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MEMORANDUM FOR PRESIDENT'S ECONOMIC POLICY ADVISORY BOARD

FROM: EDWIN L. HARPER

SUBJECT: September 8th PEPAB Meeting

As you all know, the next meeting of the President's Economic Policy Advisory Board will be on September 8th in the Roosevelt Room from 10:00 am to 3:00 pm. The President will be with us from 2:00 - 3:00 pm.

We'll begin the session with a discussion of the international lending situation. As preparation for that discussion, Walter Wriston, whom the President has asked to serve as the Chairman of PEPAB, has asked me to send you a copy of the enclosed paper "International Lending - Manageable Problems or Approaching Crisis?"

Martin Feldstein, whom the President has nominated to be the next Chairman of the Council of Economic Advisers, will discuss his views on the outlook of the economy.

Next, Dave Stockman will give us an update on the budget outlook and his major concerns as we go into the preparation of the FY '84 budget. Herb Stein and Bill Simon will also be speaking on the spending issue.

The period from 1:30 - 2:00 pm is reserved for the purpose of organizing our discussion with the President. As indicated, the President will be joining us at 2:00 pm.

I look forward to seeing you on September 8th.

P.S. Paul Volcker was invited to join us for lunch per the suggestion of a number of members of PEPAB. Paul indicated that he would very much like to join us but that he had a long standing commitment to remain in Toronto at the IMF meetings on Wednesday morning and would not be able to get back in time to join us. He's given us a raincheck for a future meeting.

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International Lending -- Manageable Problems
or Approaching Crisis?

In recent weeks, several international problems (i.e. Poland, Argentina and Mexico), added to the major domestic failures (Drysdale and Penn Square) have raised questions about the health of the world financial system. Some of the commercial banks' larger international clients, both countries and firms, clearly have become less creditworthy, at least temporarily. The question arises whether this deterioration in the borrowers' condition is mainly a transitory development associated with the business cycle or reflects a trend toward an eventual crisis.

One cannot ignore the recurring fear that the continuous growth in bank lending to developing countries inevitably will lead to a crisis. The perception exists that commercial banks during the past decade have been overloading the developing countries with an almost unbearable burden of external debt. What are the facts behind this idea?

Between 1973 and 1981, the long-term foreign debt of the 109 non-OPEC developing countries increased from $97 billion to $437 billion. Without dispute, this is an enormous increase. Nevertheless, it must be kept in mind that prices more than doubled during this period and all economic variables were affected by this inflation. In the same 8-year period, the gold (revalued to market prices) and foreign exchange holdings of these same countries more than tripled and their exports of goods and services quadrupled. So, while the foreign debt rose rapidly, the growth was much less marked in relation to the export earnings which must service the debt. For the group as a whole, foreign debt rose at a compound annual rate of 20.7%, while exports of goods and services rose by 18.5%. The growth of export receipts relative to debt was even more favorable for the larger developing countries, such as Mexico, Korea and Brazil, who are the major clients of commercial banks. Mexico's exports, for example, increased by ninefold in this period, from $2.1 billion in 1973 to $19.8 billion in 1981.

While in retrospect, more moderate growth of the debt might have been preferable, these numbers do not foretell an inevitable crisis. In fact, commercial bank international lending of the past decade was an appropriate response to the needs of this time. Following the rise in oil prices in 1973, an increasing portion of the world's saving was concentrated in a few oil exporting countries with limited opportunities for domestic investment. The "unmanageable" crisis caused by the oil embargo was handled by the Euro-markets with an efficiency few foresaw. Never in

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history has there been so massive a transfer of financial assets in so short a time with so few casualties. The private capital markets deserve considerable credit for having managed to channel these savings to those relatively capital-poor developing countries, which because of varying combinations of unexploited natural resources, disciplined labor, and sound economic policies has the potential for rapid economic growth.

On balance, the international lending to developing countries of the past decade was effective and prudent. The rapidly advancing countries who were the major borrowers from banks are in general a well-managed group who have adjusted to the economic difficulties of the past decade at least as well as the industrial countries of Europe and North America. The borrowed funds were generally well used, and both total national output and exports of these countries grew considerably faster than that of the industrial countries.

Another region whose borrowing has become a matter of special concern to the markets is Eastern Europe. A degree of uncertainty stems from the current debate over just how this lending should be viewed in terms of the East-West political conflict: questions are raised over whether or not the activities of U.S. banks have fueled the Soviet bloc's military expansion, and over whether there might be some effective way to exploit Poland's debt-servicing difficulties to advance foreign policy objectives aimed at the Soviet Union. First, as to the magnitudes, contrary to popular opinion the outstanding claims of U.S. banks on Comecon countries actually declined from $5.9 billion in 1977, the earliest date for which complete data are available, to $4.6 billion in 1981. (By contrast, in the same period, claims of U.S. banks on Korea alone, to use one example, rose from $3.3 billion to $9.0 billion, -- about twice the total claims on the entire Comecon region even though Korea's GNP is equivalent to less than 3% of the GNP of Comecon.) As to the possibility of using Comecon's Western borrowings as a political weapon, history demonstrates the difficulty of achieving the desired political objectives through the use of economic weapons, as well as the likelihood that, as with our experience with trade embargoes in recent years, we will not only fail in achieving the intended aims but will do possibly significant damage to our own economic and financial system. In addition, proposals for increased government intervention in and use of our financial institutions for foreign policy objectives ignore the lesson of recent history that it was the U.S. banking system, with its relative independence of government direction, that was able to make its own credit judgments and hold back on lending to Eastern Europe at a time

