PROBLEMS OF INTERNATIONAL FINANCE

Papers of the Seventh Annual Conference
of the
International Economics Study Group

Edited by
John Black and Graeme S. Dorrance

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PROBLEMS OF INTERNATIONAL FINANCE

This volume studies several aspects of the current problems concerning international finance.

Robert Z. Aliber considers the role of international finance in allowing adjustment to economic shocks to be spread over time so as to reduce costs of adjustment. He discusses the problems which have arisen because of the growth of a large volume of international debt without any institution able to provide quality regulation or to perform the lender-of-last-resort function of national central banks.

Geoffrey W. Maynard considers the increasing role of banks in international finance, especially in recycling the OPEC surpluses since 1973, and examines the problems arising from flexible exchange rates and high and fluctuating interest rates.

David T. Llewellyn analyses the motives of the various parties to international loans – the ultimate lenders, the ultimate borrowers, and the institutions which provide financial intermediation – and examines the relations between these groups.

K. Alec Chrystal considers the non-speculative motives for holding foreign money, and discusses the development of international monies.

Nicholas C. Hope and **David W. McMurray** look at the place of international lending in financing the non-oil developing countries.

Bahram Nowzad stresses the problems of debt burden for these countries.

Kate Phylaktis and **Geoffrey E. Wood** examine the theory of the operation of exchange controls on capital movements under different exchange-rate regimes.

Finally **Emmanuel Pikoulakis** considers the theory of monetary and fiscal policies in an open economy with a flexible exchange rate.

The general consensus is that current problems in international finance, while serious, are not out of control, and that there is reason to hope that the world financial system can find ways of surviving its current difficulties.

John Black is Professor of Economic Theory at the University of Exeter and a former Chairman of the International Economics Study Group. He was formerly Fellow and Tutor in Economics at Merton College, Oxford. He is the author of *Essential Mathematics for Economists* (with James F. Bradley) and *The Economics of Modern Britain*, and editor (with Brian Hindley) of *Current Issues in Commercial Policy and Diplomacy*, (with John H. Dunning) of *International Capital Movements* and (with L. Alan Winters) of *Policy and Performance in International Trade*. He has been an editor of *The Review of Economic Studies* and *The Economic Journal*.

Graeme S. Dorrance has recently retired from teaching at the London School of Economics and the University of Maryland.

Previous International Economics Study Group volumes published by Macmillan

TRADE AND PAYMENTS ADJUSTMENT UNDER FLEXIBLE EXCHANGE RATES
Edited by John P. Martin and Alasdair Smith

CURRENT ISSUES IN COMMERCIAL POLICY AND DIPLOMACY
Edited by John Black and Brian Hindley

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POLICY AND PERFORMANCE IN INTERNATIONAL TRADE
Edited by John Black and L. Alan Winters

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Introduction

The International Economics Study Group is one of several study groups in economics in the United Kingdom funded mainly by grants from the Social Science Research Council. It organises one-day meetings and an annual conference. These provide a forum in which professional economists from British universities, polytechnics, government departments, banks and business meet to discuss research papers by members and foreign visitors.

Since 1976 annual conferences have been held at the University of Sussex Conference Centre, Isle of Thorns, Sussex; the proceedings of four of these have already been published by Macmillan.

The 1982 conference, convened by Graeme Dorrance, was held from 17 to 19 September 1982. The International Economics Study Group would like to thank the Social Science Research Council, Barclays Bank, Lloyds Bank and Shell International for grants which made it possible, as well as all who took part, especially Graham Bird, Anthony Bottrill, Helen Hughes, James Riedel and Martin Wolf, who acted as discussants on the papers.

The topic of the 1982 conference was a consideration of problems of, and approaches to, current international financial relations, and of the prospects for international borrowing and lending. The meetings were held when the problems relating to the Mexican 'debt crisis' were the subject of widespread comment and it was being suggested that the international financial system was facing a serious breakdown. This collection of essays comprises the papers presented against this background.

