase in bank finance was also accompanied by some side-effects that have to be viewed with a more wary eye. The most notable of these is that with the rise in loan finance came a marked increase in Latin America's dependency on foreign capital. But more importantly, because banks (which extended more than 50 per cent of total foreign capital resources in 1975) effectively displaced official institutions and direct foreign investment as the major agents of financing, the nature of the foreign dependency problem underwent radical change. This section will examine some of the quantitative and qualitative aspects of Latin America's dependence on foreign finance and then suggest that recent trends have generated some special problems for the region.

A. *The extent of Latin America's dependence on foreign capital*

The quantitative aspect of the dependency problem can be viewed from many angles. Here it will be examined in terms of import requirements and debt service obligations.

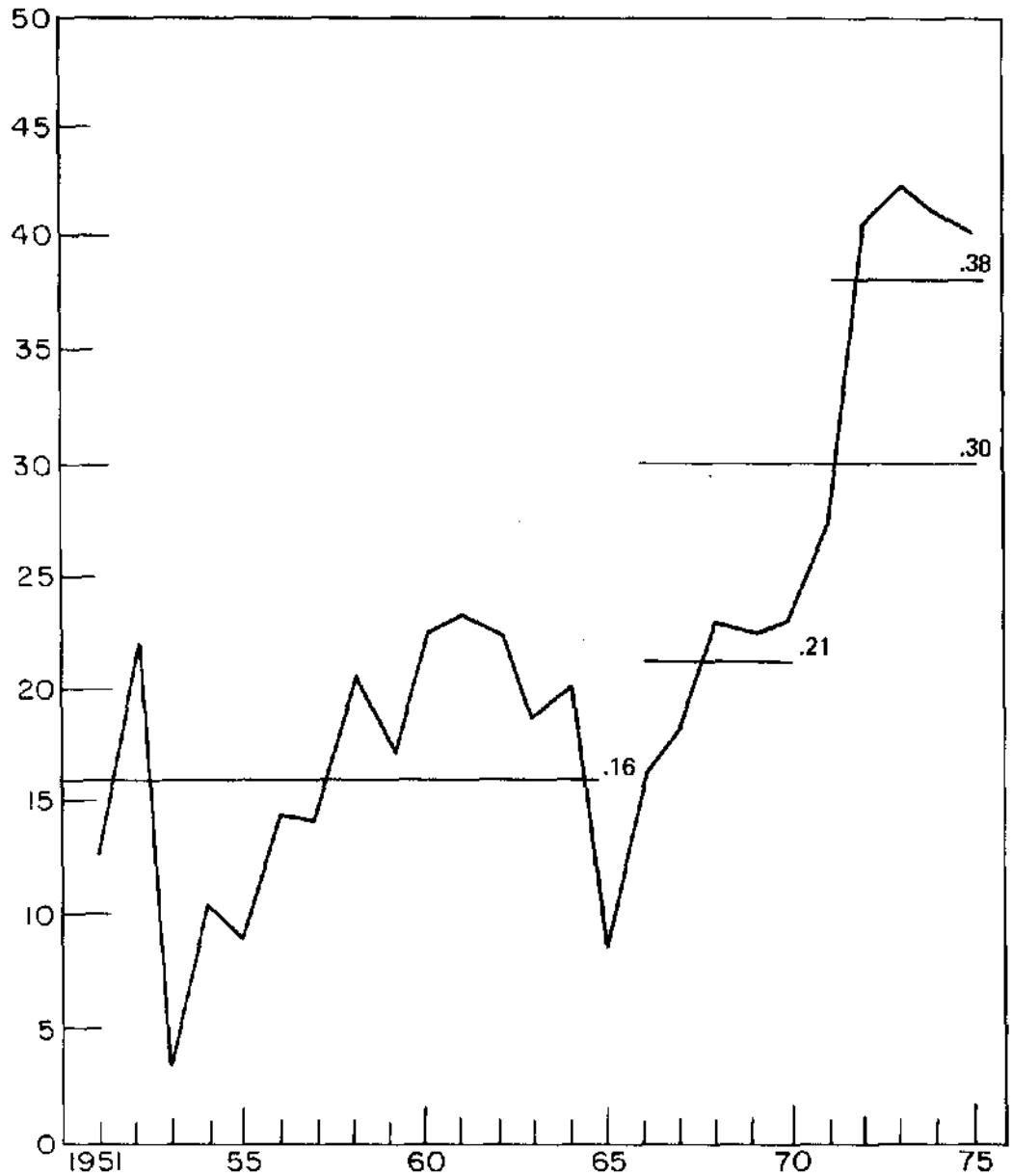
1. *Foreign capital in relation to imports*

Figure 6 presents the annual level of a coefficient relating net foreign capital inflows (including compensatory capital) to imports of goods and services over the periods 1951-1965 and 1966-1975. It also uses horizontal lines to indicate the average level of the coefficient for the basic periods considered in this paper.

Figure 6

LATIN AMERICA: NET FOREIGN CAPITAL FLOWS/IMPORTS OF GOODS AND SERVICES, 1951-1975

(Coefficient)



Source: CEPAL, on the basis of official data.

As can be seen, the coefficient showed considerable variations during 1951-1965, but averaged 16 per cent for the period. After 1965 it climbed sharply and relatively steadily, indicating a much greater reliance on foreign capital flows to sustain the region's imports of goods and services. Notwithstanding a brief pause in 1968-1970, the coefficient rose from 8 per cent in 1965 to 28 per cent in 1971. Then in 1972 it shot up to such an extent that fully 41 per cent of the region's imports were underpinned by foreign capital. The coefficient remained above 40 cent for the rest of the period.

