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Commercial bank finance from the North and the economic development of the South: congruence and conflict

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The executives of the big private banks feel very satisfied with their growing role in the financing of the less developed countries and furthermore consider that there is a general harmony of interests between borrowers and lenders: a sense of satisfaction which is shared by an appreciable number of economists and officials responsible for formulating policies both in the developed and the under-developed countries.

While he does recognize that there are some positive aspects in the situation, this optimistic attitude is not shared by the author, who maintains that such a general harmony of interests does not exist. The view is based on four main characteristics of private bank loans which are usually in conflict with the interests of development: (i) these loans involve a narrow and conservative interpretation of the criteria for judging the creditworthiness of the borrower countries which does not usually take into consideration efforts to achieve broader economic and social objectives; (ii) they involve strict repayment deadlines which can complicate the management of the debt and, when the case arises, make it impossible to secure debt relief; (iii) there is a tendency for private banks to have brief periods of high liquidity which generate a harmful boom in supply-led loans; and (iv) the private financial market is not competitive and is less than neutral at certain crucial stages in the credit cycle of a country.

After pointing out some serious deficiencies which are to be observed in the present situation, the author devotes the final section of his paper to exploring the alternatives and comes to the conclusion that the world economy should make a better use of the division of labour which has already been instituted in development financing by reviving the importance of loans from multilateral institutions and the private bond markets.

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I

Introduction*

The emergence of private commercial banks as principal lenders to less developed countries

The decade of the 1970s has been marked by the emergence of private commercial banks (herein used interchangeably with "bank" or "banks") as a major force in the transfer of resources to developing countries.[1] In the two preceding decades the external finance of these countries had generally been dominated by official multilateral and bilateral institutions, together with credit from suppliers and direct investments of foreign firms. Banks usually limited themselves to shorter-term finance often associated with trade. However, beginning in the early 1970s the interaction of many factors associated with the supply and demand for international finance generated conditions whereby banks rapidly expanded the volume of their lending to developing countries and there was a qualitative change in the relationship between bankers and the government authorities of less developed countries (LDCs).[2]

As an illustration of the nature of the change in the role of banks, it can be pointed out that in 1970 they accounted for roughly 19%

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[1] Actually, this might be better termed the re-emergence of banks, since prior to the great financial collapse of 1929 these institutions had been significant lenders to Latin America and other developing regions. See Davis, pp. 6-21.

[2] By now there is some literature that covers —in varying degrees of comprehensiveness— the recent rise in bank lending to developing countries. See Beek, Devlin (first half of 1978), Gorostiaga, Kapur, Lissakers, Sargen, Wachtel, Watson, Weinert (1973 and 1978) and Wellons (1977).

of the total current account finance (including reserve accumulation) of the non-oil-exporting developing countries, most of which was of a short-term nature (maturities of less than one year). By 1974, however, banks generated 33% of this finance, with the bulk of the transactions falling into the medium and long-term category (maturities of 1-5 and greater than 5 years, respectively). With some increase in lending by official agencies in the post-oil-crisis period coupled with the moderation of current account deficits, the banks' participation has now slipped back somewhat to between 25% and 30% of the total. Again medium and long-term transactions predominate.[3]

As it has now become customary to point out, the structure of commercial bank lending is by no means symmetrical. In absolute terms, most of the lending has gone to the upper-income developing countries, especially those of Latin America. As may be seen in table 1, Latin America accounts for nearly two-thirds of the gross indebtedness of the non-oil-exporting developing countries to commercial banks, and almost all of the net indebtedness. While the bulk of this debt is accounted for by Brazil and Mexico, other countries like Peru, Chile, Argentina and Colombia are also important clients of international banks.

The relative weight of banks in the structure of these countries' external finance has likewise become considerable. In 1966-1970 the average net contribution of banks to the current account finance of Latin America was only slightly greater than 12% of the total, but by 1974 banks accounted for more than two-thirds of net flows, and in 1976, despite new lending by international organizations, the bank contribution was still nearly 50%.[4]

Thus, the issue of bank lending to developing countries is largely associated with the upper-income group; lower-income LDCs have had only limited access to credit from banks and basically remain dependent on official concessionary finance.

The much higher profile for commercial banks in external finance has brought many tangible benefits for both lenders and borrowers: for example, for banks it has meant substantially increased earnings,[5] and for the

Table 1

INDEBTEDNESS OF NON-OIL-EXPORTING DEVELOPING COUNTRIES TO PRIVATE COMMERCIAL BANKS AT END OF DECEMBER 1977[a]
(Billions of dollars)

	Latin America[b]	Middle East[c]	Africa	Asia[d]	Total
Gross	71.1	1.9	14.0	21.6	108.6
Net[e]	36.2	−7.1	3.0	−1.2	30.9

Source: Derived from data in the Bank for International Settlements, Basle: *Forty-Eighth Annual Report*, 12 June 1978, pp. 94-95.

[a]Includes short-term debt.
[b]Excludes Caribbean area and Panama.
[c]Excludes Israel. Residual estimate.
[d]Excludes Hong Kong and Singapore.
[e]Debt less deposits in the banks.

[3]The data just cited are from Watson, table 2, pp. 12-13.

[4]See Massad and Zahler, table 1, p. 4.

[5]See Watson, p. 37 and Lissakers, pp. 10-11.

countries a significant influx of resources for development.[6] All is not well, however, as the dependence of developing country borrowers on commercial banks appears to have gone beyond prudent bounds. The focus of concern is not on the issue which has received most attention to date, i.e., the ability of borrowing countries to repay their debt and the ability of banks to absorb such risks. There is little question that in one way or another countries will continue to repay their obligations and accept the costs of doing so.[7] Rather what is of concern here is the qualitative impact of bank lending on the process of development.

The problem arises from the fact that the willingness of banks to lend extensively to developing countries has reduced pressures on the industrialized nations to support official institutions and has contributed to the long-term stagnation of funding from this source.[8] Thus, banks have not merely increased the finance available to developing countries but have also effectively displaced official institutions as the major agent for the transfer of resources to the South. Moreover, the displacement has not only been in terms of the volume of lending, but also in terms of functions, as banks have gone beyond strictly commercial lending and entered into the usual domain of official institutions, i.e., balance-of-payments support, infrastructural project lending, general programme lending, etc.

This situation gives rise to a dilemma because commercial banks do not appear to be an appropriate primary agent of finance for developing countries. Private commercial banks, as their name implies, are not development institutions and their private commercial time and risk preferences make it difficult for them to provide finance in ways which satisfy the broad socioeconomic goals of development. When external finance becomes commercialized, as it is today, this asymmetry becomes dangerous, placing strains on the development process and perhaps even on the world banking system itself. Thus, analysis will suggest that officials in the North should be less complacent about the preponderant presence of banks in development finance and that the current situation requires a more courageous stance in the North that will foster appropriate funding of the current account balances of developing countries.

II

Lending to LDCs: The view of bankers

The increased presence and power of international commercial banks in development (and world) finance has not gone unnoticed by these institutions. Through eloquent spokesmen banks have entered directly into the debate about their role in developing country finance, to which their attitude is usually very positive.[9] Their arguments are generally focussed according to their specific audiences.

When addressing themselves to the public in their own home countries the banks stress the over-exaggerated nature of the concern about their lending to developing countries, assuring their audiences that the bulk of the lending has been to creditworthy, semi-industrialized economies; that most loans have been of a short to medium-term nature and/or have carried external guarantees of the industrial-

[6] See Devlin (first half of 1978), pp. 68-79.

[7] Economists and banks in Northern countries have gone to great lengths to prove empirically that developing countries are indeed capable of paying off their debts. See, for example, Smith, Brittain, van B. Cleveland and Brittain, and Solomon. Also see Lewis, chapter 9, for an interesting perspective on the debt problem.

[8] Between 1965 and 1975 there was no real growth of official lending. See OECD, p. 153.

[9] See, for instance, Watson, Friedman, and van B. Cleveland and Brittain.

ized countries; that debt growth in the developing countries in real terms has been reasonable and is serviceable; that the record for loan losses abroad has been considerably better than that at home; and that in any case the exposed assets represent a relatively small percentage of the total loan porfolio.

