

WORLD BANKING AND FINANCE

Cooperation Versus Conflict

George Macesich

WORLD BANKING AND FINANCE

Cooperation Versus Conflict

George Macesich

PRAEGER

PRAEGER SPECIAL STUDIES • PRAEGER SCIENTIFIC

New York • Philadelphia • Eastbourne, UK
Toronto • Hong Kong • Tokyo • Sydney

Library of Congress Cataloging in Publication Data

**Macesich, George, Date-
World banking and finance.**

Includes index

1. Banks and banking, International. 2. International finance. 3. Debts, External—Developing countries. 4. Game theory. I. Title.

**HG3881.M234 1984 332.1'5 84-17908
ISBN 0-03-001397-6 (alk. paper)**

**Published in 1984 by Praeger Publishers
CBS Educational and Professional Publishing,
a Division of CBS Inc.
521 Fifth Avenue, New York, NY 10175 USA**

© 1984 by Praeger Publishers

All rights reserved

456789 052 987654321

**Printed in the United States of America
on acid-free paper**

PREFACE

This study examines the underlying forces of change in world banking and the ongoing dialogue between developing-debtor countries and developed-creditor countries within the framework of a theory of cooperation. The basic framework is the theory of cooperation and reflects the evidence provided by recent studies and history.

It draws upon computer tournaments of the Prisoner's Dilemma from game theory and how cooperation evolves. The study draws especially on the work of Robert Axelrod and William D. Hamilton and the implications of their studies for the theory of cooperation. By means of a computer tournament Axelrod studied the ways cooperation evolved. He was able to perceive the underlying principles and prove theories that established the facts and conditions of the rise of cooperation out of nothing. Subsequently he and Hamilton worked out the implications of these discoveries for evolutionary theory.

This book considers and extends the implications of their discoveries for relations between developing-debtor and developed-creditor nations. These relations can best be described as an area where independent, egoistic nations face each other in a state of near anarchy. Can developed and developing countries evolve reliable cooperative strategies? Can cooperation emerge in a world of sovereign states? In short, can cooperation evolve out of noncooperation? Specifically, how can cooperation get started at all? Can cooperation strategies survive better than their rivals? Which cooperative strategies will do best, and how will they come to predominate? The principal conclusion of the study is that cooperation can indeed work with an appropriate strategy. It turns out that the appropriate strategy is a simple Tit for Tat strategy submitted to Axelrod by Anatol Rapoport with the first move being cooperation.

World banks can and do serve as instruments (or clusters) for promoting a Tit for Tat strategy of cooperation. The large debt owed by developing nations to their developed-nation creditors including banks can serve to enhance cooperation among nations. It can promote the evolution of an international environment in which a strategy of cooperation will displace egoistic strategies. And world debt is now of a size that assures cooperators the necessary

cluster for a strategy of cooperation to be firmly established. Once established it will tend to flourish as in an ecologically evolving world reported by Axelrod and Hamilton. It is indeed an opportunity for the world to move up the ratchet of cooperation as the theory of cooperation suggests.

The book weaves together institutional and theoretical and empirical results of game theory, computer simulation, monetary theory, and policy analysis so that each reinforces the other. Only when many strands are woven together can we have a useful understanding of the ongoing dialogue between developing-debtor countries and developed-creditor countries and the changing anatomy of world banking and its significance to the world economy. It is directed to the general economist, political scientist, banker, and layman. I hope that it may have some influence in moving toward that consensus of views that our understanding and approach to the vexatious problems of cooperation between developing-debtor countries and developed-creditor countries is enhanced by the fact that mutual cooperation can indeed emerge without central control by starting with a cluster of units which rely on reciprocity. The process of trial and error in dealing with such global issues as banking and world debt is slow and painful. The conditions for cooperation and mutually rewarding strategies based on reciprocity are there.

I am indebted to many colleagues with whom I have discussed one or another aspect of the study. These include especially Marshall R. Colberg, Walter Macesich, Jr., Anna J. Schwartz, Dimitrije Dimitrijević, Branimir M. Janković, Rikard Lang, Dragomir Vojnić and Ljubisav Marković. I should also like to express appreciation for editorial assistance from Grace Colberg and for efficient and helpful typing services to Clydeyne Nelson.