What the above trend clearly shows is that during 1965-1975 Latin America dramatically increased its reliance on foreign resources for maintenance of imports. Not surprisingly, this dependence has also been reflected in much higher requirements for debt service.

2. *Debt service requirements*

While it is not the purpose of this paper to enter into detailed study of Latin America's debt *per se*,[13] it is nevertheless worth while to review briefly the region's debt service requirements in respect of foreign capital, because this will help to give a clearer idea of the extent to which the region is reliant on external resources. The first step is to define just what is meant here by debt service on capital.

In its broadest sense debt service could include remittances of foreign investment income as well as amortization and net interest payments on outstanding foreign loans. But it is more customary when reviewing the burden of service to apply a narrower concept that involves only payments on loans.

Loans display characteristics that clearly place them in the category of debt. When they are secured, the borrower is under a contractual obligation to repay the loan in a specified period. This usually involves a precise repayment schedule –often based on semi-annual or annual installments– that the borrower agrees to meet. Traditionally, repayment schedules are considered binding and foreign creditors usually take a dim view of attempts to modify them; indeed, failure to meet installments, or even indications that difficulty is being encountered, can jeopardize a country's creditworthiness and make it difficult to secure new loans and other finance. Thus, if a country is undergoing a foreign exchange crisis, and cannot roll over debt payments with new debt, it must compress imports or face the rather traumatic consequences of default and/or rescheduling.

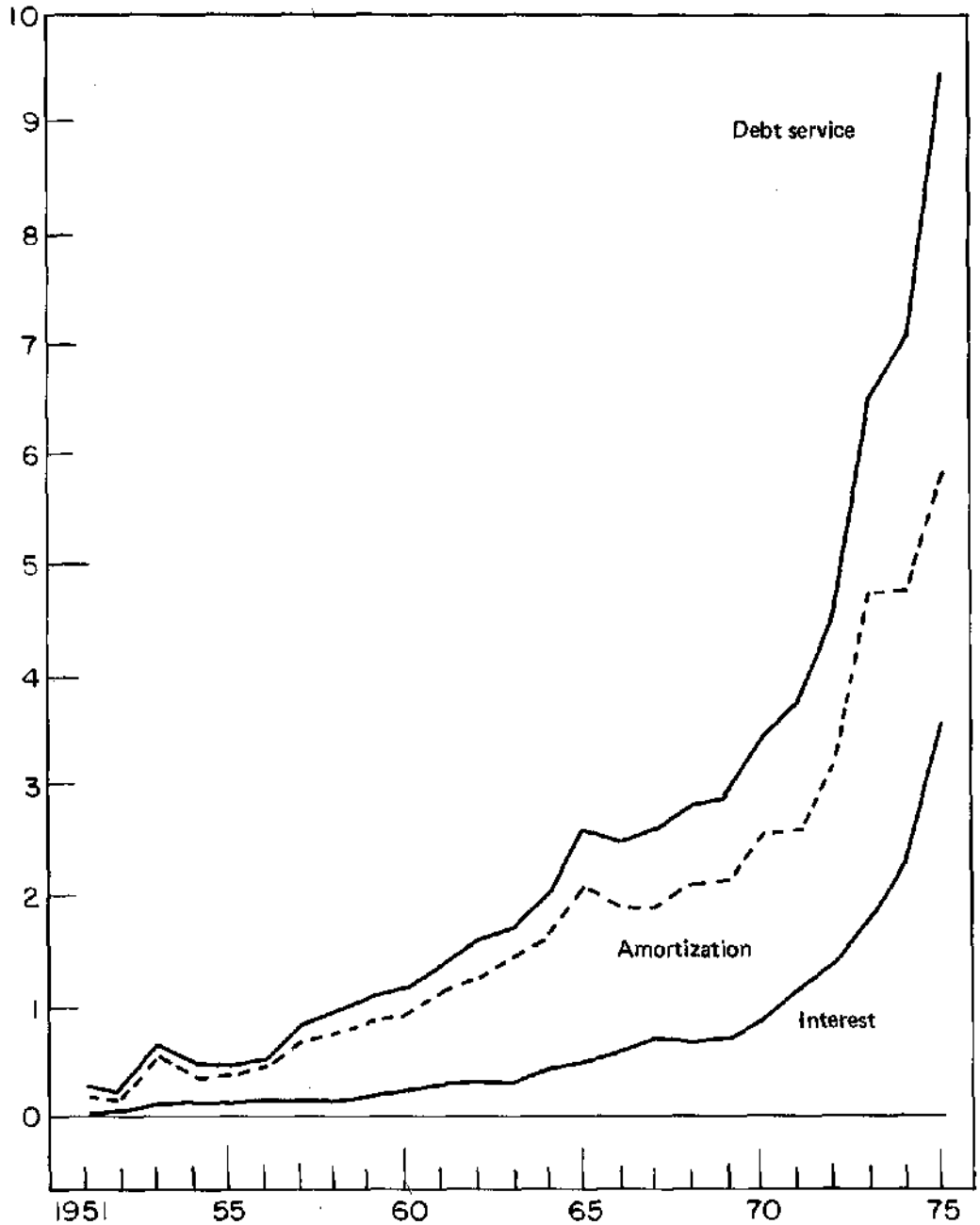
Remittances of profits on direct foreign investment, on the other hand, do not display the binding characteristics of loans. Remittances are determined by earnings on investments and thus cannot be governed by a predetermined and fixed schedule. Although controls on remittances are generally frowned upon by industrialized countries, and can even provoke retaliation, it appears that latitude exists for governments to alter the outflow of remittances on any given level of investment. For instance, governments can introduce incentives for foreign companies to reinvest their earnings in the country instead of remitting them abroad. In the event of a short-term foreign exchange crisis, a government can often successfully exert

[13] For a good survey of the debt situation, see Carlos Massad and Roberto Zahler, "Dos estudios sobre endeudamiento externo", *Cuadernos de la CEPAL*, Santiago, Chile, 1977.