When addressing officials in developing countries, banks emphasize that their presence has greatly increased the resources available for development; that their involvement in the recycling of oil surpluses has helped to avoid a drastic adjustment process; that unlike official institutions; loans from banks are quickly arranged and disbursed, are not tied to the purchase of any suppliers' goods and are of a non-political nature, based on the merits of each case; and that due to a competitive environment, borrowers enjoy the freedom to "shop around" for credits, thereby obtaining the best available terms. Finally, while banks admit that they are basically limited to short and medium-term finance, they add that they are interested in long-term relationship with creditworthy customers, so that in effect, through the continuous rollover of shorter-term credits, these funds can "perform a function similar to long-term funds".[10]

The same spokesmen see the increased participation of banks in development finance as being "demand driven", with banks responding on the basis of "normal" credit criteria.[11] Furthermore, its is claimed that —because of the benefits noted previously— "developing countries want private banks to play a significant role in their development process...".[12] Indeed, the perceived harmony of interest has been expressed on one occasion in the following way:

"The benefits of becoming —and remaining— creditworthy in the private bank markets are now seen in most developing countries to be of major proportions. In these countries, it is seen that policies needed to maintain external creditworthiness with banks are also needed to meet national development objectives. It is the maintenance of the country's economic development that is the prime purpose of policy measures, but if it also accomplishes availability of private credits, the process of development is greatly facilitated."[13]

But just what is creditworthiness? While it is seen to vary among banks, there are some common elements which are worth examining.

The concept of creditworthiness puts a premium on the availability of foreign exchange to service the debt; when an economy is run in such a way as to ensure availability this is termed "good management".[14]

Logically, then, when bankers are scrutinizing a country's creditworthiness, great emphasis is placed on external liquidity indicators such as the various components of the balance of payments, debt service, the level of foreign exchange reserves, inflation, domestic credit and exchange rate policy, etc.[15] External debt management also is important, as is industrial growth and a country's treatment of foreign investment.[16]

As a tacit recognition of the still immature state of the art,[17] most spokesmen stress the ongoing need to improve techniques of creditworthiness analysis. As part of this process, many banks, especially the larger ones, have been raiding the ranks of development institutions in an effort to recruit more personnel with relevant experience in country and development economic analysis.

As well as recognizing the need for more effective evaluation of creditworthiness, bankers have also become concerned once again about conditionality. In the 1950s and 1960s banks had been cautious, limited and conditional lenders to developing countries, with conditionality itself often linked to IMF standby agreements. But in the exceptionally competitive environment of the early 1970s, funds were lent to developing country governments with few, if any, reservations; project

[10]Friedman, p. 39.

[11]See Friedman, p. 48 and Watson, p. 27.

[12]See Friedman, p. 61.

[13]*Ibid.*, p. 66.

[14]See Friedman, pp. 24-29; Watson, pp. 42 and 45.

[15]This is clear from a review of the criteria of banks. See Goodman, *Asian Finance*, BOA Methodology, Brackenridge, Anderson, and Wolfe. Also see Friedman, pp. 24-30 and Watson, p. 42.

[16]Friedman, pp. 47 and 53.

[17]The relatively primitive state of the art is clear from the Goodman survey and research presented by Blask.

loans often received little or no scrutiny, and large amounts of freely disposable funds were contracted by LDCs, all seemingly on the security of borrower government guarantees.[18,19] However, the massive accumulation of bank debt by the developing countries in 1974-1975, coupled with the fragile external position of many of these countries, helped to bring back a trend towards conditional lending. Also important in the return to a more traditional conservative posture was the bankers' concern about the very viability of the international banking system itself.[20]

At first —seeing that the volume of their loans dwarfed lending by official agencies— the banks felt confident enough about their leverage to entertain ideas of extending conditional balance-of-payments assistance on their own.[21] The most celebrated test case was Peru, where in mid-1976 a large group of international banks agreed to support a stabilization programme in which an umbrella IMF standby credit was conspicuous by its absence.[22]

The Peruvian loan agreement generated a heated political debate about the advisability of international banks entering directly into the economic policy of developing countries. In response to this criticism, the banks once again withdrew to more familiar terrain by making their loans to "problem" countries conditioned upon an IMF standby agreement. While bankers are quick to point out that the Fund's conditions are not necessarily sufficient for private banks' creditworthiness criteria,[23] in practice standby agreements have come to serve as the "green light" for bank lending, thus conveniently passing the political embarrassments generally associated with "adjustment" onto the international organization.

Since the Peru affair of 1976, a clear strategy has been evolving for dealing with countries that have debt service problems. As just mentioned, first and foremost is the condition that a country must call in the IMF for a standby agreement. Until such an agreement is arranged, the banks will refuse to grant any new credit, other than perhaps very brief rollovers (often with maturities of only several months). Moreover, the rollovers are often granted only at the last minute and just prior to payment deadlines in order both to place pressure on government authorities to submit to the IMF conditions and to prevent outright default, which banks in any case want to avoid because of the adverse effect this might have on their annual financial statements.[24]

In situations where borrowing governments seek some form of debt relief, banks have a rather special view of their role in such operations. Official lenders —through the *ad hoc* Paris Club mechanism— will generally (although sometimes reluctantly) reschedule debts over a medium to long-term period. Banks, however, see things differently: a fundamental distinction is made between debts to official creditors and private creditors, and it is

[18]This is starkly clear from the author's study (available late 1979) of the evolution of commercial bank lending to the government of Peru over the period 1965-1976. In the latter half of the 1960s, loans were heavily secured and/or conditioned by policy limitations, especially with regard to contracting new debt. Furthermore, loans were often linked to an IMF standby credit. However, by the early 1970s credits were essentially devoid of any conditionality and many were of free disposal, i.e., with no *ex ante* purpose stated in the loan agreement. Maturities and interest spreads (margins on top of floating bank interest rate) were also considerably more favourable. As Weinert (1973, p. 37) has pointed out, there is no way this transformation in lending behaviour could have been justified by changes in the economic circumstances of Peru. For information on the scope and goals of the Peruvian project see Devlin (February 1978).

[19]The expansive (some have even said reckless) attitude of this rather unique period of world banking is well summarized by Cummings. Also see Wellons (1977), p. 24.

[20]During the first half of the 1970s many banks overextended themselves both on loans and foreign exchange transactions. This was manifested in the failure of Bankhaus I.D. Herstatt on 26 June 1974, followed by Franklin National Bank later in the year. Both banks went bankrupt due to bad management of foreign exchange transactions.

[21]See, for instance, Morgan Guaranty Trust Company (May 1976), pp. 8-9.

[22]See Belliveau. It should be pointed out that the Peruvian representatives asked the banks to participate in a stabilization programme because political considerations made the Government unwilling to undergo IMF scrutiny, (see, in Belliveau, the interview with the then Central Bank President Carlos Santistevan). In 1976 the banks also lent to Argentina on the basis of an economic programme. Information about this less publicized case appears in Biem, p. 724.

[23]See Friedman, p. 53.

[24]See the February, March, May and June 1978 issues of *The Andean Report* for a good description of how the banks used short rollover credits as a way to pressure the Peruvian Government into an agreement with the IMF.

held that private debts must receive the highest priority and be serviced as originally scheduled.[25] Thus, debt relief from banks is to be avoided because "rescheduling of debt due to private banks will seriously damage a country's creditworthiness with private lenders, and will therefore impair future access to needed private capital".[26]

This attitude is reflected in private banks' dealings with developing countries. When Zaire requested a 10-year rescheduling of the principal of private bank debts in 1976 —an agreement which would have paralleled that granted by creditors of the Paris Club— the banks resisted. Instead they proposed to "restore Zaire's creditworthiness" by having the country clear up its accumulated arrears, after which, upon fulfilment of some other conditions, a new loan would be extended to refinance upcoming payments to the banks.[27]

In another case, when Peru sought debt relief in 1978, banks again chose an independent route. The Paris Club creditors agreed to reschedule 90% of the 1979-1980 payments over a 7-year period; the banks, on the other hand, granted a rollover credit for 1979 payments of principal and then agreed to convert it to a 7-year balance-of-payments loan in 1980. Principal payments due in 1980 are to be rolled over until 1981 and then converted into a 6-year loan.[28] Maintenance of an IMF standby accord was a condition for the rescheduling by the banks and the Paris Club.

Notwithstanding difficulties with "problem" countries like Jamaica, Nicaragua, Peru, Zaire, etc., banks are generally eager to continue their role in the external finance of developing countries, although they would not mind seeing greater funding from international institutions so as to move towards "at least a partial restoration of the traditional balance between official and private financial flows".[29] They feel that this in turn would help to enhance the creditworthiness of borrowers and allow banks to maintain the volume of loans to developing countries. In addition, some bankers have suggested that there should be a greater flow of country information to banks from international institutions such as the IMF;[30] as indicated earlier, however, most bankers have shied away from the idea of formal co-operation with such institutions on the grounds that banks must maintain their freedom to make independent judgements about the creditworthiness of a borrower.

