The thrill of lending, the agony of default

BANKING GONE BAD

by Benjamin J. Cohen

If debtors prisons were still in fashion, many countries around the world would now be in jail. Poland, Rumania, Argentina, Brazil, Mexico—all recently have found themselves teetering on the edge of bankruptcy, unable to pay even the interest on the money they owe to Western governments and banks. And the list keeps growing longer. Over the last year nearly three dozen Third World and East European nations have fallen into arrears on their foreign loans. Never before have so many countries come so close to default on so much debt.

The numbers involved are staggering. The accumulated debt of Third World and East European nations now approaches three-quarters of a *trillion* dollars, representing a fivefold increase in just ten years. Spearheading this advance have been the banks of North America, Western Europe, and Japan, whose international lending grew at an average rate of 25 per cent a year between 1973 and 1981, before slowing down in 1982-83. At present, Western bank claims in the nonindustrial world top $400 billion—and many are in trouble. Since the middle of last year, no fewer than twenty-five hard-up countries have had to renegotiate the terms on at least some part of their debt to banks, and others are queuing up. Already close to $100 billion has been rescheduled. Suddenly the banks find themselves with a lot of questionable paper on their hands. The question naturally arises: How could they have let it happen? How could these presumably prudent institutions have made such a large number of dubious loans?

No doubt the banks are now asking themselves the same question. Following the global financial collapse of the 1930s, when virtually all foreign debts fell into default, banks grew understandably wary of the risks of international lending. As Herbert Feis wrote in his classic *Europe, The World's Banker*: "The financial community vowed that never again would they trust their fortunes abroad or respond to the requests of recreant foreign governments." But memories fade, and as early as the 1950s such vows were being abandoned by a new generation of bankers. In the go-go years of the 1960s and 1970s fortunes again *were* trusted abroad, as foreign banking operations spread to every corner of the globe. The change of attitude was most potently manifest in the phenomenal growth of the so-called Euro-currency market, made up of banks taking deposits and making loans in currencies outside their country of issue. Thirty years ago such an organized international lending market did not even exist. By mid-1982, according to the Bank for International Settlements, the Euro-market's gross volume of activity was approaching $1.6 trillion. The Euro-market has been the principal vehicle for bank lending to Third World and East European nations.

Although some lending to these nations was occurring even in the 1960s, its greatest impetus came from the rise of oil prices starting in 1973. OPEC's cartel action created enormous financing problems for many oil-importing countries, which could maintain their economic growth in the face of massive balance-of-payments deficits only by increasing their borrowing from abroad. At the same time, banks themselves were awash in liquidity, owing to the rising tide of OPEC surplus revenues that were being reinvested in Western financial markets. Looking back, the match-up seems inevitable: The banks needed customers, and the oil importers needed loans. And so the process of "petro-dollar recycling" was born, whereby funds flowed from oil exporters through the intermediation of Western banks to oil importers, and then back again. By the time of the second oil shock in 1979-80, the recycling process had become almost routine. The growing debts of Third World and East European nations seemed virtually in the natural order of things.

But this does not explain why the debts were allowed to grow *as much* as they did. Why did the banks get in so deep? The banks themselves argue that it was because they were encouraged to do so by Western governments, as a matter of public interest. Someone had to do the recycling. Official agencies could have taken on the responsibility but were loath to do so—mainly because it would have meant raising taxes or curtailing other forms of public expenditures at home. These were not attractive political options. We had our own problems, after all. So the banks were prompted to assume the intermediary role instead, through a combination of winks, nudges, and nods. In the words of the American Bankers Association in testimony before the House Banking Committee last spring: "There was no government directive that banks act to recycle the funds, but clearly it was expected."