Figure 7

LATIN AMERICA: DEBT SERVICE PAYMENTS, 1951-1975

(Billions of dollars at current prices)



Source: CEPAL, on the basis of official data.

"moral suasion" to induce foreign enterprises to delay or restrict their remittances; and in extreme cases governments have sometimes been able to introduce legal measures to restrict payments temporarily without doing irreparable damage to the so-called 'foreign investment climate'.[14]

It is the greater degree of flexibility associated with foreign investment income that will cause it to be excluded from consideration of debt service. Remittances do, however, represent a charge against export earnings and reduce resources available for debt service. As will be seen, this factor will be taken into account when considering the burden of such payments.

(a) *Payments*

Figure 7 displays the evolution of the region's debt service payments in *dollars at current prices.* Reflecting the increase in recourse to foreign loans, service payments follow an almost uninterrupted path of expansion during the 25-year period under review. The average nominal rate of growth is roughly 14 per cent per annum for both 1951-1965 and 1966-1975. There is, however, a noticeable acceleration of growth after 1969. The region's debt payments rose from 2.9 billion dollars in 1969 to 9.5 billion dollars in 1975; in other words, they more than tripled in 6 years, representing an average growth rate of nearly 22 per cent per annum in current terms.

This sharp growth of payments reflects the increase in the level of borrowing that began to take place in the late 1960s. Another factor contributing to the expansion of payments was the greater recourse to commercial bank credit. As Latin America shifted its reliance from relatively soft to hard commercial loans, interest costs rose and maturities shortened accordingly.

(b) *Burden of payments*

The burden of debt service payments is determined not so much by their absolute magnitude as by their size *vis-à-vis* ability to repay. A traditional 'rough and ready' measure of the burden is the debt service coefficient, which relates debt service to export earnings net of foreign investment income remitted abroad.[15]

Figure 8 presents the evolution of the region's debt service ratio over the 25-year period under study. It shows that from 1951-1957 this ratio remained comparatively modest at less than 15 per cent. But in the next few years a new plateau was reached: by 1961 the ratio exceeded 20 per cent and by 1965 it had reached nearly 29 per cent. Thus, Latin America already had what could be termed a relatively burdensome load of

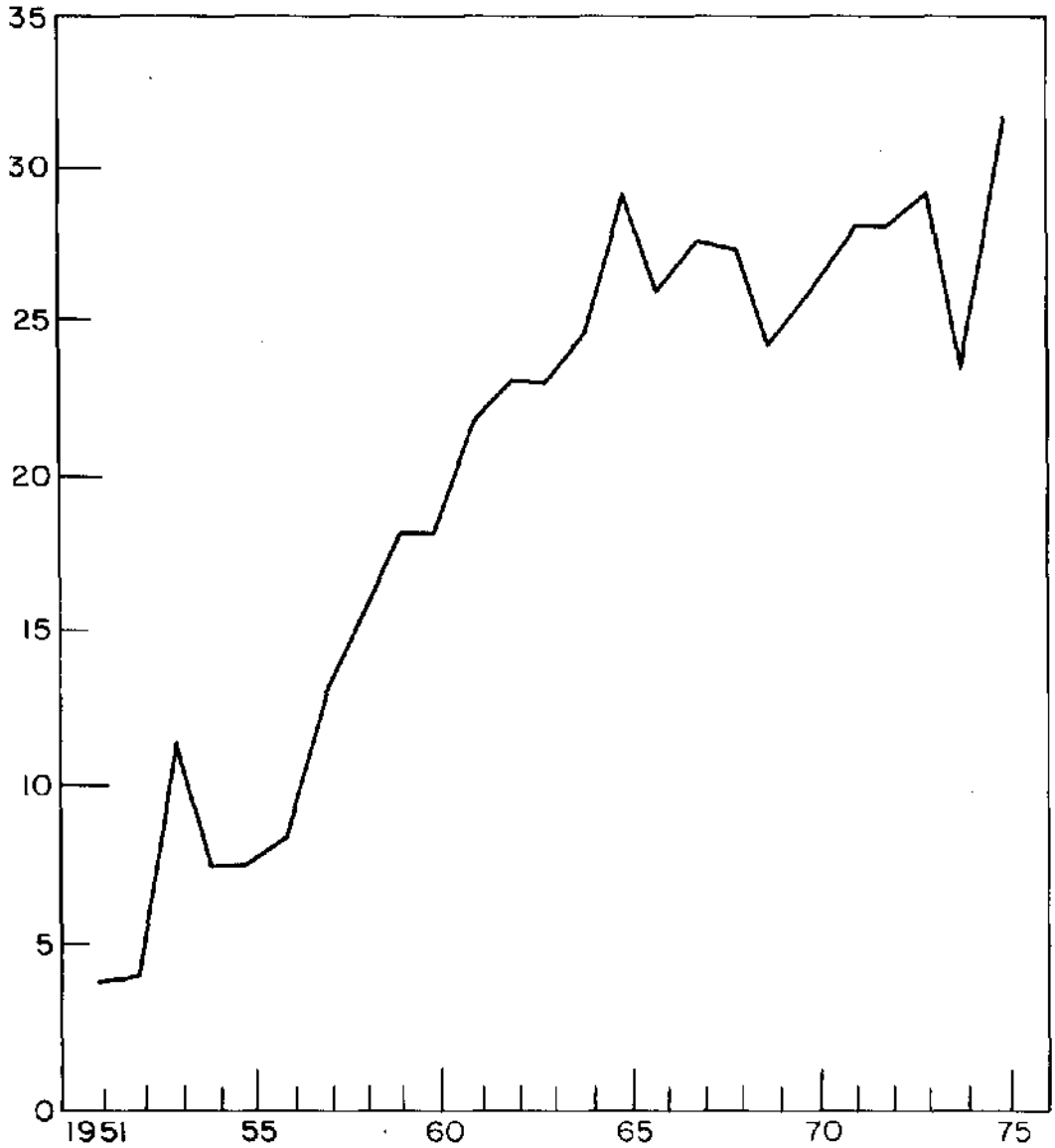
[14] It should be noted that controls are not always completely effective because foreign corporations can disguise remittances in the form of transfer pricing or other accounting techniques.

