European Communities

EUROPEAN PARLIAMENT

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# Report

drawn up on behalf of the Committee on Economic and Monetary Affairs

on the role and functions of the International Financial Institutions in the present monetary situation

Rapporteur: Mr William HOPPER

English Edition

PE 87.989/fin.

By letter of 17 February 1983, the Committee on Economic and Monetary Affairs requested authorization to draw up a report on the role and functions of the International Financial Institutions in the present monetary situation.

By letter of 25 April 1983, the committee was authorized to report on this subject.

On 25-26 May 1983, the Committee on Economic and Monetary Affairs appointed Mr W. HOPPER as rapporteur.

At its meetings of 17-19 October, 21-23 November, 29 November and 20-21 December 1983 the committee considered the draft report and adopted it at the latter date by 20 votes in favour to 1 against with 3 abstentions.

The following took part in the vote: Mr Moreau (Chairman), Mr Hopper (Vice-Chairman and Rapporteur), Mr Marck (substituting for Mr Franz); Mr Beumer (substituting for Mr Vergeer); Mr von Bismarck; Mr Bonaccini; Mr Caborn; Mr Carossino (substituting for Mr Leonardi); Mr Chanterie (substituting for Mr Van Rompuy); Mr De Goede; Mr Giavazzi; Mr Halligan (substituting for Mr Rogers); Mr Herman; Mr Hutton (substituting for Miss Forster); Mr Müller-Hermann; Mme Nikalaou (substituting for Mr Schinzel); Mr Orlandi (substituting for Mr Cingari); Mr Purvis (substituting for Mr de Ferranti); Mr Radoux (substituting for Mr Wagner); Sir Brandon Rhys-Williams; Mr Seal (substituting for Mr Heinemann); Mr Wedekind (substituting for Mr Schnitker); Mr Welsh and Mr von Wogau.

The report was tabled on the 4.1.84.

# C O N T E N T S

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The Committee on Economic and Monetary Affairs hereby submits to the European Parliament the following Motion for a Resolution together with Explanatory Statement

## MOTION FOR A RESOLUTION

on the role and functions of the International Financial Institutions in the present monetary situation

The European Parliament,

- having regard to the report by the Committee on Economic and Monetary Affairs (Doc. 1-1263/83),

A. Recalling that the post World War II financial institutions, as represented by the IMF and the World Bank, were entrusted with the task of ensuring a coherent and stable international system;

B. Aware of the growing importance of the BIS in the international finance system, in particular since the "Basle Concordat" of 1975;

C. noting the recent call by the Commonwealth leaders in New Dehli for a new Bretton Woods Conference;

D. Observing, however, that since then dangers have been visible on many fronts, such as the reduced control of the IMF over the adjustment process due to floating exchange rates and the existence of a large uncontrolled Eurocurrency market, the inadequacy of the funds of the World Bank and the IMF to finance Third World needs, and rising desequilibria in LDC's;

E. Drawing attention to the dramatic increase of sovereign lending by the private sector after the first major rise in oil prices at the end of 1973 when the burden of financial re-cycling was assumed largely by commercial banks with whom the bulk of the OPEC surplus was deposited;

F. Considering that, as a result of the second oil shock, almost all the non-oil developing countries have been affected by the combination of high real interest rates (including spreads over LIBOR) and of adverse terms of trade that resulted from the World recession;

G. Observing that in the present situation borrowing countries either deflate or attempt to increase their indebtedness further with risk of country default and potentially snowballing consequences that could endanger financial stability and accentuate the world recession;

H. Considering that the banking industry is inevitably involved in the fortunes of its borrowers;

1. Draws attention to the increase of floating interest debts together with the sharp rise in their cost, which largely explains the major increases in interest payments of developing countries in recent years;

2. Expresses its concern at the risk that some indebted governments may prefer the short-term advantage which would result from a default; such a default would in fact endanger financial stability and build up further depressionary elements;

3. Points to the difficulties that default by countries would create for commercial banks as regards their own balance sheets; in this case banks acknowledging a capital loss, ought to substantially depreciate their loans;