III

Bank lending to LDCs: Some reservations

Bankers are certainly not alone in the sanguine view they take about their role in development finance: a majority of policy-makers and economists in the industrialized countries and a significant number in the developing world seem to share their enthusiasm about lending to LDCs. Such criticism as there was in 1975-1976 —coming mostly from the Centre and concerning the risks of LDC default— has waned considerably in more recent years, permitting bankers to entertain strategies for the global manipulation of resources for development.

There is little doubt that many of the virtues that bankers extol concerning their new role in the external finance of developing countries make good sense and few reasonable peo-

[25] See Friedman, p. 69.

[26] *Ibid.*

[27] See Biem, p. 727 and Friedman, p. 71. As of May 1979, the new loan had still not been organized.

[28] The refinancing operation covers 90% of the scheduled repayment. The interest rate on the first credit is 1.875% over the London Interbank Offer Rate; interest on the second credit is still under negotiation. *Source:* unpublished data secured from the editor of *The Andean Report*. Also see *Banco Central de Reserva del Perú*, pp. 48-49.

[29] Watson, p. 8. Also see Brackenridge (p. 53), Anderson (p. 44) and Friedman (p. 81).

[30] See Watson (p. 70) and Brackenridge (p. 53).

ple would want to disagree with them. For instance, banks clearly are efficient intermediaries of financial resources, there being no better testimony to this than the way in which they skillfully managed the recycling of the OPEC surplus. Banks have also proved to be highly flexible lenders whose interest rates are indeed reasonable in real terms. Nevertheless, the picture that they paint about an overwhelming harmony of interests is an excessively optimistic one which hides some serious deficiences in the current nature of finance for developing countries.

Rather than noting a general harmony of interests, from another angle one can see a number of important asymmetries between what is good for the banks and what is good for development, using the latter term in its most far-reaching sense. The impact of these on the developing world was minimized in the 1950s and 1960s by the fact that banks were simply not in the front line of development finance. However, with their emergence as important lenders to the Third World —and principal lenders to the upper-income developing countries— the contradictions have become more apparent and, of course, more threatening to the process of development. The following paragraphs will bring out some of these problems.

A. *Banks: a conservative influence on the development policy*

There are several factors which seriously restrict the time and risk preferences of banks.

First, they are profit-oriented institutions which operate on the basis of private rates of return. They can internalize social rates of return on their lending only to the extent that these enhance the former, but, the gestation period for any such feedback process can be very long.

Second, a great deal of bankers' resources come from call or short-term time deposits. The short-term deposit base places a limit on the degree to which banks can prudently mismatch maturities, i.e., lend long on short funds. Thus, the nature of the resource base gives these institutions only a short and at most a medium-term time horizon with regard to lending.

Third, as bankers will readily admit, they have a special concern for minimizing risk and avoiding losses. This orientation is partly a matter of tradition, but it also reflects the reality that banks operate with other people's money and must ensure the safety of deposits if access to resources is to be maintained. This leads to a conservative view of life where "caution and prudence" are the watchwords for international lending operations.[31] When viewing prospective loans to developing countries, bankers are naturally primarily interested in the prospects for repayment. It is not surprising, then, that liquidity indicators dominate creditworthiness criteria; good management is synonymous with insurance of liquidity to service debts, even if this means deflation of the local economy to free foreign exchange.

Thus bankers are by nature conservative businessmen. This was of little importance when their role in channelling resources to developing countries was secondary or tertiary, as their power to influence events was limited, but today they dominate finance and their opinions and actions can have a considerable impact on the development process.

When viewed from a global perspective, it becomes clear that bankers' individual time and risk preferences —which may be perfectly rational from the standpoint of an individual institution— may distort the allocation of world resources to developing countries. This has been well expressed by Albert Fishlow, who rightly points out that private credit decisions will not necessarily lead to an appropriate level and distribution of international purchasing power:

"Capital markets do not settle by themselves at a unique interest rate that determines the distributions of all the surplus to the most productive users. Instead private loans go to selected and favoured borrowers. Perversely, lack of need facilitates access to capital. It is easier to borrow for reserve acquisition than for imports, easier to borrow when there is surplus foreign exchange rather than a shortage."[32]

[31] See Friedman, p. 79, and Greene, p. 199. For a brief period in the early 1970s there was a breakdown in this cautious tradition of international banking.

[32] Fishlow, p. 137. Guido Carli, a former President of

Moreover, bankers can not only generate a less than satisfactory global distribution of resources but can also contribute to a skewed distribution at the level of an individual developing country. Of course, bankers are not responsible for the allocation of the resources of a country: this task is undertaken by Third World policy-makers. But they can nevertheless seriously affect the decisions of such policy-makers, in several ways.

First, in a situation where commercial banks dominate external finance there is only limited access to other types of funding. Thus, the cost and shorter maturities of bank finance become a relative constraint on the possibilities for the prudent utilization of external resources in the local economy.

Second, when bankers are the primary lenders to an LDC government, they have considerable leverage and can exert pressure —either directly or indirectly— on policy-making. The situation is analogous to the impact that a bank can have on a heavily indebted corporation, for through their financial leverage bankers can steer policy in the direction of conservative financial management at the expense of bolder objectives.[33] Bold objectives for a corporation are profit maximization and expansion; in the case of a developing country the corresponding aim is the rapid maximization of development potential in the context of the enhancement of the material (and spiritual) well-being of the general population.

It should be emphasized that development, by its very nature, must be a very bold process. Often policy-makers must be ambitious and assume large future risks in order to avoid stagnation, human suffering and social disruption today. This is particularly true in a democratic developing country where competing demands on limited resources can be more easily and effectively expressed, thereby forcing authorities to seek "consensual" rather than "optimal" economic programmes.[34] However, a country that is heavily reliant on commercial bank finance will undoubtedly feel pressure in favour of a conservative policy that places priority on a strong balance-of-payments performance and reserve accumulation, often at the sacrifice of broader-based development objectives. This is so because programmes oriented towards the satisfaction of basic needs and income distribution —which are undoubtedly key ingredients in real development —usually weigh heavily on the balance of payments and reserves.[35] Bankers are unlikely to be impressed by reduced unemployment, improvements in health care and social well being if these are gained at the expense of a country's external liquidity position. Thus, Third World financial managers who are preoccupied by their countries' creditworthiness may be tempted to place basic needs and balanced income distribution at the margin of public policy. It is not surprising that many of the banks' favourite developing countries are considered by many observers to be highly authoritarian régimes whose socioeconomic policy is not characterized by a primordial concern for social justice and economic and political participation.[36]

It should also be noted that bank finance is exceptionally well placed to exert pressures because of the rather short maturity structure of the loans. The asymmetry between the long-term requirements of development and the short-term nature of bank finance means that bankers are continuously being asked to roll-over their credits, which is a terribly awkward way to accomodate the gestation period of development programmes. Not only are countries repeatedly exposed to the volatile nature of the terms offered on international financial markets, but they must also regularly pass under the cautious eye of their bankers, whose confidence must be maintained if roll-overs (and / or transfers) are to be achieved.

Italy's Central Bank, has expressed a similar concern. See Carli, pp. 20-21.

[33]See Kotz, p. 142. Also see Hayes, pp. 117-118.

[34]In an authoritarian régime, the demands of the masses may not find effective expression at all.

[35]While in theory a reform / basic needs approach to development is not necessarily inconsistent with a healthy balance of payments, the state of the art of public policy making in developing countries is unfortunately such that in practice one has tended to prevail over the other.

[36]Bankers do not necessarily prefer authoritarianism, it is just that this type of régime can more easily ensure

B. *The primacy of repayment schedules*

Another example of the less than complete harmony of interests between banks and developing countries is the rigid way in which bankers view repayment schedules.

Bankers tend to take a dim view of the strategy of renegotiating terms on old loans by contracting new refinance credits that take advantage of favourable changes in conditions on international capital markets. As expressed by one spokesman: "It goes without saying that refinancing is undertaken by most banks... only very reluctantly and only for customers with whom... (they) have excellent long-term relationships".[37]

To discourage prepayment strategies —liquidating in full outstanding old loans with receipts from cheaper new loans— banks often provide for quite sizeable penalty fees for prepayment in their contracts. In the case of Peru, for example, over 60% of all medium-term commercial bank credit to the public sector during 1971-1976 carried a prepayment penalty, typically ranging between 2 1/2 and 1/2% of the amount prepaid, depending on the contractual year in which prepayment was effected.[38] Another tactic involves "moral suasion", by which it is made perfectly clear to the borrower that any attempt to refinance or prepay would create great displeasure at the bank.[39] This latter strategy can be quite effective the larger the bank involved and the greater the country's reliance on commercial credit. Finally, in some instances banks have even been known to include clauses in their contracts which actually forbid prepayment, although few sophisticated borrowers are likely to fall victims to this tactic.