[15] The ratio is only meant to be indicative as by itself it provides an incomplete picture of the burden. No single indicator or group of indicators can provide adequate information about the burden of service payments because many of the key components of a debt problem are not easily quantifiable. For instance, it is often difficult to ascertain at what point development objectives are becoming compromised by requirements to meet debt service obligations. Another crucial element that is difficult to assess is creditors' willingness to "roll over" payments with new loans. Finally, indicators cannot adequately forecast events such as a bad harvest, political upheaval, etc., which can quickly convert a manageable debt service into a severe problem.

Figure 8

LATIN AMERICA: DEBT SERVICE RATIO, 1951-1975

(Coefficient)



Source: CEPAL, on the basis of official data.

debt prior to the massive rise in borrowing and service payments that occurred in 1966-1975.

It is interesting that the apparent burden of debt service did not change dramatically after 1965, even though, as noted earlier, payments grew very rapidly; indeed, until 1975, when the ratio rose to 32 per cent, the service coefficient actually remained below that recorded in 1965.

The movement of the debt service ratio was relatively restrained despite sharply accelerating payments, largely because export earnings were expanding as fast as debt payment obligations, or even faster. The year 1975 witnessed an abrupt change in trends, however, as export earnings stagnated because of the recession in the centre countries, while payments rose very sharply (33 per cent) because of the inevitable reverse flow on a rapidly growing mountain of debt. With roughly a third of the region's export earnings claimed by debt service, and prospects of a continued need for heavy borrowing, it is not surprising that 1975 was marked by the beginning of a heated controversy in both the North and the South about the debt problem of developing countries.

The magnitude of the debt problem, and how it relates to the dependency issue, can perhaps be better appreciated if trends are viewed from another, less traditional angle, i.e., that of the manner in which debt payments are really effected.

In order to repay debt, Latin America has had to generate sufficient amounts of foreign exchange. The principal sources of foreign exchange, exclusive of new loans, are exports, direct foreign investment and transfers (private and official). However, in order to determine the real availability of this foreign exchange, net balances must be accounted for, that is, exports less imports, foreign investment less remittances, and transfers net of similar flows going abroad.

Table 5 presents the current annual

Table 5

LATIN AMERICA: NET FOREIGN EXCHANGE EARNINGS, EXCLUSIVE OF NEW LOANS

(Millions of dollars at current prices)

Year	*Trade Balance*	*Direct foreign investment*	*Transfers*	*Total*
1966	100	-360	236	-24
1967	-222	-538	249	-511
1968	-456	-398	201	-653
1969	-4	-330	227	-107
1970	-769	-474	334	-909
1971	-2 095	-222	305	-2 012
1972	-1 674	-79	340	-1 413
1973	-980	340	457	-183
1974	-9 471	521	472	-8 478
1975	-11 205	461	526	-10 218

Source: CEPAL, on the basis of official statistics.

values of the region's trade balance, net foreign investment flows, and net transfers for 1966-1975, the period in which foreign borrowing operations showed a marked acceleration. It is seen that when the net flows are taken together there was a deficit on the resource flow in every year.[16] In other words, foreign exchange income consistently fell short of general payment obligations, not to mention obligations stemming from debt service.

If there was a chronic shortfall of income, how then, it may be asked, did Latin America manage to meet its debt service obligations? The answer is that repayment was effected by securing new loans to cover interest and amortization obligations falling due on older loans, i.e., by a roll-over. Indeed, during the period under consideration, Latin America secured loans in quantities sufficient not only to roll over debt payments, but also to cover the deficit on general payments noted above and to accumulate foreign exchange reserves. The latter phenomenon would lead one to conclude that the remarkable accumulation of foreign exchange reserves after 1966 (see table 6) was generated not by surplus real income, but by foreign borrowing.