4. Is convinced of the need to take action as regards :

   - the existing and potential liquidity problems of the borrowers (short-term problem);

   - the stability of the world financial system through coordinated measures leading to a sustained economic recovery (longer-term question);

5. Is convinced also that the aim should therefore be to maintain a moderate level of net new credits to the debtor countries while their adjustment process is underway, and then to limit future recourse to bank credits once countries have regained their creditworthiness;

Debt restructuring and International institutions

6. Believes that there is no need for new international financial institutions; the effort that would be required to create a new institution (1) should be directed to the solution of the problems themselves;

7. Declares its conviction that debt restructuring should be accomplished by adopting and widening the role of the existing international financial institutions;

8. Believes that the IMF is already playing a very important role by facilitating the flow of loans to the debtor countries and increasing the payoff to banks by avoiding default by borrowers;

9. Suggests in particular that :

- once a reasonable programme has been agreed between a country and the IMF, the creditors should be brought in to satisfy themselves about the plan's viability and even to offer suggestions for improvement; the IMF should then propose the rescheduling of existing debts taking into account not only immediate cash requirements but also the projection of earnings and expenditure over a long period of time;

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(1) See Peter B. VIENEN "A Bail-out Plan for Banks", New York Times, 6.3.1983

10. Suggests also that the IMF's approach be sufficiently flexible in order to take into account those poor countries enjoying very limited access to private sector for lending of any kind. It would be suitable, in this case, to have both a policy of relatively generous lending to such countries under multi-annual programmes and an expansion of the Compensatory Financing Facility;

11. Judges it very important to tighten the IMF's task of surveillance. Furthermore, when establishing the recommendation for a loan the IMF should pay due attention to reconciling the differing goals of "equal treatment" and "tailor made solutions";

12. Criticises the extent to which the commercial banks have got involved in long-term lending to finance some capital investment and structural deficits in the balance of payments by means of short and medium-term loans.

Such finance, in fact, should be provided by the World Bank and the regional development banks, whose role would have to be increased.

Also criticises the international monetary authorities and national governments for having encouraged commercial banks to become more and more involved;

13. Emphasises the importance of strengthening the World Bank's long term lending, which means that the resources at its disposal should be increased;

14. Is aware, in this context, of the proposal by the "Brandt Commission" that the gearing ratio of the World Bank should be increased from 1:1 to 2:1. It is also aware of the serious obstacles in the way of an increase of this kind, such as the effect that it could have on the World Bank's existing bondholders.

In addition, the present ratio 1:1 is somewhat theoretical since only 7.5% of the capital of the World Bank is actually paid up;

15. Wishes that an increase in the resources available from the World Bank be achieved by an increase in the subscribed capital, an increase in the paid-up element or a change in the borrowing ratio. Each of the changes would require an amendment of World Bank's Articles of Agreement and would therefore take years to accomplish. Changes of this kind have little reference to the current monetary crisis but they would be useful to assist in long-term economic development in the Third World;

16. Is firmly convinced that the World Bank should try to achieve greater leveraging of its resources by means of co-financing with commercial banks and export financing agencies in industrial nations. It therefore approves the Bank's trial programme, adopted early in 1983, more closely linking the finance provided by commercial lenders with the Bank itself;

17. Urges the contributing states to agree forthwith an increase in the resources of the IDA in order to meet better the needs of the poorest countries and calls on the European Community to play a leading role in convincing the USA in particular of the importance of so proceeding.