Some countries are more successful than others in circumventing bankers' reluctance to refinance, with the incidence of success increasing the higher the liquidity in the market and the more attractive the customer.[40] However, it is distressing that such obstacles prevail, because prepayment and refinance strategies are important tools to developing countries which permit them to assuage some of the impact of the surges in interest charges and contractions of maturities that can occur on private credit markets.

This is not to imply that prepayment or refinancing is a "right" of the borrower. Such strategies are undoubtedly troublesome to a bank: not only does it lose a profitable loan, but it also receives unwanted liquidity, unless it participates itself in the new credit. Moreover, a bank cannot call for *ex post* adjustment of terms on an old loan when market conditions shift in its favour. Nevertheless, what appears to be rational behaviour on the part of an individual bank, could be detrimental to all concerned from a broader perspective, because a developing country borrower that can trade in old loans for more favourable terms is a better overall credit risk and generally has increased capacity to assume new debt.

Bankers are even reluctant to depart from repayment schedules at times when countries are experiencing serious debt problems (as opposed to mere short-term liquidity problems). As shown earlier, banks reject any move to reschedule older loans, opting instead for new loans that are heavily conditioned, carry short maturities and are loaded down by high interest charges and heavy fees. For instance, the US$ 400 million of refinance credits granted to a financially hard-pressed Peru in 1976 were for 5 years (2 years' grace) at a spread of 2.25% over the London Interbank Offer Rate (LIBOR) and with accumulated flat fees of more than 1.5%.[41] And when Peru sought a general rescheduling of its debt in 1978, banks instead responded with an offer for new refinance credits. As already noted, the 7-year maturity on the new loans matches the terms of the Paris Club accord; however, it is preceded

conditions that provide favourable prospects for repayment of loans.

[37] See Benney, p. 57.

[38] The figures are from field research of the author. See the project cited in footnote 18.

[39] Brazil, which in 1978 was greatly interested in ridding itself of some costly loans, has been a victim of this strategy. See Evans.

[40] See *Euromoney*.

[41] A spread is a margin of points added to a floating base interest rate, usually the London Interbank Offer Rate, Flat Fees are a one-time percentage charge on the face value of a loan. The figures are from field research of the author. See the project cited in footnote 18.

by two years of "short leash" rollovers, which is a convenient way to maintain leverage over government policy during the difficult 1979-1980 period.

From the viewpoint of an individual bank it is no doubt sound business to extend new loans with high spreads and short maturities to countries with debt problems: a premium commensurate with perceived higher risks ensures profitability, shorter maturities minimize risk and increase leverage, and a new loan ensures that "problem" credits do not appear on annual financial statements. However, from the standpoint of development, a debt crisis merits long-term rescheduling — longer even than the Paris Club is accustomed to offering— on moderate terms so that payments can be really smoothed out instead of just being postponed one or two years, after which they can soar up again quickly to cause renewed damage.[42] Also, rescheduling should be viewed as a convenient and desirable way of rescuing developing countries, instead of carrying the pejorative connotations it does today.

C. *The intermittently very active supply curve*

As mentioned earlier, bankers generally see their increased role in development finance as being "demand driven", i.e., a result of their having responded to the "demands" of developing countries. This is a clever ploy because bankers who advocate this position can elude responsibility for any ensuing problems that might develop with regard to repayment. One can imagine the response to a request for debt relief as being something along the lines of the following: "it was you who sought the credit and it is not our fault that you are now having difficulty in repaying it".

But bankers are often more deeply involved in the repayment problems of developing countries than they would lead many to believe. To some degree the current burden of payments of developing countries reflects the effect of the uniquely permissive lending environment of 1972-1974, followed by radical retrenchment in 1975-1976.

The period 1972-1974 was a time of high liquidity when banks were aggressively competing for new customers in the developing world. Actually, developing countries were caught up in the tail end of an accumulating wave of expansion of international banking that began in the late 1950s, led by large US banks, and was followed in the 1960s by the Europeans and in the 1970s by the US regional banks and the Japanese banks.[43] In the early 1970s the possibilities for continued rapid growth of lending to the industrialized countries were becoming exhausted, aggravated by a recession in the Centre in 1970-1971. In an environment of high liquidity and severe competitive pressure for growth of assets, lending consequently spilled over into the developing world, but even so the race for volume and marginal earnings greatly intensified, causing interest margins to decline drastically and maturities to reach unprecedented lengths. Developing countries, naturally enough, were eager to take advantage of these unusual conditions. When the OPEC oil surplus started flowing to the banks in late 1973, these institutions were even more eager to lend, while deficit-burdened countries were, of course, ready borrowers, especially as conditions were very favourable, with margins that had fallen below 1% and maturities that could easily range up to between 10 and 15 years.

Expansion of lending to LDCs continued at a very heated pace until mid-1974, when a series of important bank failures —derived from poor management of foreign exchange trading— marked an end to this euphoric period of lending. Nervous bankers quickly reappraised their international strategies and became much more selective lenders. Moreover, terms became very onerous, as margins for developing countries rose to 2% or more and maturities shrank to the point where a term of over 6 years was uncommon and loans for more than 10 years simply became impossible to obtain.[44] This severe contraction of terms on

[42] See Corea, pp. 72-73.

[43] For a good analysis of how and why US banks were in the vanguard of the "internationalization" of world banking, see Robinson, and also Lissakers.

[44] See Devlin (first half 1978), pp. 77-79.

lending contributed to a bunching of maturities and consequent debt service problems in recent years. Bankers maintained their highly restrictive terms on LDCs up to 1978, when margins again began to decline and maturities to widen as the bankers' resolve for prudent pricing of loans was eroded by the pressures of continued liquidity.[45]

The point to be made here is that the first half of the 1970s was a high-pressure period in the history of world banking and a time in which the supply side sometimes led events. The general environment of the times has been characterized by some financial men themselves as being one of "supercharged credit expansion"; a "glad-handed, name-your-price approach" to credit extension.[46] And the result was that some countries were literally deluged with offers of credit.[47]

Even more important to this analysis is the fact that during the expansive phase bankers often paid little attention to the end-use of the credit, i.e., it made little difference whether credit was for military hardware, commercial aircraft or steel mills. Indeed, many banks did not have the infrastructure to evaluate credits and thus usually relied on the security of a sovereign government guarantee, itself evaluated to a large extent by "feel", other subjective criteria, and even rumours.[48] Standards continued to be lax during the early stages of the petrodollar recycling process, as banks tapped resources at relatively low interest costs and reloaned them at high interest rates and high placement fees.[49] In this type of environment only relatively sophisticated borrowers could resist bankers' overtures: for those which couldn't, like Zaire, Peru and Jamaica, the consequences are well known.

Thus it seems that bankers are not completely innocent with regard to the current debt problems of developing countries: indeed, they appear to be at least partly to blame for present circumstances and it would seem justified to expect them to take a lenient attitude on any future rescue operations. It must also be remembered that commercial banks' profits on international operations were phenomenal in the early 1970s, due in no small part to the profitability of business with LDCs.[50] Indeed, in view of the fact that risk premiums have been charged on LDC loans, might there not even be room in some cases to absorb moderate losses on future rescue missions?

D. *Commercial banks are not always competitive and neutral*

International banking is often seen as being a highly competitive operation where institutions vigorously seek business on non-political terms. Carlos Díaz-Alejandro has gone even further and has described the Eurocurrency market as "standoffish and remote", so that it provides LDCs with greater opportunities for "national self-determination"[51] than is available from the sometimes politically influenced lending of official agencies.

The above view appears to be true of one point in the credit cycle, but not so much of others.