GEORGE MACESICH

CONTENTS

Preface	vii
List of Tables and Figures	xi
1 World Economy and a Theory of Cooperation	1
The Debt Problem	1
Role of Banks	4
Developing and Developed Country Dialogue	5
A Theory of Cooperation	10
2 World Debt and the Banks	23
A Look at the Evidence	23
The Exposure of Banks	29
Victims of Their Own Folly?	30
A Regulatory Backlash	32
Interdependence of World Banking Problems	37
3 Lessons From the Past	41
Importance of a Proper Environment	41
American Experience in the Turbulent 1830s	43
French Indemnity Payment of 1871	51
The Post-World War I German Reparations and Debt Episode	57
4 In Search of Solutions	65
Perspective	65
Proposed Solutions	72
5 Changing Anatomy of Banking	87
Introduction	87
Changing Regulatory Environment	87
Business of Banking	89
Input "Mix"	90

Output “Mix”	92
Loans	92
Investment Output	93
Pricing of Input and Output	94
Pricing Input	94
Pricing Output	96
Changing Nature of Bank Liability Management	98
New Competitive Environment	101
6 Comparative Banking Practices	109
Bankers and Their Clients	109
Country Practice	110
Changing Perceptions of Bankers	123
7 Monetary Financial Organization in Developing Debtor Countries	129
The Issue	129
Financial Institutions and Economic Development	129
Demand and Supply of Financial Institutions	131
Money Market	132
Socioeconomic, Legal, and Political Systems and Financial Institutions	138
General Characteristics of Financial Institutions in Selected Developing Countries	139
8 Theory of Cooperation and Monetary Stability	149
Debt Default Issue	149
Role for Money and Monetary Policy	155
A Bretton Woods II?	162
Index	171
About the Author	179

LIST OF TABLES AND FIGURES

TABLES

2.1	How Much Developing Countries Owe Their Creditors	24
2.2	Big American Banks' Mexican Loans	30
2.3	Bank Deposit Insurance Schemes in Selected Countries	34
3.1	Indexes of Physical Volume of Trade, Prices, Stock of Money, National Income and Velocity in the United States, 1834-45	45
3.2	France's Balance of Trade, 1867-78	57

FIGURES

1.1	Prisoner's Dilemma: Developed-Creditor Nations and Developing-Debtor Nations	10
3.1	Index of Prices	48
3.2	Index of Physical Volume of Trade and Components of Physical Volume of Trade	49
7.1	Distortions of Prices, 1970-80	140

1.

WORLD ECONOMY AND A THEORY OF COOPERATION

THE DEBT PROBLEM

The sharp disinflation from 1979-83 forced a series of wrenching changes in the structure of the world economy. This disinflation transition represents the most radical disturbance that has hit the world economy since World War II. As a result of human action but not human intention we did not have Milton Friedman's well known monetarist policy of gradualism, but the more publicized central bank variety of a series of sharp shocks.

The falling tide of inflation has left aground many developing-debtor countries, some of whom had guessed wrong on inflation, with more than \$600 billion in foreign debt owed, for the most part, to the world banks of developed-creditor countries.¹ To refloat these countries will require financial statesmanship by banks, domestic monetary authorities, as well as bank examining authorities, and the International Monetary Fund (IMF) together with the cooperation of developing-debtor countries.

World banks, including U.S. banks, that participated in the lending to the developing-debtor countries are primarily responsible for the debt problem, but it would be unrealistic to suggest that the bank examining authorities of developed-creditor countries responsible for appraising the soundness of loans and investments of the banks have lived up to their responsibilities. In the United States the Comptroller's office, with the Federal Deposit Insurance Corporation (FDIC), examines the national banks; the state member

banks are examined by state authorities as well as federal agencies and the FDIC. Instead of criticizing these loans, many governments and the IMF are suggesting that banks increase their present exposure.

The problem can be solved and it involves changes in the present policies that would involve a continuing role for banks. It does not mean the monetization of bad debts, nor providing capital and loans to support and refloat stranded developing-debtor nations without their casting over the side excess cargo of misguided and misdirected programs. For instance, the key to cutting fuel and food imports without cutting growth in these countries lies in the greater use of the price mechanism.

Indeed the World Bank in its Sixth World Development Report underscores that developing countries can curb oil imports without permanently slowing their growth by raising their domestic prices in tune with world prices. Not many did so after the oil shock of 1973-74. The argument for not doing so was that oil was essential to growth. The 1979-80 oil shock forced them to cut back on subsidies to fuel. To their surprise, growth did not suffer permanent damage thanks to better and more efficient fuel uses dictated by higher relative prices for oil.