Restructuring of private-sector lending

18. Stresses the importance of the banking system and World capital market as a source of international credit;

19. Draws attention to the fact that debt crises may create liquidity crises in the banking system; and urges the central banks to clarify their responsibilities among themselves in this respect;

20. Notes with satisfaction the recent improvement in the surveillance procedures under the 'Basle Concordat', regrets, however, the lack of adequate supervision of banks in off-shore centres. Believes that a tightening should proceed gradually and prudently to avoid the danger of 'competitive non-control' with banks gravitating to financial centres where controls or prudential requirements are less onerous;

21. Calls for a Community approach to official discussions on the international financial system and the rescheduling of the external debt of countries in difficulty, especially as regards regions or countries with which EEC's relations are particularly close;

22. Points also to the lack of information. Commercial banks do not appear to have adequate information at their disposal as regards their exposure in particular countries, the BIS systems being available for use by banks only after a long interval and IMF and World Bank information obtained on a confidential basis and therefore not readily available;

23. Welcomes, in this context, the setting up in Washington by American, European and Japanese banks of an Institute of International Finance as an information exchange between borrowing countries and members of the Institute.

World Economic situation and international monetary issues

24. Notes that there are some signs of improvement in the world economic situation. The economic recovery in the USA, contrary to the expectations of most of the American economists, now appears to be established and will lead to an increase in export earnings in the Third World countries. Furthermore the countries of Eastern Europe have been able to control their imports to the extent that they are now running a trade surplus with the West.

Both these developments will reduce international indebtedness and lessen the tensions in the international monetary system;

25. Believes, nonetheless, it would be a great mistake if this improvement was used as an excuse for inaction given that the international monetary situation remains fragile and that many of the serious problems which have affected it in recent years could reoccur.

26. Welcomes the growing appreciation of the importance of capital flows between nations as determinant of trade surpluses, in particular as recently exemplified in negotiations between Japan and the USA;

27. Believes there is no requirement for a New Bretton Woods Conference as requested by the Commonwealth leaders in New Dehli if by that is meant a conference to redesign the world's financial system; Believes also that the existing financial institutions should organise a conference or a series of conferences on aspects of existing economic systems with a view of improving the workings of the whole system. In particular, attention should be paid to the following objectives :

- to study the events affecting the monetary system in the past decade (with a view to learning a lesson from them);

- to decide upon improvement to the role and functioning of the existing international financial institutions;

- to coordinate national economic policies at an international level in a manner which would parallel the similar coordination of national economic policies which is taking place within the EEC.

28. Instructs its President to forward this resolution to the Council, the Commission and the Parliaments of the Member States of the Community.

## EXPLANATORY STATEMENT

### INTRODUCTION

1. This report focuses on international financial institutions, in a situation where borrowing countries either deflate or attempt to increase their indebtedness further. Under these circumstances, the major risk is country default with potentially snowballing consequencies that could endanger financial stability and accentuate the world recession.

2. The debt problem in fact is not limited to international loans alone but poses a twin threat to the solvency of the Western commercial banking system and to the prosperity of the countries that have become heavily indebted. Those countries that borrowed to sustain "debt-led growth" through the 1970s now find themselves obliged to balance their international payments on the basis of the sharply reduced levels of capital inflow available to them. Furthermore, the cutback in developing countries imports will reduce the exports of the industrial countries. On the other hand, the recent aggravation of the sovereign risk problems has occured at a time when some of the lending banks are also exposed to unusual risks in connection with lending to private sector corporate customers. The banking industry is inevitably involved in the fortunes of its borrowers, whether they be sovereign states or private sector business.

### The historical background

3. The post World War II financial institutions, as represented by the IMF and the IBRD were entrusted precisely with the task of ensuring a coherent and stable international system with generally accepted rules of the game. Since then, however, dangers have been visible on many fronts : the reduced control of the IMF over the adjustment process due to floating exchange rates and the existence of a large uncontrolled Eurocurrency market, the inadequate funds of the IBRD and the IMF to finance Third World needs and rising desequilibria in LDC's.

4. In particular, the end of the dollar-standard in August 1971 gave rise to currency shifts that led to excessive decline of the dollar. It also opened the door to an excessive and volatile reserve expansion which escaped international concertation and control. Thereby it has contributed to the rise in world inflation and a more irregular financial environment.

5. Sovereign lending by the private sector began dramatically after the first major rise in oil prices at the end of 1973, when the Committee of Twenty itself urged IMF members to avoid policies that would simply pass on the oil deficit to others (1).