Table 6

LATIN AMERICA: ANNUAL NET ACCUMULATION OF FOREIGN EXCHANGE RESERVES

(Millions of dollars at current prices)

1966	*1967*	*1968*	*1969*	*1970*	*1971*	*1972*	*1973*	*1974*	*1975*
262	364	622	840	1 443	-4	2 554	3 381	-772	-2 348

Source: CEPAL, on the basis of official statistics.

The practice of paying off old loans with new ones is not uncommon in development or in commercial finance; indeed, few countries would probably actually want to repay their debt. However, the success of a roll-over policy is highly dependent on the willingness of creditors to respond. Furthermore, as interest is effectively capitalized, the amount creditors must consider for roll-over increases each year, with the pace of the spiral accelerating as interest rates rise and maturities shorten.

[16] The negative resource flow is even larger when the net impact of errors and omissions, national assets, and SDR allocations is taken into account.

Many countries in Latin America are now largely dependent on banks for their roll-over operations. This appears to have made the region more vulnerable, because, as will be seen, the "commercialization" of external development finance has introduced some new and serious complications into debt management and development policy.

B. *Banks and the question of vulnerability*

Banks have in a fairly short time come to dominate the external finance of developing countries. But their institutional and operational framework remains

wholly commercial. This can create complications because a developing country that has a disproportionate amount of finance channelled through banks becomes vulnerable to the exigencies of commercial finance, which are not always consonant with the requirements of development. Moreover, under the adverse conditions prevailing in the world economy today, complications deriving from the commercialization of development finance can become so severe as to threaten the development aspirations of the countries concerned.

The purpose of the following pages is to outline some of the characteristics of bank finance which are seen either to complicate or actually to conflict with the goals of development. The paper will then conclude with some ideas on ways in which the pressures generated by current trends can be relieved.

1. *Variable interest rates on loans*

With regard to interest paid on official finance, rates are usually kept constant throughout the life of a loan. Commercial loans, however, carry variable rates that are adjusted periodically (usually every 6 months) to the movement of LIBOR or a similar interbank rate. This may seriously complicate debt management, as interest charges are subject to the vagaries of financial markets and can rise suddenly without warning, as was the case in 1974, when uncertainties over the oil crisis, inflation, and jitters induced by a series of bank failures all caused LIBOR, and therefore interest payments, to skyrocket.

The available data presented in table 7 show that the London banks' bid rates for Eurodollar deposits --which represent a conservative approximation to LIBOR -- rose from a monthly average of 8.3 per cent in the first half of 1973 to 10.6 per cent in the first half of 1974, i.e., increased by 28 per cent. Even more telling is the degree of variation that is encountered if the low bid of 1973 is compared with the high bid of 1974; at the beginning of the former year the rate was as low as 6.8 per cent, while towards

Table 7

SIX-MONTHS DEPOSIT RATE FOR EURODOLLARS

(Per cent per annum)

		Highest	*Lowest*	*Monthly average*
1973	1st half	9.3	6.8	8.3
	2nd half	11.5	8.8	10.3
1974	1st half	13.4	8.5	10.6
	2nd half	14.1	10.1	11.8
1975	1st half	7.8	7.0	7.5
	2nd half	8.7	6.6	7.7
1976	1st half	7.3	5.9	6.4
	2nd half	6.5	5.3	5.9
1977	1st half	6.3	5.7	5.8

Source: World Bank, *Borrowing in International Capital Markets*, various issues.

the end of the latter it had climbed as high as 14.1 per cent.

Admittedly, the period referred to above was a rather turbulent one in the banking industry, and as seen in the table, fluctuations smoothed out considerably in 1975-1977. However, the point to be made here is that variable rates render countries with heavy commercial debt more susceptible to the shocks of international finance and thereby introduce another element of uncertainty into economic management, already made difficult by the volatile nature of world commodity trade.

It should be remembered, too, that the Eurocurrency market is particularly susceptible to shocks and turbulence in view of the fact that it operates in a kind of regulatory limbo.

As is by now well known, the Eurocurrency market originally developed in a rather *ad hoc* fashion, in part out of attempts of commercial banks to evade financial restrictions imposed by national governments. Thus, the market operates in a free-wheeling environment in which banks are able to escape regulations –such as reserve requirements– that national banking authorities customarily feel it prudent to apply in their domestic financial markets. Consequently, there is at present little information on, or control of, international banking operations.

The lack of control has created problems for many countries, as billions of dollars have sloshed around world markets, often contributing to radical fluctuations in the balance of payments, exchange rates and domestic liquidity. But more importantly, because international banking transcends national boundaries, there is often no clearly-established bank of last resort to bolster institutions weakened by bad loans or investments. This characteristic (which might well be the Achilles' heel of the international banking system), coupled with a high degree of interdependence among banks, can cause international bankers to become nervous over events which would normally be viewed more or less calmly at home. This in turn can be disruptive to Latin American countries dependent on bank finance, since a nervous market usually manifests itself in rising interest costs, and possibly a contraction in the volume and/or the maturity structure of new loans.

2. *Hard lending terms*

Generally speaking, the cost of bank credit is greater than that of credits available from official institutions. Even in the realm of commercial rates, developing countries usually have to agree to accept considerably higher spreads than are commonly granted to the industrialized countries, on the grounds that greater risks are involved. When developing countries borrow at spreads as high as in 1974-1977 (1 1/2-2 per cent or more), they lock themselves into a rate structure which –given the variable nature of interest rates– may involve very burdensome payments. Moreover, spreads often understate effective costs, since recent trends have shown banks willing to conceal margins in a labyrinth of bankers' fees.[17]

[17] Given that spreads are supposed to correspond to the bankers' perception of risk (creditworthiness), countries are often reluctant to have unusually large spreads publicized. In consideration of this concern, bankers often hide margins in the myriad fees that customarily accompany syndication of a loan.