The general tenor of the discussions was relaxed. It was recognised that the international financial system faced a number of short-term difficulties, but it had faced such obstacles on a number of occasions in recent years, and there was no reason to believe that the current difficulties could not be overcome if proper policies were followed in the future. In general, proper policies had been followed in the past, and the International Monetary Fund and others, such as the Bank for International Settlements, appeared prepared to be innovative. It was largely accepted that the institutional arrangements that would develop by 1990 would be as different from those prevailing, as the 1980s arrangements are from those in existence in the early 1970s. Yet the possibilities of a serious financial crisis, or of a breakdown of the international financial system, were regarded as being remote; and even to say this, it was felt, might overstate any inherent weaknesses in the international financial system. In large part, this rather optimistic consensus resulted from the long-term horizons accepted by these authors who refused to be stampeded by short-term rumours.

I THE BACKGROUND

Three general, but overlapping, themes dominated the discussions. First, with the background of the Mexican and similar 'crises', the stability of the international financial system was questioned. Here, the long-run views taken by all the authors, and practically all the participants in the conference, contributed to the relaxed atmosphere. Second, there was considerable interest in the lines that should be followed in analysing the institutional and statistical information that is becoming available on the operation of international financial institutions. Finally, there are some more theoretical questions that warrant further examination.

Most discussions of international financial transactions are based on considerations of national current account or capital account surpluses or deficits unless they are examinations of the types of instrument traded in the markets. Today, most national capital markets are linked through the international markets and it is not countries, but individual economic agents, that borrow and lend. For any economy, the ex post international capital account balance will be the net of the capital surpluses and deficits of its domestic agents. Domestic borrowers and lenders compare the alternative opportunities in their domestic markets to those available to them in international markets, and individually decide to have recourse either to domestic or to international markets. Even though many individual agents do not have effective direct access to international markets, if some important marginal borrowers or lenders have access to these markets, the domestic markets will reflect the conditions on international markets. Further, as financial intermediaries were very innovative in the 1970s, the effective access to international markets has broadened. Money-market and similar funds have made deposit-type assets available to a wide range of domestic lenders, but have made loans on the international markets as counterparts to these liabilities, paying interest to domestic lenders based on the returns on international assets. Similarly, merchant banks and similar organisations with access to international markets have developed networks of branches making loans to domestic borrowers who would have difficulty in achieving direct access to international markets.

The fact that transactions on international capital markets are completed by independent agents rather than by countries makes it quite normal that residents of individual countries should be concurrently lending and borrowing on international capital markets. For certain types of transaction, the economies of scale and the limitations of international institutions to large transactions can make international deposit and similar rates higher than comparable rates on domestic markets. The absence of a reserve ratio 'tax' on international transactions can also contribute to this disparity; at the same time, international lending rates are lower than comparable domestic rates. Hence, concurrent borrowing and lending by residents on international markets may be encouraged. This concurrency is likely to be particularly important in countries where the domestic financial system is developing rather than sophisticated; yet, on many occasions US residents have had concurrent recourse to international markets. It also frequently reflects the more efficient transformation activities of institutions, including foreign branches of domestic institutions, engaged in the international capital markets. Thus, for example, many OPEC official agencies and private lenders had a strong desire for deposit-type assets, while the borrowers, particularly those facing extended economic adjustment problems, wished to borrow on medium- to long-term bases. Much of the recycling of petro-dollars reflected a transformation of short-term sources of funds into longer-term loans. Even individual agents may be concurrent borrowers and lenders. Thus some national Treasuries that have been active borrowers at medium- to long-term have also been active accumulators of international reserves (that is, deposit lenders) during the 1970s and early 1980s.

While international capital transactions are flows of funds they are also the product of shifts in the portfolio structure of individual economic agents, including the financial institutions engaged in the international markets. Some of these movements may be fairly stable over the long-term, as investors build up their wealth and only slowly change its composition. Other movements are the product of short-term changes in portfolios that continue until portfolio structures are adjusted and then cease or continue only at markedly diminished rates. The adjustment in US bank portfolios between 1974 and 1976 that reflected the pent-up demand arising from US capital outflow restrictions from 1963 to 1974 is one example of such a sudden surge. Similarly, the adjustment of UK institutional portfolios following the abolition of exchange controls in 1979 is another example.

The growing popularity of international investments with primarily domestic financial institutions during the 1970s represented a shift in portfolio structures that extended over an unusually long period and contributed to the high annual flows from the early 1970s to the early 1980s. It is as yet (1983) unclear whether the surprises of 1982 will lead many of these institutions to readjust their portfolios towards a lower proportion of foreign assets.