Thereafter there occurred a massive surge in the amount of international lending : financial re-cycling was assumed largely by commercial banks, whose liquidity was being justified with the bulk of the OPEC surplus.

6. At that time the recycling of petrodollars via the private sector banks was well regarded by everyone : the developing countries for obvious reasons; the oil exporting countries, because it gave the OPEC "low absorbers" the kind of investment medium which they liked best, namely a private sector libaility of a highly liquid nature; the industrialised countries which appreciated seeing somebody running corresponding deficits vis-a-vis OPEC countries running large surpluses on current account.

7. The second oil shock, and the decision of the major industrial countries to prevent that shock being translated into a new upward step in the inflation rate, led to a severe world recession and a drastic worsening in the external position of the developing countries : monetary restraint as the principal weapon of anti-inflationary policy, together with lax U.S. fiscal policy, led to the very high nominal and real interest rates on the floating rate debt that predominates in international borrowing; tight monetary policies curtailed the loanable funds available to the

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(1) See "International Monetary Reform : Documents of the Committee of Twenty, Washington, IMF, 1974.

banks and thus brought into question the continued expansion of international lending. Almost all the non-oil developing countries have been affected by the combination of high real interest rates (including spreads over LIBOR) and adverse terms of trade that resulted from the world recession.

8. The decline in the growth of export earning combined with the attempt to minimise the impact on domestic absorption has led to a sharp increase in bank borrowing. In 1981 net lending to non-OPEC LDCs by BIS reporting banks increased by 20% and that by US banks by 24% [(1)]. In 1982, banks assessment of the risks involved in lending to developing countries has become much more pessimistic. Furthermore, the concentration of commercial bank lending on a few fast growing NICs [(2)] and Eastern European countries increases, of course, the vulnerability of banks to any adverse developments in these countries. Net lending to developing countries has therefore been declining sharply in 1982.

In 1983 the IMF Managing Director has predicted that international bank exposure will increase by only a nominal 8% even after the $5 billion loan to Mexico is taken into account.

Present Situation

9. It appears in retrospect that certain developing countries have borrowed unwisely using some of the resources to finance consumption and investments of dubious value rather than to strengthen their productive potential. It is also worth recalling the mismatch between the long-term horizon of the investment being undertaken and the medium-term (and often very short-term maturity of the debt contracted to finance the investment.

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(1) See "World Financial Markets", Morgan Guaranty Trust Group, New York, October 1982

(2) Argentina, Brazil, South Korea and Mexico account for more than half of the total outstanding loans of private banks to non-OPEC LDCs, for some 85% of the net floating debt and almost all of total net private banks exposure to such countries.

Furhtermore, the increase in the volume of floating-interest debts, (1) together with the sharp use in its cost, largely explains the major increases in interest payments of developing countries in recent years. On the other hand, overeagerness by banks to lend has sometimes allowed borrowing governments to delay necessary adjustments.

10. The major problem to be faced at the present time is, whether and to what extent financial institutions operating in an international context can be expected to meet future credit demands of developing countries. It is necessary here to remember that "insolvency" by borrowing countries can stem from both a temporary shortage of foreign exchange - liquidity problem - and a long-term incapcity to service debt-insolvency problem for which there are only two solutions : default or adjustment.

The essential question is, whether short-run current account deficits of LDCs and Eastern European countries are compatible with long-term "fundamentals", that is whether borrowers can be expected to earn enough foreign exchange to pay interest costs over the long run . In fact if the borrower's ability to pay interest over the long run is put into question deflation of domestic demand becomes necessary.

11. The risk is that some indebted governments may prefer the short-term gains from defaulting; and temptation to default is likely to increase when precedences are established or when a country does not act in isolation.

As already stated before, the fact of LDCs becoming insolvent, now and in the future, could have snowballing effects, endangering financial stability and building up further depressionary elements. As far as the commercial banks are concerned, country default would create difficulties for their own balance sheets. In this case banks, acknowledging a capital loss, ought to depreciate substantially their loans.