It is clear that bankers are most attracted to "virgins",[52] that is, countries not excessively burdened by external debt, not heavily represented in the portfolio of an individual bank, and perceived at the same time to be creditworthy. At this initial stage in a country's credit cycle —a position many developing countries enjoyed in the early 1970s— banks may very well compete vigorously to attract potential business, thus giving the country excellent opportunities for bargaining on the amount, costs and terms of credit. Moreover, at this

[45] A major factor behind the liberalization of borrowing conditions was the behaviour of the Japanese banks. Unnerved by the uncertain events of mid-1974, they participated in a mass withdrawal from the market place, helping to tighten the borrowing environment. However, by 1978 Japan's accumulating balance-of-payments surpluses fostered a re-emergence of these banks. They returned with a vengeance, and their aggressive approach to bidding for new business helped to drive interest rate margins down to levels that many bankers thought to be imprudent.

[46] From an interview with bankers quoted in Hayes, p. 49.

[47] See Devlin (first half 1978), pp. 77-78 and p. 94.

[48] See Weinert (1973), p. 35. Also see Wellons (1977), p. 24.

[49] See Hayes, p. 297.

[50] See Lissakers, pp. 10-11.

[51] See Díaz-Alejandro, pp. 188-197.

[52] This term came to my attention in a conversation with Arturo Porzecanski.

stage bankers are unlikely to be concerned about the use of a loan. The actual degree of competition experienced will depend on many other factors such as the liquidity of banks, the number of institutions operating in the international market, the general business psychology of the time and the quality of the creditworthiness of the borrower. In the case of the latter factor —in view of the way creditworthiness is viewed by banks— the willingness of these institutions to extend credit will probably be inversely related to the country's need for credit.

All things being equal, the more commercial credit paper that banks accumulated on a given country, the more their exposure becomes a consideration and the more their eagerness to compete for new business may wane. The bargaining position of the borrower is correspondingly eroded, and bankers even may become concerned about the use of credit.[53] The degree of erosion, for its part, depends on other variables. If many new banks are entering the international market, this may compensate for the waning interest of other institutions. If liquidity surges and no new attractive customers appear, bankers may have no choice but to compete for existing customers. If a country's creditworthiness somehow improves, bankers may then be willing to absorb more exposure, thereby favourably affecting the competitiveness equation.[54]

If a country that has borrowed from banks loses its creditworthiness there is simply no competition at all: indeed, there may be a quasi-monopolistic situation that absolutely limits access to credit and encourages the market to intervene in the domestic affairs of the borrower. While no one could reasonably expect banks to compete for an uncreditworthy country, this type of situation is an important consideration that is often overlooked by those who are awed by the competitive environment of Eurocurrency lending. It must be remembered that developing countries, facing as they do volatile external markets and/or sensitive domestic socio-political and economic conditions, are especially prone to the external balance-of-payments crises that can cause them to fall out of grace with banks.

When a country exhibits serious external problems and faltering liquidity, banks will cease to compete to lend it money and its access to new commercial credit is effectively cut off. It is now a "problem" country and bankers actually collude in search of ways to insure that they will not individually and collectively incur losses.

A good example again is Peru. In 1976, when Peru was seeking a large balance-of-payments loan (really a refinance credit) to bail out its external accounts, its major private creditors formed a Steering Committee to negotiate with the government. Such a committee is undoubtedly an efficient way to organize negotiations, for without central co-ordination chaos could prevail. Nevertheless, this does not alter the fact that public officials faced an uncompetitive environment, as the banks that composed the Steering Committee negotiated in a block and represented most of the more than 100 banks which had lent to the government. All banks demanded identical conditions on the refinance credits, and Peru could not realistically turn elsewhere for credit, since the block represented nearly all the major international lenders. The collusive nature of the negotiations is confirmed by the fact that the syndicates formed were not of an international character; regional groups of banks —Americans, Canadians, Europeans, Japanese— banded together to enforce individual credit agreements which all displayed the same lending terms and *verbatim* formulation of many of the convenants.[55] Later, in 1978, when Peru sought to reschedule its commercial debts, the banks formed another Steering Committee.

[53] Until liquidity considerations led to the swamping of the market in mid-1978, Brazil may have faced a less competitive environment as a result of its paper having flooded secondary markets. In 1977-1978, when some developing countries were experiencing declining margins on their loans on account of increasing liquidity in banking circles, Brazil was still paying rates closer to those which had prevailed in the stiff environment of 1975-1976.

[54] Regulatory authorities of some countries place country lending limits on banks. If banks run up against this barrier exposure may become an absolute constraint on competition for some banks.

[55] Research of the author. See project cited in footnote 18.

Of course, in its negotiations with the banks Peru was not completely without a bargaining position, for it could always default: something the banks would surely want to avoid. Indeed, some have even seen the threat of default as a way in which banks can become "hostages" to the demands of developing countries.[56]

A borrowing country's leverage should not be exaggerated, however. In the first place, a country cannot default selectively —thereby perhaps generating a more competitive environment— because of the cross-default clauses which figure in almost all commercial bank loan contracts.[57] Moreover, defaulting on all commercial banks is not a realistic option for a government wishing to remain a member of the Western capitalist community, since it would result in the cutting off of virtually all external commercial credit; it would cause the government to face the wrath of its national business sector, which would undoubtedly have its access to credit adversely affected; and it could very well bring retaliation from the home governments of the banks. Moreover, the risks associated with default are by no means symmetrical, for while banks could probably absorb a prolonged default by any *one* borrorwer, a country would find it much more difficult to absorb the effects of a blockade by its commercial creditors.[58] Only if several countries joined together in default would there be serious possibilities for taking banks hostage, but even then, unless one of the countries were a super borrower such as Brazil or Mexico, the outcome would more than likely be merely a stalemate.[59]

When a country is at the bottom end of a credit cycle, banks can also be very interventionist. Peru is a case in point. In 1976, when the government sought its balance-of-payments loan the banks reluctantly agreed. However, bankers insisted on a two-tranche credit with the second tranche being conditional upon a favourable evaluation of the progress of the government's stabilization programme.[60] Another more blatant form of interventionism was a condition that the government must settle a tax dispute with one foreign firm and compensate another which had been nationalized a year earlier: not surprisingly, both corporations had close links with the banks in the Steering Committee.[61] Then in 1978, when Peru was negotiating with the Steering Committee to refinance its commercial debts, it was widely reported that one member of the Committee threatened to tie the success of the negotiations to satisfactory settlement of a dispute it had with the government over the handling of the foreign exchange earnings of a local foreign firm to which the bank had extended a large loan.[62]

Banks have also sought to influence the policies of governments that are not in an open debt crisis. For instance, a widely-circulated and highly-respected publication of one of the largest international banks in 1976 made the following comments about Brazil's management of its economy:

"In this regard, Brazil's delay in internal adjustment has come as a disappointment. There, the growth in aggregate demand, the reemergence of the fiscal deficit, and the acceleration of inflation (estimated at 45%-50% for this year) have been inconsistent with the clear necessity for a current account adjustment".[63]

It is no coincidence that the bank was a major creditor of Brazil, thus making the statement not unlike the medieval practice of admonishing debtors in the main public square. This rather heavy-handed commentary is not something one would expect from a "remote and neutral" market.

Another final consideration about the

[56]See Lissakers, p. 58.

[57]Cross-default clauses are not what one would expect from a "standoffish and remote" market.

[58]A study by the US Federal Reserve Bank shows that in the case of the six largest US banks only two borrowing countries each account for as much as 1.5% of total assets. Other borrowers account for much smaller proportions. See Watson, p. 50.

[59]*Ibid.*

[60]See Belliveau.

[61]See Wellons (1976), p. 74.

[62]See *Latin American Economic Report*, No. 20, May 26, 1978. It is only fair to add that the bank later denied ever having established such a link.

[63]Morgan Guaranty Trust Company (October 1976), pp. 3-4.

competitiveness of international banking is that while there are indeed hundreds of institutions dealing in the Eurocurrency market —generating conditions that some think approximate a perfectly competitive environment— access to credit is actually controlled by a relatively small coterie of banks. This is because only very large banks have the resources and good will to be leaders or organizers of syndicates. It is these banks —which maybe number roughly 50 in all —that dominate the market. As leaders of credit operations it is they who evaluate a country's creditworthiness and pass on information to prospective lenders in the placement memorandum that accompanies each loan syndication. Thus, the opinion of these banks can influence the attitude of the whole market towards a borrower. Moreover, it would appear that there is a considerable degree of concentration among the leading banks themselves. For instance, table 2 shows that of the top 50 lead managers of syndicated credits in 1977 and 1978, the top 10 were responsible for 58% and 44%, respectively, of the total amount mobilized through such syndication.[64] Thus, one could conclude that a handful of banks have a disproportionate amount of power in the distribution of international commercial bank credit, perhaps making for a less competitive environment than would at first sight seem to exist in view of the hundreds of banks dealing in the Eurocurrency market.