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when other lenders, both official and non-official, in countries with closer ties between governments and banks, were increasing their exposure to this region. Indeed, it was the United States Government, in response to farm pressure, which more than tripled its loan and loan guarantees to Poland between 1977 and 1981 while the private sector was not increasing its exposure at all.

Whatever judgment one reaches on the wisdom of past lending, two major developments in recent months are forcing banks to reevaluate the creditworthiness of international borrowers. First, the high real interest rates in the past two years have weakened the financial position of almost all borrowers including both sovereign countries and private firms. Second, the recent volatility in exchange rates, commodity prices, output, interest rates, and in the behavior of financial markets far exceeds the swings of earlier years and introduces a higher degree of uncertainty in judging creditworthiness. These two developments, high interest rates and unprecedented volatility have weakened borrowers, increased the risks of international lending, and could ultimately produce problems in the financial system unless they are handled carefully.

The sharp rise in interest rates alone is enough to force a reevaluation of international lending. An international debt of $70 billion for Mexico or Brazil takes on different meaning when the interest rate on the debt is 16% instead of 10%. This is particularly true when the increase in interest rates is in real terms, as was the case in the past two years.

The higher interest rates have not been limited to the US$. In several major Latin American countries (Brazil, Argentina, Chile, etc.) domestic real interest rates during the past two years have been substantially higher than in the U.S. Savers in these countries perceived such enormous risks and uncertainties, including the risks of major devaluations, that exceptionally high interest rates are required to stimulate savings and retain them in the country. While realistic interest rates are an essential part of any effective economic program, the level to which rates have risen has been unprecedented and has severely weakened the creditworthiness of many private sector borrowers.

In addition to high and widely fluctuating interest rates, many other crucial economic variables have been unusually volatile in recent months, increasing the adjustment problems of firms and countries and enlarging the risks in lending. Exchange rates, commodity prices, output, and financial markets themselves, to

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name only four of the more important variables all have experienced large swings. The fluctuations of the U.S.$ with respect to the currencies of other industrial countries are well-known. But the devaluations of many Latin American currencies are even more dramatic. At the beginning of the year, when the Mexican exchange rate was 27 pesos to the US$1, conventional wisdom said that the peso was 20 to 25% overvalued. Bank credit officers, when extending loans to a Mexican firm included an analysis of whether the firm could withstand a devaluation to 35 pesos to the dollar. Today, eight months later, firms are facing an exchange rate of nearly 100 pesos to the dollar for repayment of these debts. The same exceptionally large devaluations have occurred in Argentina, Chile, and Ecuador, weakening private borrowers in these countries who were heavily indebted in dollars. These problems of individual firms may turn out to be a bigger threat to international lending than the more-publicized balance of payments crises. That is to say, the Mexican authorities almost certainly will resolve the country's balance of payments problems, but perhaps with a program which includes such large exchange rate adjustments and such high interest rates that the financial condition of many private firms is severely weakened.

The recent volatility in commodity markets and in output also have been a threat to creditworthiness of both firms and countries. The decline in gold prices from over $800 to under $300 in two years was typical of many metals. Zaire, which has been struggling financially for several years, failed to pay the full interest due on its rescheduled debt early this year. This arrear was heavily influenced by a combination of historically low copper prices (60¢ a pound) and historically high libor (19%), both of which would have been almost inconceivable 2 or 3 years ago. Today, interest rates have fallen substantially and copper prices are marginally better. It is ironic that while the greatest perceived danger of recent years was that non-oil producing developing countries could not cope with the escalating oil prices, it was in fact a weakening of the oil market and the problems this caused oil exporters which contributed to the major payments crisis of 1982.

Potentially the most disturbing new "volatility" is that in the financial markets themselves. The markets in recent weeks seemed to be poised on a thin edge from which they could fall to one side or the other quite easily. An error of judgment by a commercial bank (bad loans to the energy sector) or by a country (Mexican wage increase which annulled the previous devaluation) can cause depositors to withdraw funds on a massive scale. In

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many smaller banks, the herd instinct is stronger than the analytical capacity to judge the creditworthiness of an international borrower. Mexico is creditworthy because everyone else is lending to it and it becomes uncreditworthy because others stop lending.