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(1) Between 1977 and 1982 annual nominal interest costs of developing countries rose sharply from 7.8 to 17.5%

Action is therefore to be taken as regards :

(a) the existing and potential liquidity problems of the borrowers (short-term problem);

(b) the stability of the world financial system through the definition of coordinated measures leading to a sustained economic recovery (longer-term question).

<u>Debt restructuring and International institutions</u>

12. Lending by commercial banking is an inappropriate way to finance economic development, since the terms offered cannot match all the terms needed. Furthermore bankers may not be willing to financing borrowers suffering from lack of liquidity: they could be reluctant to provide unconditional support for borrowing countries (whose expenditures are not consistent anymore with present world demand conditions and relative prices) unless a stabilisation programme is first put into place. On the other hand, any precipitate reduction in lending would impose intolerable strains on the debtor countries: fast adjustment by the debtor nations would further depress international demand and prolong the slump.

13. The aim should therefore be to maintain a moderate level of net new credits to the debtor countries while the adjustment process is under way, and then to limit future recourse to bank credits once countries have regained their creditworthiness. The achievement of this aim can only be possible through cooperation.

14. There have been suggestions that debt restructuring should be accomplished by creating a new institution (a sort of a subsidiary of the World Bank or IMF) charged with acting as a new intermediary between the banks and the developing countries. This institution would acquire the claims of the commercial banks and reschedule them on a once-off long term loan with some modest measures of debt relief (1). Nevertheless, the way this new institute would have to work would still need further improvements. It seems preferable to increase the role of the existing international financial institutions.

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(1) See Peter B. Kenen "A Bail-out Plan for Banks", New York Times 6 March 1983

15. The IMF is now playing a crucially important role by facilitating the flow of loans to the debtor country and increasing the payoff to banks by avoiding borrowers default.

Actually debt restructuring must be negotiated between debtor and creditors and such an exercise will continue to require a lead from the IMF, involving its own financial participation, its certification of an adjustment programme and its organisation of support from commercial banks : once a reasonable programme has been agreed between a country and the IMF the creditors should be brought in to satisfy themselves about the plan's viability and even to offer suggestions for improvement. The IMF should then propose the rescheduling of existing debts by taking into account not only immediate cash requirements but also the projection of earning and expenditure over a long period of time.

16. In addition, the IMF's approach should be sufficiently flexible in order to take into account the fact that its clientele also includes a large number of poor countries enjoying very limited access to the private sector of any kind.

A policy of relatively generous lending to such countries under multi-annual programmes might then be suitable. The same applies to the need for an expansion of the Compensatory Financing Facility.

Furthermore, when establishing the Fund's recommendation for a loan (which is primarily the responibilities of its Exchange and Trade Relations Department) attention should be paid to reconciling the differing goals of "equal treatment" and "tailor made solutions".

17. The extent to which the commercial banks get involved in long-term lending to finance capital investment is certainly to be criticised. Such finance, in fact, should be provided in a securer form, which means that for this purpose, the role of the World Bank and the regional development banks would have to be increased.

In order to make it possible for the World Bank to strengthen its long term lending activities the resources at its disposal should be increased.

18. The World Bank could increase its lending capacity by altering its gearing ratio (the ratio of exposure outstanding to total capital, including callable and paid-in capital). In fact, the World Bank's Charter sets out an extremely conservative 1:1 ratio to total capital [1]. Raising its gearing ratio would permit the World Bank to borrow more from the market without having to ask for new loans by its Member States. The Independent Commission on International Development Issues (the Brandt Commission) recommended in its 1980 report that there be a gradual expansion of the gearing ratio, rising slowly to a still conservative 2:1.

19. Such an increase seems to be very difficult to achieve given the effect it could have on the World Bank's existing bondholders.

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(1) Commercial banks may risk an exposure of 25:1 or more of their capital base.