Table 2

PRIVATE COMMERCIAL BANKS: DISTRIBUTION OF SYNDICATES AMONG TOP 50 EUROCREDIT LEAD MANAGERS

(Percentage of credits mobilized)

	1977		1978	
	Value of credits	Number of credits	Value of credits	Number of credits
Top 5 banks	38	33	25	30
Top 10 banks	58	44	44	50
Top 50 banks	100	100	100	100

Source: Derived from data in *Euromoney*, February 1979.

IV
Exploring the alternatives

We have just seen some of the drawbacks that might be associated with having commercial banks at the forefront of the allocation of resources to developing countries. Unfortunately, in economics it is easier to diagnose problems than to prescribe cures for them and this final section of the paper now has the difficult task of suggesting some alternatives.

A. *The international division of labour for development finance*

In general it appears that what is needed is some rethinking about the current division of labour for development finance. There are many sources of finance, and each one is usually particularly good at performing certain tasks.

Let us look first at commercial banks. They are especially good at financing trade. They have a world-wide network of branches and correspondents with which to follow trade flows, and decisions on finance can be made quickly because of their familiarity with their clients. Assessment of risk does not have to be terribly sophisticated, because much of the finance is self-liquidating and the duration of agreements is on the short side: this, inciden-

[64] In 1975-1976 concentration among lead banks was much more severe. Greater dispersion in 1977-1978 was the result of a higher profile for Japanese and German banks, coupled with the restrained activities of American banks.

tally, is in keeping with both the limited risk-assessing ability of most commercial banks and the short-term deposit base of these institutions.

Banks are also exceptionally suited for financing highly profitable commercial ventures with a quick return, say between 5 and 7 years. Another area which appears suitable is the financing of working capital, i.e., the pure need for short-term liquidity.

Just as banks are exceptionally suited for the above tasks, however, they are inferior at some others. One area where banks display severe limitations is in the provision of finance for ventures with a long payout. Social infrastructure requires maturities far beyond the reach of banks, and not surprisingly, these institutions are sometimes chary about lending in this area. But many commercial ventures, too, may be out of the reach of banks, particularly those that are very capital intensive. Some might argue that there are few commercial projects that cannot provide returns within the 10-12 year maturities being offered by banks in 1978-1979. However, this assumes that maturities will never shrink again as they did in 1974-1975. It also assumes that ventures will meet their cash flow projections: something that is far from certain for infant industries in developing countries.

Moreover, banks cannot adequately fill liquidity needs when lack of liquidity is due to structural imbalances (real or financial) in the economy. Thus, if balance of payments or fiscal difficulties stem from something other than a temporary exogenous factor (e.g., a fall in the price of a major export commodity), banks are an inferior source of finance. In these circumstances —which are very common in developing countries— if banks extend "no questions asked" finance they become a permissive influence that masks the need for changes in structure and policy. Peru up to 1975 fell victim to an overly co-operative banking community. On the other hand, if banks attempt to induce changes in policy and structure they become interventionist. Because of their private commercial character, when they negotiate with sovereign governments they are open to charges of conflicts of interest and political subversion. To this must be added the fact that the maturities that they can offer under the risk associated with restructuring may simply be inadequate for the circumstances. Consequently, when banks embark upon the financing of structural balance-of-payments problems they enter into a "no win" situation.

Accordingly, when the commercial banks initiated the recycling of the OPEC surplus few complained: banks recycled quickly, and most thought the crisis to be temporary, as a full recovery in the Centre was seen to be imminent and "market forces" would quickly put an end to the OPEC cartel. But, of course, so far this has not been the case, as balance-of-payments disequilibria have gained a more permanent character and most developing countries (and developed countries as well) appear to be interested in restructuring (over and above the normal restructuring associated with development) to accomodate themselves to a new era of higher energy costs and slower growth in the Centre. It is most distressing, however, to find that no adequate finance is available to developing countries for such restructuring: Brazil, for example, has had no choice but to fund its massive import substitution/restructuring programme on the limited and uncertain maturities of commercial banks.

Which institutions, then, would appear to be the experts in those areas where commercial banks face constraints? The author believes that the answer is the multilateral agencies and private bond markets.

Multilateral agencies —i.e., the World Bank, the Inter-American Development Bank, etc. — display great virtues with regard to some of the special needs of developing countries.

First, they possess highly trained professional staff who have a wealth of experience with the problems confronting developing countries. They can help in project preparation, troubleshoot where problems arise, and assist in follow-up evaluation. Moreover, they are interested in the success of the project and not just its finance and repayment, and furthermore they are capable of collaborating with authorities in the formulation of global policy for development without raising suspicions of conflicts of interest.

Second, and even more important, multilateral agencies are not commercial institutions and therefore can accept time and risk situations compatible with the far-reaching needs of development. Thus, multilateral agencies can and do lend to countries which display liquidity and political conditions that would simply unnerve a private banker. Moreover, their special character enables these agencies to permit repayment periods of up to 25 years or more, which is the type of finance that can smoothly promote the broad-based socioeconomic change integral to the process of development. Implicit in this capability is a willingness to finance projects of a basic needs character, and to encourage this type of development as well.

Third, unlike commercial banks where developing countries have no influence over policy, developing countries are voting members of multilateral agencies and have an opportunity to influence events in them. Nor is this virtue negated by the fact that LDCs are a minority voting block. As long as industrialized countries contribute the bulk of the funds, the credibility of multilateral agencies is best maintained if those countries have technical control over decision-making. If the LDCs act together, however, they can form an effective lobby for pressuring the industrialized countries to adopt policies favourable to their needs. LDCs can also improve their voice in policy matters by ensuring that they gain maximum representation on the staffs of multilateral agencies by sponsoring candidates for their technical competence and not for their domestic political connexions.[65]

The above is not to suggest that multilateral institutions are perfect. The quality of their finance undoubtedly can be improved. For instance, there could be greater articulation between the IMF and World Bank so that standby programmes can, where appropriate, take on a long-term character and facilitate real structural —as opposed to just temporary monetary/financial — change. In line with much longer standby agreements, conditionality could be moderated to take into greater account domestic political and social objectives and the need to avoid reductions of employment and per capita income in developing countries.[66] There is also a great need for significant programme lending by development institutions like the World Bank and IDB.[67] Many more examples of desirable changes could be given. Fortunately, unlike commercial banks, whose actions are constrained by the commercial interests of their stockholders and the rules of prudent banking, the policy frontiers of multilateral institutions are only limited by the courage and imagination of policy-makers in the industrialized countries.

As for private bond markets, they afford developing countries the opportunity to acquire funds for considerably longer terms than those usually offered by commercial banks. Also, their interest rates are generally fixed through the life of the maturities, providing LDCs with a predictable cost that can easily be incorporated into planning strategies. Another consideration is that bond markets are really standoffish and remote in the sense that borrower and lender never meet each other. Their major drawback is that investors tend to be rather unpredictable and therefore access may be somewhat unreliable.

There are two other important specialists in the international financial arena that are worthy of mention: commercial suppliers and bilateral government agencies. Both are usually associated with "vested interest" finance, i.e., finance which is itself only a means to a broader objective. The conditions of finance can prove to be very attractive, and although this may be offset by their being tied to particular goods or political positions, the interests of the borrower may nevertheless sometimes overlap with those of the lender, making for a mutually beneficial transaction. It is in these circumstances that suppliers and government can play an important role in the division of labour for development finance.

[65]This point has been raised before by Jeker, p. 225.

[66]For an excellent comprehensive critique of IMF standby programmes and suggestions for reform see United Nations, 1979.

[67]Non-project lending is essential if the World Bank and IDB are to take on a larger role in stabilization efforts that involve structural changes in an economy.

B. *Can this division of labour be made to work?*

We have just outlined what may be considered a reasonable division of labour for development finance based on an existing infrastructure. Unfortunately, some actors in the global division of labour have had their activities restricted for one reason or another, creating a vacuum that has been filled in an *ad hoc* fashion by comercial banks, which in contrast have been able to expand almost without limits because of surging world liquidity and an unregulated Eurocurrency market. The problem, as we have seen, is that banks cannot properly assume their new role and it is necessary to find some way of rectifying this imbalance in the sources of finance.