The major need for the moment is for a calming influence from all the important players on the international scene: commercial banks, governments, bank regulators, and the International Monetary Fund.

After a decade of rapid growth, a marked slowdown in international bank lending now appears to be occurring, and there is a danger that the pendulum will swing too far in that direction. Mexico is a good example. It appears that Mexico borrowed net, mainly from banks, about $18 billion in 1981. This large borrowing was due to several factors. Early in 1981, $10 billion of net borrowing would have been a reasonable estimate of the needs for the year, a sum which already was large enough to be worrisome. Nevertheless, at that time the future stream of oil revenue looked very promising; in addition, creditors were confident that as soon as the election was over in mid-1982, the new authorities would take action to reduce the annual borrowing needs to a more sustainable level, perhaps $5-7 billion. Abruptly, in mid-1981 the world oil market changed, and both the volume and price of Mexican oil exports declined. By late in the year, Mexican private savers had sensed a crisis and were taking advantage of the overvalued rate to send funds abroad. By the end of the year the world financial community had let Mexico net $18 billion, by far the largest amount ever to go into a developing country in one year, and this was used to support an untenable program.

The hope now is that Mexico will agree on a program with the IMF for 1983 and beyond which would limit net foreign borrowing to perhaps $4 billion per year. A $4 billion annual addition to the present outstanding debt of $80 billion would cause debt to grow at a 5% rate, which appears to be a reasonable plan for the next few years. The mood of the market has changed so dramatically, however, that Mexico, after borrowing $18 billion in 1981 to finance an unsatisfactory set of policies, might now find it difficult $4 billion net in 1983 to finance a good program. This is an example of the swings in mood which threaten to dominate the markets.

The commercial banks face a challenge in organizing themselves to handle the Mexican case and other similar cases

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which may arise. Provided Mexico adopts a satisfactory program, the country clearly is fully creditworthy in the medium term. Banks as a group have a strong self interest in supporting the country through a short-run crisis, which they themselves have played some role in creating through heavy lending. The management of the larger banks will see the problem in these broad terms, but it may be too much to expect the smaller banks to see more than their own immediate self interest. Many small banks will have become frightened by the short-run crisis and simply want to get their funds out of Mexico. This of course will not be possible because neither the larger banks nor official lenders such as the IMF will be prepared to inject sufficient funds to allow other lenders to withdraw.

Bank regulators will need to avoid an overreaction in this situation, which will not be easy at a time when they are under attack. The German bank regulators, for example, after tacitly allowing a large build up in exposure in Eastern Europe are now reportedly pressing German banks to reduce their international exposure almost indiscriminately, and a withdrawal of short-term funds by German banks from Mexico apparently has contributed to the present nervousness of the markets about that country at a time when the appropriate reaction by banks would be to reconfirm their commitments to support the borrower in the short-term provided it takes the measures required for the long term. The dangers of an overreaction are increasingly being recognized, however, as shown by a recent warning to commercial banks from a high official of the Bank of England against a precipitous withdrawal from international lending.

Both banks and bank regulators need to be reminded that large government and corporate borrowers almost never repay debt except by issuing new debt. This is true both of the U.S. government and the telephone company. The key question is not whether debt will be repaid in a stated time frame, but whether the borrower manages in a way which permits continued access to capital markets. Naturally rich countries such as Argentina have from time to time been managed poorly and been frozen out of capital markets, while relatively poor countries such as Korea which with good financial management have been able to continue to tap the markets. Many large importers of oil have been able to adjust to the higher price of petroleum while some oil exporters have got into difficulty. In the end, the central issue in being able to handle debt is the fiscal, monetary and exchange rate management of the country.

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Finally, a word about the role of the IMF in underpinning the international system. Because the size of the IMF has lagged well behind the growth in world trade, the funds which can be supplied by the IMF in problem countries are relatively small in relation to the emerging needs. The maximum the IMF can provide to Mexico, for example, is about $1.3 billion per year for 3 years. There are several reasons for this lag in sizes of IMF quotas. Perhaps most important is the loss of confidence by the major industrial countries in the adequacy of IMF (and also World Bank) policies in the late 1970's. During that period, the IMF, in order to curry favor with developing countries, occasionally supported programs which seemed designed mainly to provide financing for deficits rather than to bring the deficits down to levels which were sustainable in the medium-term. This absence of a strong adjustment pressure from the IMF left a serious gap in the system, because even the largest of the commercial banks does not have the trained manpower or access to confidential information to permit it to spot a dangerously developing country situation as quickly as the IMF can do. Nor do the banks have the political power to force adjustments on countries where these are required. Fortunately, the permissive period of the IMF now seems to have ended, largely as a result of the clear support of the U.S. and other industrial countries for more adequate programs. This has created a situation in which there is a strong case for enlargement of IMF resources either through increases in national quotas or by giving the IMF access to private capital markets, while using U.S. influence to ensure that the institution plays its full role in the adjustment process.

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