The international debt burden problem has been a specific aspect of international financial relations that has attracted considerable attention in recent years. The increased attention to this problem can be partly explained by the change in the structure of international financial flows. In the 1940s and early 1950s, aid and loans on concessional terms accounted for the major part of international resource transfers. As the international financial system was liberalised in the 1950s, residents of the important net savings countries, primarily large companies, looked to opportunities for investment in the expanding net borrowing countries, such as the European reconstructing countries and some of the less developed countries (LDCs). This direct investment involved no fixed repayment and profit transfers were dependent on profit earnings – these transfers did not involve fixed debt burdens. With the growing importance of institutional investors in all middle and high income countries, and the growth of available savings in a relatively few non-industrialised countries (such as some members of OPEC) international financial flows tended to become institutionalised. Lenders looked for deposit-type or negotiable security assets and borrowers wished to accept debt with predetermined maturities. In some cases, the borrowing countries preferred financial obligations that enabled them to finance domestic investments where the operations would be subject to domestic sovereignty rather than controlled by foreign transnational companies. However, one of the costs of this institutionalisation was the growth of predetermined debt-servicing charges in the place of foreign capital servicing that was related to domestic earnings.

Institutionalisation has also tended to accelerate the rate of debt repayments. In many cases, direct investments are never redeemed. As long as a foreign-owned enterprise earns profits, the investors are satisfied to accept the stream of profits. In fact they usually forgo the transfer of some of the profits earned, reinvesting a considerable part so as to augment their income streams. On the other hand, financial institutions, which accept liabilities that are legally repayable at definite times, can only make loans that are also repayable on predetermined terms. With many of the savers desiring liquidity as well as income, the financial institutions, satisfying this demand by accepting short-term liabilities, are restrained in their freedom to make longer-term loans. It was generally accepted that financial institutions had engaged in considerable maturity transformation so that their assets tended to be of longer average maturity than their liabilities, but that there were limits to this transformation.

II THE CONTRIBUTIONS

Many of these theses are reflected in Aliber's chapter which indicates how the international financial system has allowed adjustment to the stocks in goods and service markets to be spread over fairly lengthy periods, thereby lessening the adjustment costs. In fact, LDC borrowings have been larger than would have been required to adjust smoothly to the change in petroleum prices. The countries with high returns on capital have been able to draw resources from the countries with excess savings. Aliber acknowledges that certain countries may have borrowed more than could be justified on purely market criteria. He also recognises that most domestic financial systems have a lender-of-last-resort to guarantee the essential liquidity of the system. Such a safety net is not yet available on the international scene and in this chapter he argues that it is difficult to foresee how such a guarantee mechanism might evolve.

While the discussion of this argument tended to accept its general conclusions, certain reservations were expressed. The high level of debt, particularly the LDC debts, was accepted as a matter of concern. The fact that, in some cases, this was the product of inappropriate fiscal/monetary policy mixes indicated that lenders should be more prepared to examine the domestic policies of borrowing countries when making country risk assessments. In particular, it was maintained that they should be concerned to ensure that foreign loans provide the marginal finance for productive investment rather than supporting high levels of consumption or financing investments with low social returns. It was suggested, however, that undue attention had been directed to the distortions arising from inappropriate borrowing – some of the individual cases are horrendous. On the whole most financing has, in fact, been directed to the support of investment projects. Foreign borrowing that financed consumption was undertaken primarily to facilitate the adjustment processes that were made necessary by the shocks to which individual countries had been subjected in the 1970s.

Some of the effects of the institutionalisation of international capital transfers are outlined by Maynard who concentrates on the role of banks in the international financial intermediation process and draws attention

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to a major change in the structure of international capital flows during the 1970s. In the 1950s and 1960s these markets tended to be ones where residents of the industrial countries were not only the major lenders but also the major borrowers, and most of the borrowers were private enterprises. After the 1973–4 increase in oil prices, OPEC countries (particularly a few with large current account surpluses – Iraq, Kuwait, Libya and Saudi Arabia) became important lenders in the international markets and developing countries entered the markets as important borrowers. Maynard points out that these lenders wished to acquire liquid assets, while the borrowers wished to be free of the immediate burden of short-term debt. The banks – in the widest definition of this term, including some underwriting houses – moved into the breach to accommodate these discrepant desires. As a result, total international lending rose from slightly over 10 billion dollars per year at the end of the 1960s to over 100 billion per year at the end of the subsequent decade, and the developing countries' share of this total rose from slightly over 1 billion dollars per year to approximately 50 billion per year.