Multilateral agencies have suffered from a lack of an automatic funding mechanism, wariness on the part of donors, and a general ideological shift away from multilateralism. In an age of fiscal deficits and tax revolts new contributions to development institutions have become unfashionable: indeed, perhaps one reason for the industrialized countries' complacency about the role of their banks in development finance is that it is simply less of a fiscal burden to have private commercial banks channelling resources to developing countries.[68]

What is needed to counter this trend is a campaign to alert public opinion to the need for massive resource transfers on more reasonable terms to developing countries. This can be viewed as simply enlightened self-interest, for while commercial bank financing appears on the surface to be working smoothly, the inferior quality of the finance, coupled with other well-known maladies of the international economy, may be generating underlying social and economic tensions that could make the world of the 1980s a much less pleasant place to live in. Moreover, transfers to the South usually come back to the North in the form of purchases of goods for import, thus creating new business and jobs for the industrialized nations.

[68]To the extent that commercial bank profits are taxed by the industrialized countries, the shift to bank finance of development could even be profitable for the governments of the industrialized countries.

There has been no lack of proposals for transfers. The annex to this paper reproduces an excellent summary of current proposals prepared by the Overseas Development Council. They are all characterized by sophisticated mechanisms to provide long-term finance to developing countries. Multilateral agencies are seen in the role of managers of funds. The mayor obstacle to the proposed programmes seems to be the generation of resources. It may therefore be worthwhile to briefly review some tentative ideas on how resources could be generated, concentrating on the need for automatic funding.

One possibility is to assign to the World Bank and IMF a more direct role in transferring savings from North to South. Many have complained about the lack of symmetry in pressures on countries to adjust their balance of payments;[69] deficit countries must submit to vigorous IMF programmes, while surplus countries suffer at worst moral suasion. Why not arrange for surplus countries in the industrialized world and OPEC to place 50% of their annual surplus (after adjustment for coverage of "normal" capital outflows) on deposit with the aforementioned institution? Something near a commercial interest rate could be paid, as in the Fund's Supplementary Oil Facility. Alternatively, if desired, a tax could be placed on the surplus by offering much less than a commercial rate. Withdrawals would not be permitted until a surplus country's "non-deposited" surplus fell to some critical level —say the equivalent of 3 months' imports— and even then withdrawals would still be in line with the trends in the country's balance of payments. Since surpluses tend to accumulate in the industrialized countries and OPEC, the fund would be continuously renewed. The special character of developing institutions would allow them to mismatch maturities and transfer these resources to the South on appropriate terms. Admittedly, unless the surplus is heavily taxed this proposal would place only mild additional pressure on surplus countries, since access to surplus receipts is maintained: its chief value, therefore, is that it would allow

[69]For a critique of the lack of symmetry in adjustment pressure, see United Nations, pp. III.8-III.13.

more resources to be channelled through development agencies.

Ways also need to be explored on how to achieve permanent increases in the capital base of international agencies which will facilitate their ability to capture funds on international capital markets. One measure might be to channel SDR allocations to subscriptions of capital in these institutions. Inviting the centrally planned economies to participate in the development effort by joining development institutions would also increase capital and have the added benefit of providing greater ideological plurality in these agencies. The industrialized countries and OPEC, for their part, could consider directly guaranteeing bond issues of multilateral agencies, thereby facilitating greater leverage over the existing capital base.

Less certain are the possibilities of raising capital contributions via taxes in developed countries. The constraints are more political than real, however, as ample room exists for new revenue. Emergency economic development taxes on luxury consumption, i.e., cigarettes, liquor, oversized cars, second homes, luxury restaurants, etc., could painlessly produce considerable annual contributions. The problem in this approach is that small interest groups may be able to resist the introduction of what otherwise are rational measures.

Another scheme that enjoys some support is co-financing between multilateral banks and Third World finance institutions. In this way banks would come under the umbrella of multilateralism and effectively expand the resources being channelled through development agencies. Banks participating in co-financing would presumably offer slightly lower interest rates and somewhat longer maturities. The value of the scheme is that it requires no real change in the existing financial system. The disadvantage is that it could be construed as a substitute for increasing the capital base of multilateral agencies. It could also further erode the degree of plurality in sources of finance and "cartelize" development finance.

In exploring the resource problem, it might also be useful to question the current practice of charging all developing countries the same rate of interest on *regular* (i.e., non-IDA) loans from development institutions. In order to stretch development funds to the greatest degree possible, one might consider varying interest rates to suit the level of development of the borrower country. Lower-income countries could continue to receive absolutely concessionary rates, whereas upper-income countries, which are not so much interested in aid as in rather longer maturities, could be charged commercial rates of interest. Furthermore, rates to upper-income countries could continue to be fixed in principle, but with provision for the periodic adjustment of old loans should they become uncommercial over the medium term. Even with commercial rates there could be some cost savings on loans: with greater access to multilateral finance there might be less need to maintain large amounts of borrowed international reserves, many of the fees and ancillary charges of loan syndication would be eliminated, and prepayment could be effected without penalty.

Turning to international bond markets, these have not been a dynamic source of funds for developing countries since the great financial collapse of the 1930s. The industrialized countries have placed great administrative barriers in the way of LDC bond issues, creating a two-tier system whereby rich countries tap Eurobonds and poor countries Eurocredits. This is regrettable, because bond markets can be a very suitable way to finance development, and while they cannot take the place of dynamic multilateral development finance, they certainly can take some pressure off development and institutions. Undoubtedly, rich countries should reconsider their policies in this area.

As for bilateral finance, this has no doubt slipped because of aid weariness and it might be difficult to stimulate this source again, although it might be possible to secure reconsideration of schemes which are actually designed to restrict funding, such as the Gentlemen's Agreement among OECD export credit agencies, at least as far as finance for LDCs is concerned.

After reviewing proposals for North-South transfers of resources and some possibilities for financing them, one cannot help but think that current problems are of a political rather than an economic nature. There are a multitude of technical ways to enhance the functioning of the international division of labour in the field of development finance. The problem is to develop the political will to implement them. Many may feel that any massive reordering at this time runs counter to political realities and it is therefore best to accept the present system, with perhaps some minor modifications. However, one should remember that reality can be modified to some degree, and with due willpower and courage it would be possible to improve upon the present transfer mechanism, which has evolved in an *ad hoc* fashion and is less than adequate for the promotion of broad-based socioeconomic development. Hard-core realists who may be skeptical of change should perhaps ponder on the fact that those who are excessively realistic can be the most unrealistic of all.

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Annex

A COMPARISON OF SOME CURRENT PROPOSALS FOR MASSIVE RESOURCE

	Senator Javits' Proposal: Growth Development Fund.	Mexican Proposal: Long-term Recycling Facility (IMF/IBRD Development Committee).	Venezuelan Proposal: Joint OPEC/OECD Global Stimulation Plan (Ronald Müller).
Amount/ Size	US$ 25 billion (US$ 5 billion per year)	US$ 15 billion	Not specified, but in range of US$ 20-40 billion.
Timeframe	5-year initial period	Long term	5-10 years, commencing before 1980.
Objective	To establish a capital fund for productive investments in the LDCs that will promote rational agricultural and industrial development and trade leading to the expansion of markets and the stimulation of the world economy.	To increase the supply of long-term funds to the LDCs for financing capital goods purchases.	To mobilize unused savings in OPEC and the OECD into a capital pool and to invest these funds in the non-oil-LDCs in such a way as to increase their purchases of exports from the industrial nations; to head-off medium-term international supply shortages; and to implement structural adjustment plans in the OECD.
Problem Focus	1. Economic growth is stagnating in many countries, necessitating a rise in capital stock to increase productivity. 2. OPEC recycling is inadequate because it fails to generate macro-economic policies in oil-importing nations needed to restore purchasing power. 3. The foreign exchange drain resulting from oil imports is constraining the purchasing power of oil-importing LDCs.	1. Low long-term growth rates in DCs are slowing world trade, fostering protectionism, and leading to sluggish demand for capital goods of DCs. 2. LDCs have potential demand for capital goods not made effective for lack of financing. 3. The high level of financing by the international banking system cannot be sustained in the future. 4. There are short- and medium-term recycling facilities for balance-of-payments adjustments but none for the longer term.	1. With simultaneous unemployment and inflation together with declining profitability and productivity in DC industries, OECD capital formation is lagging and there is a trend towards long-term stagnation. 2. OPEC recycling could be longer-term. 3. There are serious policy lags in DCs and LDCs regarding macro-economic management and international economic co-ordination. 4. The Third World could be a new source of sustained demand—a new growth frontier—for the world economy. 5. There is a need to alleviate the poverty and debt problems of the LDCs.
Sources of Funds	Industrial and OPEC countries.	Public and private investors of countries with strong balance-of-payments and financial positions (including institutional investors).	1. Underutilized savings in OPEC and OECD; 20-25% from OPEC's accumulated petro-dollar earnings, and the rest from private investors. 2. Contributions from OECD nations to World Bank (additional or reallocation).
Administration of Funds	Fund could be designed and implemented by the World Bank, regional development banks, and the IMF, or a new institution could be created.	New lending operation at the World Bank.	Special window at World Bank and IFC, and/or regional institutions.