Even bigger input saving can be achieved in agriculture and the food industry. By raising agricultural prices, some developing-debtor nations have found fewer people moving into overcrowded cities. The spending power of the majority of people is increased while at the same time less food needs to be imported and the whole economy benefits.

The legitimate needs of the developing-debtor countries can be met with increasing levels of international trade and continued decrease in unemployment. It is, however, incumbent upon these countries to set their own houses in order without imposing the thankless task onto the IMF for telling them to do so. Misplaced ideological rhetoric for instance against equity investments and related issues are but cases in point. In highly interdependent world capital markets such a strategy serves only to punish its practitioner. In effect, developing-debtor countries must see more to the "supply-side" of their economies, using this term for once in its correct sense.

All of this will require diplomacy — the process of eliminating or reducing conflict through reflection, talk, and bargaining — which is now more valuable than ever in dealing with the global debt issue.

Diplomacy permits — demands, if one is serious — genuine exchange of views. Diplomacy allows one to find out the other country's needs, which may turn out to be compatible with one's own. Diplomacy's give and take tests the importance of one's own country's needs. Successful diplomacy leaves in its wake good relations, mutual trust, and hope for better times. It is not a failure of will for developed-creditor countries to listen to those countries that are weaker, or even hostile. We usually honor that quality when we see it in private life. Moreover, the debt issue and the growing fear of protectionism has already changed the terms of their dialogue with the strong.

Some accords are imperfect — such is the nature of compromise and human affairs generally. Some were lucky rather than skillful achievements — such are among the happy contingencies of diplomacy. And some happened because a country was ready to retaliate in kind — such retaliation is a useful reserve, as we shall see, for those occasions when the other party insists on a course of action irrespective of the consequences on anyone else.

This study presents and discusses a theory of cooperation with reciprocity and a strategy for its implementation as one way of dealing with the global debt problem. In our theory, world banks play an important role owing to their unique characteristics. For instance, large world banks, unlike many of the smaller banks, have a long standing relationship with a given country which enables them to take a longer-term view when dealing with their foreign clients. They tend, moreover, to have less of an incentive to declare a default on loans. Many of these foreign loans are unsecured foreign government loans and/or guaranteed by a foreign government. As a result debt servicing may be interrupted but most, not necessarily all, loans are eventually repaid.²

It may not be necessary to undertake a massive refunding operation nor a mandatory transfer of bank claims to a new international organization, nor even a systematic stretching out of existing maturities. Consistent with our theory, for example, would be a more automatic supply of short-term liquidity by the Bank for International Settlements (BIS) and the IMF, and creation of a market for bank claims with some official support by central banks. A system of partial guarantees by multilateral world institutions, not by national governments, to help commercial banks make new loan commitments and adequate surveillance by the IMF so as to ensure that new

lending will support sound economic policies are also methods which would be consistent with our theory of cooperation.

This does not mean that developing-debtor nations will be relieved from dealing with long-term problems related to the structural aspects of the debt crisis — essential problems with great social implications and effects on employment and population, on natural resources and energy, on innovation and capital formation. Similar structural problems face many of the developed-creditor countries as well. But if developed-creditor nations are able to maintain monetary stability and avoid inflation, to forbid themselves the use of protectionist measures, and to view the debt issue in proper perspective as an opportunity for promoting world cooperation, the world will be the better for it.

ROLE OF BANKS

World banks in their lending activities have managed to transfer significant resources from the developed to developing countries. As a result they may have provided the world with a mechanism whereby a strategy of cooperation based on reciprocity can gain a foothold in an otherwise iterated Prisoner's Dilemma³ game which the developed and developing countries play out on the world scene.

Clearly banks did not have such a result in mind — again a result of human action if not human intention. They have more at risk in the current international debt crisis, which has every indication of continuing for many years, than any other sector of the economy. In the scramble for market share, these banks set a pattern of lend first and ask questions later. If opportunity knocked, they opened the door. If regulators stood in the way, the banks challenged them. In the process they are changing the anatomy of world banking and providing the world with a rare opportunity for constructive cooperation.

Here is a good example of the endogenous unplanned aspect of social institutions which is counter to the usual social-scientific view of institutions as planned or designed mechanisms given exogenously to the theorist. It is Nobel Laureate F. A. Hayek who suggests research into the unplanned or unconscious interaction of social agents in order to investigate the spontaneous or unintended social institutions they create.⁴ Indeed, it is a major theme of Hayek's

social philosophy that emergent or spontaneous outcomes, or more descriptively, the unintended consequences of human action are both efficient and desirable.⁵ In our example the market place is finding ways to accomplish changes in banking and the world economy without the benefit of conscious action by government.