The argument, however, is disingenuous. Are we really to believe that these proud institutions were so meekly submissive to the will of public officials? Would they really

Benjamin J. Cohen is William L. Clayton Professor of International Economic Affairs at the Fletcher School of Law and Diplomacy, Tufts University, and Worldview's *"Current Account" columnist.*

have gotten in so deep had they not thought that there was also something in it for them? Bank managements must answer to their investors and stockholders; they can never take their eye off the bottom line. It is not unreasonable to assume that if they were so ready to recycle petro-dollars, it must have been because they believed that there was money—perhaps lots of money—to be made from it. Governments may have given them the green light, but it was they alone who chose to put the accelerator to the floor and keep it there. Profit, not public interest, was their driving force. And if some of their loans are now in trouble, they have only themselves to blame. It is they who made the decisions, and it is they who must bear the responsibility.

THE INFORMATION ISSUE

Future historians will undoubtedly describe the 1970s as a decade that saw one of the greatest international financial manias since the South Sea bubble. What happened was not unfamiliar to students of financial behavior: The markets saw a good thing and got carried away with themselves. Petro-dollar recycling looked like a bonanza to the banks. The loan-loss record on foreign loans was better than on domestic loans; the average rate of return, higher. And perhaps most important of all, international lending was *exciting*. "The international side looked glamorous," says one bank officer. "Bankers like travel and exotic locations. It was certainly more exciting than Cleveland or Pittsburgh, and an easier way to make money than

AMOUNTS OWED TO U.S. BANKS BY FOREIGN BORROWERS
(in millions of dollars)

EASTERN EUROPE	
Bulgaria	191.8
Czechoslovakia	170.9
East Germany	633.4
Hungary	937.4
Poland	1513.3
Rumania	281.9
USSR	229.0
Yugoslavia	2319.5
Total	6277.5

OPEC MEMBERS	
Algeria	1235.7
Ecuador	2029.1
Gabon	169.3
Indonesia	2969.3
Iran	495.8
Iraq	166.0
Kuwait	1376.7
Libya	92.5
Nigeria	1854.0
Qatar	38.7
Saudi Arabia	1793.2
United Arab Emirates	1357.9
Venezuela	11575.3
Total	25154.0

NON-OIL-EXPORTING DEVELOPING COUNTRIES: Latin America & Caribbean	
Argentina	8231.0
Bolivia	377.2
Brazil	20437.6
Chile	6080.5
Colombia	3195.7
Costa Rica	497.7
Dominican Republic	501.0
El Salvador	94.5
Guatemala	179.2
Honduras	191.6
Jamaica	262.2
Mexico	24376.8
Nicaragua	403.8
Paraguay	304.2
Peru	2541.0
Trinidad & Tobago	182.2
Uruguay	920.3
Other	491.6
Total	69269.0

NON-OIL-EXPORTING DEVELOPING COUNTRIES: Asia	
China (PRC)	256.6
China (Taiwan)	4763.3
India	854.9
Israel	2252.3
Jordan	156.9
Korea, South	11034.6
Malaysia	1429.4
Pakistan	237.7
Philippines	5745.5
Syria	33.0
Thailand	1757.5
Other	842.5
Total	29364.7

NON-OIL-EXPORTING DEVELOPING COUNTRIES: Africa	
Cameroon	153.0
Egypt	1173.9
Ghana	14.5
Ivory Coast	644.2
Kenya	182.6
Malawi	91.8
Morocco	756.5
Senegal	73.6
Sudan	211.9
Tunisia	170.4
Zaire	143.3
Zambia	193.1
Other	737.4
Total	4546.7

OFFSHORE BANKING CENTERS	
Bahamas	7524.2
Bahrain	2424.8
Bermuda	484.6
British West Indies	8519.7
Hong Kong	7916.8
Lebanon	168.8
Liberia	1961.4
Macao	354.4
Netherlands Antilles	1117.4
Panama	5608.9
Singapore	8004.7
Total	44086.1

(Source: Federal Financial Institutions Examination Council)

nursing along a $100,000 loan to some scrap-metal broker." As the euphoria spread, more and more banks crowded into the business, and the competition grew increasingly heated. Ultimately, normal market disciplines simply melted away.