TRANSFERS AND GLOBAL STIMULATION

	OECD Investment Plan	Trilateral Food Task Force Programme Doubling Rice Production in S/SE Asia (Hayami/Takase).	Roger Hansen's Proposal: A Global Basic Human Needs Régime
Amount Size	US$ 5-10 billion in additional capital flows.	Total capital cost of US$ 52.6 billion (1975 constant US$) but only US$ 1.8 billion annually in additional flows.	US$ 12 billion (constant US$) per annum which would cover all investment costs and half of the annual maintenance costs.
Timeframe	3-5 years of increased transfers, within a medium-term timeframe of up to 8 years.	15 year period; 1978-1993.	20 year period.
Objective	To undertake a major increase in investment flows to LDCs as a general stimulus to world economic activity directed at structural change over the medium term in key supply sectors.	To double rice production in Asia through irrigation improvements.	To establish a global basic human needs régime with a view to eliminating absolute poverty in two decades.
Problem Focus	1. The recovery of the OECD economies from the recession is not yet self-sustaining and a stimulus is needed for economic activity. 2. There is currently substantial underutilization of resources in the OECD and a widespread feeling of uncertainty deters investment. 3. Current patterns of investment in key supply sectors are inadequate for the long-term needs of both DCs and LDCs.	1. Focusing entirely on the world food problem, Asia is chosen because two-thirds of the world's malnourished live there, and Asia has great potential for a quantitative increase in food production. 2. Improvement and expansion of irrigation, which requires capital, is critical to increasing food production in Asia.	1. The poverty problem is not insurmountable, but without a focused attack its dimensions are likely to grow along with population problems. 2. There is a need for a less interventionist channel for ODA - a highly qualified, specialized basic needs agency. 3. Incremental increases in ODA through existing channels are unlikely to have a major impact on poverty because ODA is currently determined largely by other objectives, concerns and political pressures.
Sources of Funds	Equity and debt from private and commercial sources in OPEC and OECD (not ODA because politically unrealistic).	1. Multilateral or bilateral foreign agricultural aid, including OPEC assistance. 2. Asian developing countries' irrigation budgets. 3. US$ 1.8 billion per year in additional capital contributions (presumably ODA) by DC and OPEC countries.	1. ODA from DAC countries pledged on a multiyear basis. OECD countries should put most of their ODA into basic needs programmes and raise their ODA levels to 0.45-0.50% of GNP by the early 1980s. 2. ODA from OPEC as well as other better-off LDCs.
Administration of Funds	Co-financing arrangements through the World Bank family.	Donor countries and agencies would direct funds to agricultural sector in Asian LDCs.	Preferably through North-South action, a neutral international agency would be created, to receive financial contributions, make allocative decisions and monitor performance. The UN system, including the World Bank and regional development banks, could also be involved.

A COMPARISON OF SOME CURRENT PROPOSALS FOR MASSIVE RESOURCE

	Senator Javits' Proposal: Growth Development Fund	Mexican Proposal: Long-term Recycling Facility (IMF/IBRD Development Committee)	Venezuelan Proposal: Joint OPEC/OECD Global Stimulation Plan (Ronald Müller)
Main Characteristics	1. Funds would be divided into two parts: half (US$ 2.5 billion) would go to the poorest LDCs, and the other half on a loan basis to the more creditworthy advanced developing countries. 2. Terms could be negotiated to meet the concerns of donor countries regarding the sustained value of their funds invested in the Fund and the need for liquid assets in the event of economic emergencies. 3. The fund could give priority to energy investments.	1. Total capital subscription of the facility could be divided into three borrowing operations of US$ 5 billion each. 2. Debt instruments denominated in SDRs would be issued to lenders for a 15-year term with a market rate of interest. 3. Secondary market would be developed to give liquidity to these instruments. 4. Governments not contributing direct loans could guarantee loans granted by the facility. 5. Purchases of DC capital goods financed by the facility would be limited to countries granting loans or guarantees. 6. Capital goods would be purchased in connexion with specific projects approved in LDCs by the World Bank. Loans could be extended to national private firms operating in LDCs.	1. OPEC money would be raised through the issue of "OPEC Development Bonds" in international capital markets. OPEC would purchase 20-25% of the total subscription of long-term Triple A bonds (12-20 year maturities). 2. The remainder would be sold to private investors in capital markets. 3. OPEC would act as first guarantor, with the World Bank family as the second. 4. Funds would be targeted to purchases in OECD sectors operating at low capacity utilization levels; in the medium term funds would be targeted to international sectors where supply shortages are likely. 5. In the third year, intensified domestic structural adjustment efforts would commence. 6. About 20-25% of the funds would go to poorest LDCs.
Sector Investment Focus	1. Projects that expand demand for OECD goods. 2. Energy exploration and alternative energy source projects. 3. IDA-related projects in poorest LDCs.	Projects that require long-term capital purchases from OECD countries.	1. Basic needs projects in the poorest LDCs (20-25% of funds). 2. Projects that generate a rate of return equivalent to that of AAA Bonds. 3. Targeting in the short term of OECD industries operating at low capacity utilization. 4. Targeting in the medium term on supply sectors where there could be shortages.
Country/ Regional Focus	1. More "creditworthy" advanced developing countries. 2. Poorest LDCs.	(Middle-income LDCs).	(All LDCs).
Benefits	1. Would stimulate economic growth in the LDCs. 2. Would expand demand for exports of the OECD, leading to higher levels of employment and domestic economic activity, and fewer pressures for protectionism.	1. Would contribute to the stimulation of capital goods sectors in DCs that suffer from inadequate demand, and would also facilitate structural adjustments in DCs. 2. Would provide necessary long-term resources for LDCs to finance their demand for capital goods. 3. Would provide an additional investment outlet for surplus countries. 4. Would help develop a better structure of assets and liabilities in the financial system.	1. Would increase OECD-wide capital formation. 2. Would expand demand for goods from OECD industrial sectors with excess capacity. 3. Would have positive employment impacts and be less inflationary than current OECD domestic demand stimulation, because it would absorb liquid or near-liquid assets, and would be targeted to OECD industrial sectors operating at low capacity utilization levels. 4. Would alleviate the need for immediate structural adjustment in many DCs. 5. Would help LDCs' debt and poverty problems.

TRANSFERS AND GLOBAL STIMULATION

	OECD Investment Plan	Trilateral Food Task Force Programme Doubling Rice Production in S/SE Asia (Hayami/Takase).	Roger Hansen's Proposal: A Global Basic Human Needs Régime.
Main Characteristics	1. The programme would rely on co-financing through the World Bank family. 2. Funds would not be tied to specific industries in DCs but would be directed in the medium term to sectors where supply problems will become critical: food, energy, commodities, and related infrastructure.	1. Resources would be invested in irrigation and related needs, including research, modern farm inputs, and marketing systems. 2. Target for 1993 would be to double rice production from the 1974 level of 156 million tons to 321 million tons for a population of 1.72 billion by converting 17.5 million hectares of inadequately irrigated areas and 30.4 million hectares of rained areas to adequately irrigated areas.	1. The programme would require long-term high levels of Northern funding. 2. The programme would require LDC willingness to commit funds to an altered development strategy. 3. Funds would be allocated by an international agency on the basis of an LDC's programme performance and yearly budgetary needs. 4. The agency would monitor programme performance to assure that funds are being used in accordance with negotiated programme guidelines.
Sector Investment Focus	Projects related to food, commodities, energy and related infrastructure.	Rice production.	Basic needs development projects in LDCs.
Country/Regional Focus	(All developing countries).	Countries in South and Southeast Asia.	(Developing countries committed to basic needs programmes).
Benefits	1. Would stimulate demand and increase production in both LDCs and DCs.	1. Would improve the supply-demand balance for food and have income-creating effects which would enhance the purchasing power of peasants.	Could susbtantially reduce or eliminate absolute poverty for the one billion people who now exist in this state.

Source: Overseas Development Council, Washington, D.C., 1978.