In fact, the investors who currently have lent the bank about $40 billion have done so relying on the virtual total protection of that 1:1 ratio. In addition, this ratio is somewhat theoretical since only 7.5% of the capital of the World Bank is actually paid up. Furthermore a change in the borrowing ratio, an increase in the subscribed capital or an increase in the paid-up element would require an amendment of the World Bank's Articles of Agreement and would therefore take years to accomplish.

20. An increasingly important means of channelling a sufficient amount of new capital to the developing countries are certainly the co-financing arrangements between the World Bank and government and private lenders. In fact, although co-financing is not a new activity for the World Bank - such arrangements were initiated in 1974 - it has assumed greater importance in view of the uncertainty of adequate capital flows to the developing countries needed to assist them in their adjustment efforts. Actually, about one third of the present development projects assisted by the World Bank receive financial support from a cofinancer.[1] Furthermore, early in 1983, the World Bank approved a trial programme more closely linking the finance provided by commercial lenders with the Bank. The main feature of this programme are that the World Bank, in addition to making its own loan for an investment, may participate in the parallel commercial loan.

Restructuring of private-sector lending

21. It is quite important that the restructuring of public sector lending should proceed in line with that of bank lending. In fact, while the IMF and World Bank may be able to further expand their own lending, they cannot

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(1) Between financial years 1972 and 1983, the total cost of projects supported by the Bank totalled $275 billion, with about half of this sum obtained from other lenders.

(2) This participation may take the form of direct financial participation in the later maturities of a loan made by commercial banks, the use of a World Bank Guarantee, or a contingent participation by the World Bank in the commercial loan.

be expected to assume a primary role as a source of credit, replacing the banking system and World capital markets.

22. This raises two related issues. Debt crises may create a liquidity crises in the banking system.

23. The first is the lack of bank supervisors. This lack is particularly serious for the international financial system, especially bearing in mind the concentration of highly leveraged financial intermediaries in off-shore centres. Prudential requirements and surveillance in such areas as capital adequacy should be increased. This tightening should, however proceed gradually and prudently because there is a danger of 'competitive non-control' with banks gravitating to financial centres where controls or prudential requirements are less onerous.

24. The second is the lack of information. Data on international indebtedness on a systematic basis might in some cases have alerted the commercial banks more quickly to the gravity of their present problems. The BIS systems are the only ones which provide information on international bank lending but they become available for use by banks only after a long interval. Furthermore, commercial banks do not appear to have adequate information

at their disposal as regards their exposure in particular countries : information held in the IMF and World Bank on the economies of individual countries is not readily available to commercial banks since much of it is obtained on a confidential basis from member countries. In this context the setting up in Washington, by American, European and Japanese banks, of an Institute of International Finance as an information exchange between borrowing countries and members of the Institute is worthy of particular note.

<u>World economic situation and international monetary issues</u>

25. The major threat to successful resolution of the debt crisis lies in the possibility of an adequate global recovery failing to materialise. The current developments, however, seem to indicate a certain improvement.

26. The U.S. economic recovery now appears to be established [(1)] and will lead to an increase in export earning in the Third World countries. The countries of Eastern Europe have been able to control their imports to the extent that they are running a trade surplus with the West. Both these developments will reduce international indebtedness and lessen the tensions in the international monetary system. Nonetheless, it would be a great mistake if these signs of improvement were used as an excuse for inaction : the international monetary situation, in fact, remains very fragile and uncertain.

27. Action is certainly to be taken as regards international monetary issues. In this context, particular attention should be paid to the preparation of a new Bretton Woods Conference with the following objectives :

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(1) In 1983 the GNP is estimated by the U.S. Department of Commerce to have grown at an annual rate of 7.9% in real terms in the third quarter, following increases of 9.7% in the second quarter and 2.6% in the first quarter.

- to study the events affecting the monetary system in the past decade (with a view to learning a lesson from them);

- to decide upon alternatives to the role and functioning of the existing international financial institutions;

- to coordinate national economic policies at an international level in a manner which would parallel the similar coordination of national economic policies which is taking place within the EEC;