Witness what happened to interest rates. Typically, rates on Euro-currency credits are set at an agreed margin or spread over the banks' own cost of funds (most often using, as a proxy, the London interbank offer rate—LIBOR), the margin ostensibly representing the banks' assessment of the risk of individual loans. Rates themselves "float," that is, are subject to periodic revision to reflect movements of LIBOR. As the competition for sovereign borrowers grew more fierce, spreads narrowed almost to the vanishing point. In 1976 the average margin on loans to developing countries was 2¼ per cent. By 1979 spreads had dropped as low as .75 per cent on average, and even lower for prime borrowers. As late as the spring of 1982, just months before the worst financial crisis in its history, Mexico was still able to obtain funds at no more than .5 per cent over LIBOR. It would not be an overstatement to suggest that over the course of the decade there was some erosion of restraint in the assessment of international risk.

In fact, until the troubles of the past year, risk hardly seemed to figure in bankers' calculations at all. In principle, banks had available to them all sorts of sophisticated risk-appraisal techniques to safeguard against incautious lending. In practice, such techniques proved to be of only limited value when applied to sovereign borrowers. To hear the banks tell it, their biggest problem was inadequate information about the financial conditions and activities of potential customers. Third World nations seldom have good data on their finances, and most East European countries refuse to furnish many details at all. How could lenders intelligently assess the risks of prospective credits, the banks ask, if they had no idea of just how much a country was borrowing until well after the fact? International agencies like the World Bank and International Monetary Fund were criticized for their refusal to share confidential data obtained from member-governments. More recently, thirty-one lending banks from eight countries agreed to establish a new organization of their own, the Institute of International Finance, in order to close some of these information gaps.

But the question may legitimately be raised whether fuller information, in and of itself, would really have made much difference. Indeed, one might ask why the banks lent at all if they knew so little about their customers. Some bankers, in their franker moments, admit that information gaps existed as much within their own institutions as in the system at large. Frequently the left hand just did not know what the right hand was doing. Consider the response of one European banker to a recent survey by the Group of Thirty, a New York-based private research body. The banker insisted that he would never have sanctioned a further growth of short-term credits to Mexico in the spring of 1982 had he been informed of the extent to which they were building up. Closer questioning revealed, however, that the information had in fact been known to his subordinates but not passed upward. "If the figures had been brought to my attention, I would surely have acted differently," he said. Another banker is quoted as stressing the need not for more statistics but for better judgment: "Banks would not have acted differently had quicker detailed information been available to them. What is important is not only information but how we react to it."

In reality, the information issue is a red herring. Improved data would not have sufficed to slow the banks in their lemming-like drive to share in an attractive, expanding market. Lenders fought furiously to maintain or improve their international league standing, and credits were sold like biscuits. Young, aggressive loan officers were sent out to drum up business wherever they could, from Argentina to Zaire. Often they were given specific profit targets, sometimes even monthly quotas. Knowing that their own salaries and career prospects were at stake, the last thing they wanted to worry about was risk. As one of them said: "It was always tempting to sign up a loan. By the time the problems began, you'd moved on somewhere else and the chairman had retired." And so profits were taken up front, the residue of potentially bad debt being left to someone else to cope with.

FLAWS IN THE LOGIC

Not that the banks were therefore stupid or venal; myopic is probably a more accurate description. The risks of international lending were not so much disdained as conveniently de-emphasized. Bankers demonstrated a remarkable capacity for self-deception, persuading themselves by a variety of unexamined, self-serving arguments that there was little to worry about. Most of these arguments, in retrospect, can be seen to hold little water. The wonder is that anyone believed them at the time.

For example, there was the argument that countries cannot go bankrupt. Unlike corporations, sovereign borrowers cannot be eliminated by insolvency. So why worry? This was a favorite theme of Citibank's Walter Wriston: "Countries do not fail to exist." But for precisely that reason, governments could not always be relied upon to exercise prudential self-restraint in their external borrowing. Faced by the exigencies of budget and balance-of-payments deficits, many were bound at some point to succumb to the temptation of easy credits from abroad, becoming overcommitted in the process. If anything, the argument ought to have put lenders more, not less, on their guard. There was always an element of illusion in it, as British financial expert Harold Lever has pointed out. "I call Walter Wriston the Peter Pan of bankers," Lever says, "because he still believes in fairies."