This study examines the underlying forces of change in world banking and of the on-going dialogue between developing-debtor countries and developed-creditor countries within the context of a theory of cooperation. It argues that these forces are best understood by drawing on theory, history, and comparative experience in the United States and other countries. The study thus weaves together institutional, theoretical, and empirical results of monetary theory, game theory, computer simulation, and policy analysis so that each reinforces the others. It is only when many strands are woven together that we can have a useful understanding of the on-going dialogue between developing-debtor countries and developed-creditor countries and the changing anatomy of world banking and its significance to the world economy.

DEVELOPING AND DEVELOPED COUNTRY DIALOGUE

The status of the dialogue between developing and developed countries is suggested by the Sixth U.N. Conference on Trade and Development (UNACTAD VI) held in Belgrade, Yugoslavia in June, 1983. The conference addressed itself to a number of continuing problems if not to their solutions. The conference, between the world's "rich and poor" ended in frustration. To be sure in terms of mere dialogue — more gentle persuasion and less fist banging — the conference was generally rated a success. For the first time the conference benefited from no visible confrontation.

This change in tactics and subsequent lack of polemical debate is deceptive. The conference showed that the industrialized North and developing South are no closer to bridging the economic divide that lies between them.

The poor nations want billions of dollars from the richer nations to refloat their economies marooned by the economic downturn of 1979-83. This downturn has left 94 of the 125 developing countries represented in the conference saddled with debt amounting to about \$626 billion at the end of 1982.

What they received were minor concessions. They were offered no fresh financial commitments nor did they win approval for a doubling of quotas to the International Monetary Fund which assists countries with balance of payment difficulties. The major industrial countries did agree to try to halt protectionism by sticking to stand-still provisions, but they fell short of their demand for a rollback of protectionist measures. On commodities, the third-world countries failed to carry the United States along with them on a conference resolution to ratify the common fund to boost low commodity prices.

Some observers of the UNCTAD VI Conference argue that it stumbled because of a problem of perceptions.⁶ I agree. Thus the rich countries at first assumed that since the poor nations were adopting a conciliatory rather than confrontational stance, it signaled a moderation in the actual substance of their platform. It did not.

The poor countries, in truth, misinterpreted the endorsement by the rich nations of their more moderate attitude as a sign of consensus that the two sides would move forward on the actual specifics of the third world package. As it turned out, they were wrong.

The participants were simply operating on different wave lengths. Central to everything, however, was what had produced the 1979-83 world economic downturn and what measures should be taken to remedy it.

The developed countries largely view the problem as cyclical. In short, as recovery takes hold the benefits will trickle down to the developing countries. Their export prices will go up and they will be able to pay their debts.

As a result the developed nations persist in their cyclical view of world economic downturn. They will not risk upsetting an economic recovery by injecting additional liquidity through a new allocation of special drawing rights (central bank reserves created by the IMF) or adjusting existing financial institutions such as the IMF or the World Bank.

The view of the developing countries is simply opposite. They view the world problems as structural, not cyclical. They do not hold with the trickle-down theory, and are convinced that even if there is a recovery, another recession will only put them back in the economic hole out of which they are now trying to climb.

The remedy, then, is a redistribution of world resources and a revamping of the global economic system that they say discriminates against them.

It is important to understand at the outset that lending and borrowing nations have profited greatly from the trade activity fueled by the loans of world banks. That trade has woven a fabric of interdependence that we tamper with only at our peril.

Development in third world countries is vitally intertwined with bank lending. There is, of course, room for disagreement as to whether it was possible for government, bankers, regulators, and others to have foreseen the depth of the recession of 1979-83 before excess lending occurred. Energy problems and the recycling of petrodollars unleashed a unilateral transfer of wealth to oil-producing countries and pushed the international financial markets into a state of turmoil that later was aggravated by the worldwide recession.

Countries have met the energy problem in one of three ways. The United States tried to protect current consumption to the detriment of the future stock of capital. The Japanese cut consumption. And countries like Brazil, Mexico, Yugoslavia, and others found it very difficult to do as the Japanese did, so they borrowed. Their debt increased rapidly, and the recession's weakening of world markets along with exchange rate volatility, made repayment all the more difficult.