It is true that in many cases the cost of commercial credit is reasonable when viewed in real terms and/or in comparison with the cost of domestic credit. Moreover, if the rate on the loan remains below the marginal return on capital —something that may be hard to ensure, given variable rates— the higher cost can be fully accommodated.

More serious, however, is the problem of the rather short maturities associated with commercial loans. While official institutions commonly offer 20-30 years on their credits, banks extend much shorter maturities; since 1975 they have been in the habit of offering a maximum of 5-7 years on theirs. Loans with such a repayment schedule do not seem generally suitable for project finance, as the number of investments with a payout upon maturity would appear limited. It is possible, of course, for banks to refinance their loans when they fall due, but this is clearly an unsatisfactory and dangerous method of financing long-term capital investment in developing countries; it introduces more uncertainty and makes a country more vulnerable to the changing attitudes of bankers and the variable conditions of financial markets.

It has already been mentioned that in the earlier part of the decade the terms for commercial bank credits could prove to be more favourable, as it was not uncommon for developing countries to attract margins below 1 per cent and maturities in the range of 10-15 years. What is the likelihood of commercial lending terms returning to the levels of the early 1970s? This is purely a matter of speculation, but it is worth noting that there has been considerable resistance on the part of bankers to a softening of terms, as it seems that there is now a new awareness that international lending is not immune from the allegation of "borrowing short and lending long". Indeed, the terms extended during the expansive period of banking may have been a novelty stemming from exceptional circumstances; evidently bankers will (or should) be reluctant to depart radically from their restrictive posture, which is much more in line with traditionally prudent lending practices.[18]

3. *The short-term horizon of commercial finance*

Banks, as traditional lenders of short-term commercial finance, naturally had an infrastructure geared to these operations. Their creditworthiness criteria and analyses reflected this situation, being largely financial, commercial and short-term in nature. These institutions adjusted to the rise in bank lending to developing countries by incorporating more country analyses into their creditworthiness evaluations, but attention was still primarily focused on short-term financial criteria such as exports, inflation rates, money supply, reserves levels, etc.; minimum emphasis was placed on long-term trends and indicators of development *per se*, such as the amount of critical poverty in a country, its employment situation, income distribution, mortality and literacy rates, etc. The trouble is that under these circumstances a country that is heavily reliant on bank credit may be encouraged to pursue a style of development which maximizes indicators of external solvency at the expense of important socio-economic development objectives.

[18] Richard Cummings, "International Credits – Milestones or Millstones", *Journal of Commercial Bank Lending*, January 1975, pp. 40-52.

Another problem associated with the banks' short-term and essentially commercial orientation is that they can have a rather low threshold with regard to the weathering of the debt problems that frequently attack developing countries. When a country first encounters difficulties, banks normally roll over credits because it is in their interest to do so. However, in providing finance they naturally want to minimize their risk, with the result that they extend new credits on a short leash, that is to say with the briefest maturity and a high interest rate. Thus, instead of accommodating a country with terms that help to smooth out payments and provide extended relief, banks generally prefer stopgap financing that often provokes the need for further tinkering and may even contribute to a crisis that makes formal rescheduling necessary. (The latter can be somewhat traumatic and associated with abrupt changes in political and economic policy.)

It is important to note that some of the sharper edges of the commercial orientation of banks may have been blunted slightly by recent trends. As already noted, since the Herrstatt collapse the banking market has been taken over by larger institutions. Some of these banks have had the resources and the good sense to contract senior personnel with extensive experience in development issues; this presumably will help to sensitize top management to the problems encountered by developing countries and the diverse strategies that can be employed to overcome them. But there is nevertheless a limit to how far banks can adapt themselves to the longer-term requirements of development, inasmuch as they are constrained by commercial considerations and the laws of prudent banking; after all, a bank's primary interests are correctly linked to those of its depositors and private shareholders.

4. *Bank involvement in government policy*

One of the consequences of the banks' assumption of the major role in Latin America's external finance is that these institutions have gained enough leverage to exert direct influence on the formulation of government policy. And it is natural for banks to want to exercise this leverage, because when they are involved in broad-based balance-of-payments support, as has been the case since 1974, it is obvious that public policy decisions are a crucial factor in repayment, or, more exactly, requirements for new lending. In other words, balance-of-payments support is generally extended on the basis of the goodwill of government policy.

One of the first open expressions of intent in this regard appeared in early 1976, and is to be found in the following extract from a publication of a major international bank:

> "...It is incumbent on banks to improve further their competence in appraising borrowing countries' economic and financial policies. The Fund (IMF) generally will be involved only in the critical cases where the necessity for internal adjustment is clearcut. But, in the less-than-critical cases, bank credit decisions also involve a judgement on the way an economy is managed and on the prospects for the balance of payments. In deciding whether to extend credits, and in setting the terms and conditions for loans, banks can influence the nature and timing of borrowing countries' poli-

cies. This is a heavy responsibility, and admittedly one which is difficult to carry out, particularly in the face of competitive pressures. However, from the viewpoint of the borrower, the discipline of the marketplace can have an important bearing on whether sound economic and financial policies are taken on a timely basis."[19]

The intent expressed on this occasion was quickly acted upon, as witnessed by the widely-reported case of Peru. In July 1976 a large loan was organized for Peru by a group of big international banks on the condition that an acceptable stabilization programme be adopted. Furthermore, the loan was to be disbursed in two tranches, with the second tranche made contingent on the performance of the programme, which was to be monitored by the country's private creditors.