This rapid growth occurred when exchange rates were becoming more volatile and more uncertain and interest rate volatility was also increasing. Maynard draws attention to the growth of variable-rate debt instruments as a means of reducing the costs of interest-rate volatility for lenders, and, to a certain extent, for borrowers. The increasing levels of debt also have raised concern regarding the debt burden and the stability of the international financial system. Here Maynard is more optimistic than many commentators. He sees the recent relatively high growth rates in most of the borrowing countries, and the rising level of domestic investment in most of them, as signs that 'international capital markets did a better job at redistributing world savings to areas where the real return on capital remained relatively higher than they have been given credit for so far'.

Attention should finally be drawn to Maynard's views on the need for a 'lender-of-last-resort' or an international safety net held by the IMF or some international central banking group. This idea has certain appeal as it fits in with generally accepted domestic banking theory. One of the surprising aspects of the 'international financial crises' of late 1982 and early 1983 was the ease with which they were met. They provided more income for financial journalists than real worry for lending institutions. If the inter-governmental community were to move further in the direction of underwriting the lending institutions' operations it could well encourage greater irresponsibility by these institutions and raise serious questions of moral hazard.[1]

Llewellyn deals mainly with the relation between domestic and international financial transactions. He indicates some of the criteria, particularly portfolio criteria, that must be observed in any further studies of international capital market questions, and argues quite strongly for the need to integrate international capital market studies with domestic flow of funds and balance sheet analyses. He also finds some evidence to support these views but, in general, this must be taken as a guide to further work rather than as a group of startling conclusions.

In the discussion, it was recognised that Llewellyn's presentation was a preliminary framework intended to provide a basis for further development. The suggestion was made that he concentrated too much on overall surplus and deficit agents and that many international capital transactions arose from the specific need of individual agents to use certain types of credit (for example, trade credit) and to have certain types of asset (for example, liquid deposits or income-earning direct investments). These specific requirements could explain many of the concurrent borrowing and lending transactions. It was also suggested that the model should be developed to incorporate interest-rate effects into what was essentially a price-free structure.

Chrystal's contribution is a specific example of the type of analysis proposed by Llewellyn (although it is clear that Chrystal reached his conclusions following lines of thought quite different from those pursued by Llewellyn). Chrystal examines some of the influences on those parts of portfolios that are held as foreign currency trading balances – he specifically abstracts from all speculative demands for international balances. He recognises that the international currency markets are highly institutionalised. Most traders in goods and services either buy foreign exchange from, or sell it to, domestic banks and, as a consequence, trading balances are held predominantly by banks – most dealers in goods and services either sell export proceeds only or cover import requirements only. Very few individual agents (chiefly large multinational companies) both buy and sell exchange. He also recognises that direct dealings between particular currencies (for example, trading drachmas for cruzeiros) involve high transaction costs. Consequently, the trading balances of banks will reflect their portfolio targets, as they are both buyers and sellers of exchange. By combining the demands and supplies of many agents, they can minimise balances below the levels that would be required if all agents were holding individual transaction balances. There are markedly different transactions costs in different markets (for example it may be easier to sell drachmas against dollars and to buy cruzeiros with dollars than to attempt to buy cruzeiros directly against drachmas). It is reasonable therefore for banks' holdings of transactions balances to be concentrated in such intermediary currencies as the dollar, DM, or yen, irrespective of the currency in which individual transactions are invoiced (that may, in fact, not be the currency of settlement between individual traders). Chrystal examines some of the conditions that will influence the size and composition of these primarily institutional trading balances.

Some objections were raised to the development of a model that excluded speculative and foreign interest rate considerations. Speculative and trading balances are frequently consolidated and held in interest-bearing form (overnight Euro-dollar balances have recently carried interest higher than the transaction costs of moving into and out of them). It was also suggested that any model of liquid foreign balances should incorporate the relation between changes in these balances and domestic monetary policy. Admittedly, Chrystal included a domestic interest rate in his model, but it would be desirable to relate the size of foreign exchange balances to domestic monetary aggregates.