More important, perhaps, is what the third world countries would look like politically, economically and socially if they had not borrowed? *In short, what are the results of the unintended actions taken for the most part by the world's banks in their own behalf and in their interest?*

A case in point is Brazil with an outstanding debt of almost \$100 billion. In 1964, Brazil began reforming and stabilizing its economy, leading to policies of high industrial growth. Energized by infusions of foreign loan capital and direct investment from 1968 to 1973, the Brazilian economy galloped along at an annual growth rate of over 11 percent.

Countries like Brazil, as we noted, were hit hard by the OPEC events of 1973. Their planners saw a need for massive investments in hydroelectric and other energy related projects to lessen vulnerability to imported oil. In today's markets those decisions could be questioned. In tomorrow's, perhaps not.

Brazil's growth did slacken to about 6 percent in the late 1970s, yet even that pace more than matched the long-term growth levels in the industrialized countries.

Another illustration is South Korea. In 1962, manufacturing accounted for less than 16 percent of GNP; after ten years of heavy investment that figure jumped to 36 percent. During the first half of that period, economic growth averaged about 8 percent. Then, during a period when external bank lending became more pronounced, the growth rate climbed to almost 12 percent, where it stood for several years. Major financial reforms sharply increased the intermediary role of banks in private capital markets to support a major spurt of industrialization.

And in Yugoslavia after a significant slowing down of the rate of increase in GMP (gross material product) following the 1965 Reform from 8.6 percent in 1953-64 to 5.5 percent in 1965-70, the rate of increase in GMP rose to nearly 6 percent in the 1970s. This is more than six times higher than the rate of growth of population (.9 percent annual rate).⁷ The second characteristic of the rate of economic development in this period is the variability of the rate of growth of GMP from a high of 8.6 percent in 1974 to a low of 3.1 percent in 1980 and 2.0 percent in 1981. Starting from a rather low level in the 1940s, per capita GMP reached \$2,486 at the end of the 1970s. Translated into GNP (gross national product) it is about 15 percent higher, about \$2,860. Compared with European countries at a similar level of economic development, the per capita GNP of Yugoslavia is higher than those of Portugal, (\$2,180) and Turkey (\$1,160) but lower than those of Greece (\$3,960) and Spain (more than \$5,000).

Though many factors are necessary for growth in the developing countries, it is clear almost by definition of a developing country that only a small portion of the financing can be generated by internal savings.

In addition to direct lending to third world countries, development moves forward by means of investment by transnational companies. To an important extent, that investment is mobilized by bank lending.

As for the industrial countries a kind of double recycling has taken place: as funds invested in local projects begin raising incomes, markets develop that generate jobs and export revenues for the

industrial countries. In the case of the United States, exports make up an evergrowing proportion of the economy. Indeed over 40 percent of American exports now go to third world countries.

For their part many banks are still making significant profits. Thus in Britain the big four clearing banks' profits in the first half of 1982 were significantly greater than in 1980. American banks registered a 5 to 10 percent increase in profits in 1982 over 1981.

Most banks in the United States and elsewhere are thus in reasonable shape. They have built up provisions over the years against the possibility of having sometime in the future to write off a loan. Their continuing ability to do so, however, depends on the economic cycle.

Bank losses lag behind economic cycles because enterprises do not always collapse at once but do so over time, bolstering themselves for as long as possible with more short-term bank debt. The severity of the post-1979 economic decline has underscored the cyclical factor. For instance one report notes that Britain's Midland Bank had, in 1982, 70 medium-to-large companies in its unit with debts of around £350 million.⁸

The nonperforming assets (so-called because interest is not being paid) of large American money center banks has increased significantly over the cycle, however they are still less than they were in 1970. Such large disasters as Chrysler and International Harvester in the United States, A.E.G. in Germany, and Massey-Ferguson in Canada occur slowly. Still, during the past economic contraction, corporate bankruptcies in America were at record levels. Business failures in Britain were up 35 percent in 1982. In Canada, banks' 1982 losses on loans exceeded those in 1981.

Bank insolvency and threatened world banking collapse, nevertheless, did not take place. Provisions provided by banks for bad loans are also supplemented by bank capital. The ratios of capital to assets have been improving, especially in the case of large American banks by comparison to recent years. These are the banks with considerable exposure overseas.

The hidden reserves of German and Swiss banks have absorbed large losses without significant damage to their balance sheets. Indeed, observers note that the recent crises in these two countries has strengthened the argument for hidden reserves.