What appeared to be open involvement in Peruvian public policy generated concern in many circles, largely on account of doubts about whether banks were institutionally equipped to cope with the highly technical and political nature of a stabilization programme. Thus, these banks subsequently retreated somewhat from their original position on direct involvement in government policy. Some of them are now suggesting direct or indirect collaboration with IMF as an alternative way to protect their interests.

The point to be made here is that as long as banks dominate a country's development finance they have *de facto* leverage to exert pressure on public policy, and if it is not used directly as in the case of Peru, they will be tempted to exercise it in a myriad more subtle ways that need not be discussed here. (It must be remembered that banks have a logical desire to protect their depositors and private shareholders.) And involvement in policy, whether direct or indirect, is undesirable by virtue of the fact that banks are commercial and not development institutions. Not only can their short-term commercial orientation be prejudicial to the continuity of public development programmes, but in the exertion of influence on public policy the possibilities for conflicts of interest obviously loom quite large.

C. *Conclusions*

The preceding discussion has shown that the commercialization of external finance places new uncertainties in the path of development and seriously complicates economic management. This in itself is cause for concern, although one might expect that public officials in some of the more advanced developing countries like those in Latin America could perhaps mobilize their talent and imagination to surmount or at least neutralize some of the difficulties associated with dependence on bank finance. However, conditions are not normal; indeed, the heavy reliance of countries on bank finance is in part a symptom of the abnormal events that are having to be faced by Latin America and the developing world.

As is well known, since the oil crisis the international economy has been highly unsettled and plagued by stagflation, high unemployment, grave financial imbalances and a severe and prolonged recession. In such an adverse external environment it is not surprising that even the best-managed non-oil developing economies are finding themselves taxed by

[19] Morgan Guaranty Trust Company of New York, *World Financial Markets*, May 1976, p. 9.

the weight of their commercial obligations. While countries continue to honour these obligations, they do so at the cost of disruptions in growth, in employment and in overall development objectives. Moreover, with little prospect of an early straightening-out of the world economy, more serious problems may develop, as countries are now beginning to feel the impact of the bunching of maturities brought on by the contraction of bank lending terms in 1975.

These conditions alone would suggest that internationally-sponsored corrective measures are in order if serious and ill-afforded setbacks are to be avoided in the Third World. But the argument for a bold multilateral approach to current difficulties is strengthened if one takes it into account that developing countries' commercial debt evolved in rather haphazard fashion and as the result of autonomous forces over which borrowers at times had only limited control.

As noted earlier in this paper, the initial penetration of banks into external finance appeared to be largely supply-led. In the race for marginal earning, banks were extremely eager to extend credit, the attitude of the times perhaps being best summed up in a remark made by one local banker of the region:

> "Foreign bankers wanted to give us money before we asked for it. The Italians had lira for our dam. The French had francs for our steel mill."[20]

And the offer of loans was accompanied by highly attractive terms which proved to be unsustainable. Also, in the eagerness to expand, the institutional machinery for evaluating credits often lagged far behind the ability and willingness of bankers to lend, with the result that sometimes insufficient attention was given to key issues such as the use of credit, facility of maturity transformation, and even the medium-term ability of a country to generate foreign exchange to service its debt.[21]

The excesses of the period were then compounded by the oil crisis. Since the industrialized countries and OPEC were unable to respond with an official multilateral mechanism to handle the recycling of surplus receipts to deficit countries, the job fell in *ad hoc* fashion to the banks. These institutions were therefore forced to assume a role for which they were neither prepared nor well-suited. As a result banks lent and countries borrowed considerably more than they would have considered wise if viable alternatives had been made available to them. Another consequence was that the initial plurality that banks gave to the development finance scene was eroded as they came virtually to control access to credit.

Thus, the justification for international action appears to be strong. First, a commercialized type of external finance is not altogether satisfactory for the longer-term needs of development.

[20] See Everett Martin, "Peru's economic woes are worrying bankers who aid Third World", *Wall Street Journal*, September 1, 1977.

[21] Perhaps the most glaring example of prudence taking a back seat is the much-publicized case of Zaire. This African country has a per capita income of only 140 dollars (1973). Yet banks saw fit to lend this relatively backward country resources in the neighbourhood of 800 million dollars (including guaranteed export credits); much of it seemingly on the basis of the euphoria generated by cyclically high copper prices. When copper prices plummeted, the country found itself unable to repay the banks.

Secondly, the process of commercialization itself was haphazard and lacked discipline. Thirdly, the present state of the international economy is slowly sapping the strength of non-oil developing countries to resist the quantitative and qualitative effects of a highly commercialized finance structure.

What then are the solutions?

On paper the formula is simple. In practice, however, implementation will prove difficult because much depends on the willingness of the centre countries to assume responsibilities which they have shown reluctance to accept. OPEC too, and the deficit developing countries themselves, cannot escape hard decisions.