Then there was the argument that countries could always be relied upon to honor their debts, no matter how troubled their economies, since it was so clearly in their own interest to do so. Default could shut a nation out of the financial markets for generations and would make its assets and exports subject to seizure anywhere in the world. Therefore, no country would ever voluntarily suspend payments of interest or principal due. But here too there were flaws in the logic. In the first place, the argument assumed pure economic rationality in a context in which complex political or even personal considerations might well take precedence. Economic rationality did not dissuade Fidel Castro, after his successful revolution, from repudiating Cuba's foreign debts in 1961. It might prove equally irrelevant in other countries at other times. The issue was clearly drawn by Stuart Greenbaum, a professor at Northwestern University:

Imagine you are a Latin dictator deep in debt. If you cut back on imports, you get riots in the streets. If you default, you are ostracized by the world capital markets. Now if the first approach leaves you swinging from a tree branch, you know you are going to go the default route.

Furthermore, even if countries *want* to keep up the service on their debt, they might not be able to. As recent experience has already amply demonstrated, circumstances can force borrowers into arrears whether they like it or not. Technically, such countries are already in default. But since legally it is only a creditor that can declare a formal default, banks prefer to finesse the situation by renegotiating debt instead, normally by rescheduling overdue loans to some new date in the future. The advantage for banks is that they can thereby avoid writing off some of the paper on their books as bad debt. The disadvantage is that they find themselves locked into positions for far longer periods of time than they had originally intended. At first, only medium and long-term loans were rescheduled, but now short-term debts and even interest arrears are being included in restructurings. And even more significant, the whole process itself is becoming increasingly routine as the same countries fall into arrears time after time. Repeated often enough, the process comes to represent default in all but name—default by attrition, as it were. Debts are formally honored but never repaid.

A third argument was that if there were any risks in international lending, they could be safely limited through diversification. Spreading loans across a large number of countries would minimize bank vulnerability to problems in any single nation or region. But this overlooked gathering world economic difficulties, especially after the second oil shock, which threatened prospects for *all* sovereign borrowers, wherever located. These included not only low commodity prices and stagnant export markets, which reduced debtors' ability to service their obligations, but also record-high interest rates, which added greatly to the cost of floating-rate debt. Such problems could not be diversified away. The banks were clearly overoptimistic in believing that they could protect themselves so easily. Too late do they recognize the need to assess the outlook for borrowers in the widest possible context.

Finally, there was the argument—more an unspoken assumption—that in the last resort banks could count on help from official sources, either in the form of emergency loans to troubled debtors or as liquidity or solvency backing for the banks themselves. Governments, they reasoned, considered the banking system too vital to be allowed to fail. Lenders ultimately would be sheltered from their own mistakes by the umbrella of taxpayer money. In fact, the banks were not far wrong. Governments have indeed come to their aid—in early 1982, for example, when the Reagan administration chose to repay several hundred million dollars' worth of Poland's overdue bank debt, under existing loan-guaranty programs, rather than countenance formal default; or later last year, when official rescue packages were quickly arranged for Argentina, Brazil, and Mexico, the world's three biggest sovereign borrowers. But as was demonstrated by this past summer's debate in the U.S. Congress over the proposed increase of IMF resources, such support does not come without a price. Lawmakers and their constituents, understandably irritated over the possibility that IMF credits might be used in effect to "bail out" imprudent lenders, insisted on their pound of flesh in the form of mandated increases of bank loan-loss reserves and ceilings on fees when debts are rescheduled. A public umbrella, the banks discovered, is not necessarily cheap.

In fact, the banks have learned much from the frenzy of the last decade—too late, it would appear, to save them entirely from the consequences of their own actions, but possibly in time to avoid a repetition of the 1930s. Perhaps it is just as well that debtors prisons no longer are in fashion. If they were, one could argue that it is the banks, not the borrowers, that deserve to be thrown into them. As Benjamin Franklin said, "Creditors have better memories than debtors"—or *should* have. WV

COMING

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