Hope and McMurray each dealt specifically with the debt burden and debt management problems. Their chapter draws attention to the fact that, in many respects, there is no 'developing country' financing problem. Rather, each country's problems are, in a sense, unique. However, they indicate that there are certain similarities in the problems faced by countries that have relied primarily on borrowing on international financial markets. These are different from those of countries that have been able to rely on aid to meet their balance-of-payments deficits. There is an intermediate group that has relied on a mixture of aid and market borrowing. A major part of the paper is devoted to a review of the criteria that a developing country should adopt in its international debt strategy. Hope and McMurray start with the fact that, when considering future borrowing, the authorities should know the amount of their country's outstanding debts. This seemingly simple point has yet to be acknowledged by many countries, despite the efforts of the World Bank, the IMF, and the OECD to compile such data, not only for their own use, but for policy determination by individual countries. The chapter emphasises the relation between appropriate domestic financial policies and long-term access to capital markets on reasonable terms.

Along with several other contributors, Hope and McMurray draw attention to the growth during the 1970s of bank financing as a source of international capital. On an optimistic note, this paper suggests that the growth of institutional lending has provided a degree of sophistication in international financing that has produced benefits for those countries which rely on international borrowing. They express a view, similar to the one that 'it is not true that developing countries as a whole borrowed excessively, that they squandered the proceeds, and that they now face a generalised debt problem. There is no generalised debt crisis.'[2]

Nowzad directs attention to the debt problems of the developing countries. He shows that many developing countries have, in fact, faced external debt difficulties that have had serious consequences for their growth prospects, and in the view of some commentators are putting strains on the international financial system. He points out that these problems arise not only from unwise borrowing policies followed by countries, but also from unwise lending policies adopted by financial institutions. Part of the difficulties reflect the changes in the terms of international borrowing. Over the 1970s, average maturities have tended to shorten (if anything, the terms for private lending have lengthened, but there has been a marked substitution of private for longer-term official loans) and interest rates (reflecting inflationary expectations) have tended to rise. However, an examination of individual cases suggests that, aside from the Eastern European countries, those countries that have experienced serious debt problems have tended to be ones with relatively slow growth rates and relatively high inflation rates compared with those of the developing countries that have not experienced serious international debt problems. That is, there is evidence that international financing problems were, in a number of cases, the product of domestic policies. On a slightly different line, Nowzad finds little, if any, evidence to support the view that, allowing for recent changes in policy, the international financial system is under serious strain.

In discussion at the conference, attention was drawn to the number of cases where inappropriate exchange rate policies were the most damaging of domestic financial policies. It was also indicated that the assessment of the debt burden problem may be even more complex than Nowzad suggests – no single ratio, or even several, can be used in measuring the problem. For example, the most commonly used debt service ratio includes amortisation together with interest payments. In many instances there may be a strong case for refinancing amortisation payments. Further, if interest payments include an element of inflation compensation, they also include, in effect, an element of advance redemption or reduction in the real value of the debts.[3] Hence, there may be a case for borrowing to meet part of the interest payment so that the stream of amortisation is stable in constant-price terms. In brief, an assessment of the debt burden problem is complex.

The increasing freedom from direct controls and of competitiveness have contributed markedly to the growth of international capital markets. Phylaktis and Wood draw attention to the fact that exchange controls still exist in many countries and that any analysis of capital movements should take account of these controls. They suggest that in most cases, it is possible to derive a 'tax equivalent' effect of exchange controls. These tax-equivalent effects will influence portfolio adjustments and the exchange rate. At least in the long-run, interest parities and purchasing power parities, adjusted for the effects of exchange controls, may be expected to prevail. In fact, after the monetary effects of changes in capital transactions lead to new portfolio structures, interest rate parities will probably be maintained. As emphasised at the conference, the adjustment process resulting from any imposition of exchange controls is likely to be extended over time and may not be completed if there are expectations that a subsequent change in exchange controls is possible.

Finally, Pikoulakis examines some of the adjustment reactions within a system of fluctuating exchange rates where allowance is made for current account trade in goods and services, and capital account adjustment of portfolios, but where different types of asset are imperfect substitutes for each other. He suggests that this imperfect substitutability may contribute to stability in the international monetary system – a theoretical conclusion that is consistent with the more optimistic views of several of the more pragmatic papers included in this collection.

NOTES

1. On this point, see Dorrance (1981).
2. World Bank, *World Debt Tables, 1982–1983 Edition*, p. vii.
3. See Nowzad and Williams (1981).

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