One solution that has received much attention to date is the need for adjustment by deficit and surplus countries, with its consequent reduction of the need for bank finance. While this proposal has merit, it encounters serious practical limitations for reasons that are well stated by J.A. Kirbyshire, Chief Advisor to the Bank of England:

> "To recognise that there is indeed a large –and continuing– adjustment element in the recent [world] situation is not necessarily to admit that financing has been excessive or that more adjustment should have taken place. That question calls for very difficult judgements, and it is fortunately not my primary concern today. I would only say, against the present background of high world unemployment and rates of inflation, that unless the adjustment can be initiated by the countries which are externally stronger, it is likely to be very costly in terms of world economic activity. On the other hand, if too much of the adjustment is borne by these countries, there is an obvious danger of recrudescense of inflation. If policies destructive of world trade and widespread financial disruption are to be avoided, we may have to err on the side of more financing and slower adjustment than might otherwise seem desirable."[22]

And it can be added to Kirbyshire's remarks that the requirements for finance are likely to remain especially high for deficit developing countries because their ability to adjust is limited by their sheer poverty.

Given the likelihood of continued heavy financing requirements, the first and most obvious measure to relieve problems is for the centre and OPEC to make a determined effort to correct once and for all the glaring imbalance in the types of finance available to developing countries. To this end, a sharp increase in funding of official institutions, especially of the multilateral type, is called for. Funding should be sufficient for these institutions to continue to attend to the very poor and at the same time provide a better response to the financial needs of 'middle-class' developing countries like those in Latin America, which have been marginalized from official finance in part because of the inability of industrialized nations to meet their commitments for international development assistance (1 per cent of GNP). The new 10-billion-dollar IMF facility would be a step in the right direction, although most observers feel that it falls considerably short of financing requirements. Moreover, it will

[22] J.A. Kirbyshire, "Should developments in the Euro-markets be a source of concern to regulatory authorities?", *Bank of England Quarterly Bulletin*, vol. 17, no. 1, March 1977, p. 43.

not be sufficient merely to fund the IMF; the capital base of institutions like the World Bank, Inter-American Development Bank, Asian Development Bank, Caribbean Development Bank, etc., must be greatly expanded so that they can provide much-needed long-term investment funds to developing countries.

In addition to the funding of more official finance, there must also be a reversal of recent trends towards pressure on official institutions to commercialize their lending terms.[23] While some firming of interest rates might be necessary to attract capital, this should be counterbalanced by a softening of maturities; indeed, it seems reasonable that even middle-class countries should have regular access to loans with repayment periods of up to 30-40 years in order to meet their longer-term investment requirements.

Furthermore, official institutions should be encouraged to streamline their operations so that there is less red tape and delay in disbursement of their funds. With regard to balance-of-payments assistance, institutions should design conditionality so that it is more reasonable (especially with regard to the period of adjustment) and accommodates developing countries' legitimate efforts to maintain growth and minimize unemployment and socio-economic dislocation. If conditionality and red tape can be moderated, developing countries will be less tempted to seek out inappropriate sources of finance.

With regard to private finance, industrialized countries should take active measures to give developing countries easier access to their bond markets. To the extent that developing countries have access to private sources of development finance, it is these capital markets which are best suited to cover such countries' long-term investment needs.

The increased financing from official institutions and capital markets will remove pressure from banks, which are now showing clear signs of concern about the share of developing countries' deficits that they are being asked to finance.[24] The banks, while maintaining a high profile in external finance, will then be able to withdraw to the area where they are best equipped to operate, that is, trade financing.

With a rejuvenation of official finance and promotion of readier access to more suitable sources of private investment finance, the middle class of the developing world would have a proper opportunity to select the mix of credit flows —from banks, official institutions, bonds, suppliers' credits, foreign direct investment, etc.— that is most suitable to their needs and level of development.

In conclusion, it may be said that developing countries themselves should

[23] In 1976 some industrialized countries had put pressure on the World Bank to harden its interest rates (even to the extent of charging a floating rate) and reduce the accelerated growth of lending. Meanwhile, official export agencies had been attempting to implement a gentleman's agreement to harmonize (read: reduce competition) on the terms offered to borrowers.

[24] Opposition has arisen to channelling more funds to international organizations on the grounds that this would represent a "bail-out" for banks. While such an argument may be ideologically pleasing to some, it is clearly counterproductive to the interests of developing countries which are suffering from the weight of their external obligations. It is also against the interests of the industrialized countries, because an overburdened banking system can be a source of instability in both domestic and international financial markets.

also revaluate their development strategy of the last 10 years, which has involved very heavy recourse to external debt finance, in an endeavour to see if similar objectives cannot be achieved through greater reliance on national resources and ingenuity.

In many commercially indebted countries domestic policies have perhaps been geared too hard and too long on external debt. In some cases there is room for improvement in the domestic savings effort. In others, monetary and exchange rate policies can be adjusted to eliminate artificial incentives to borrow abroad. A further measure would involve continuation of export promotion activities. And, as some countries in the region have found, there may now be new opportunities for lowering import requirements through substitution.

In so far as countries find it necessary to borrow, they should carefully monitor loans to ensure that conditions for maturity transformation are satisfactory and that the best available terms are secured.

Finally, special attention could be given to the investment strategies of transnational corporations. As noted earlier, there has been a tendency to finance expansion with ever-growing amounts of debt as opposed to equity contributions. Steps should be taken to see if subsidiaries of these corporations can be encouraged to substitute increased equity contributions from the parent firm for some of their foreign borrowing. This would have the effect of transferring some of the pressures of reverse payment flows on foreign private investment capital from debt service —over which governments have little control— to income remittances, which are more pliable and can be influenced by government policy (notwithstanding evasive techniques such as transfer pricing).