The Growth of Multinational Banking, the Euro-currency Market and their Effects on Developing Countries

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This paper describes the recent rapid growth of transnational banking and lending, as well as it causes. Since the early seventies, a growing proportion of this lending has been oriented towards developing countries. The principal causes for this trend are outlined, and the changes in the mechanisms of the 'Eurodollar market' which made access to it easier for developing countries are described. The trends prevailing in developing countries' financing throughout the seventies are then examined. Finally, the economic and political effects of the rapid growth in lending by private banks to the Third World are discussed.

I. INTRODUCTION

Since the early 1970s a rapidly growing proportion of the multinational banks' lending has been oriented towards developing countries, which has led to a 'privatisation' of these countries' debt structure. This contrasts sharply with the '50s and '60s when external flows to the periphery came basically through official channels (either bilateral or multilateral), and with the '30s and '40s, when little external finance (either public or private) was available to the countries of the periphery.

It is hoped that this paper will provide a suitable framework for analysing and evaluating the influence which recent changes in the forms of external finance (and in particular growing participation of private multinational banks) are having on the countries of the periphery. In most cases, nationalist progressive political movements in the developing countries have for a long time evaluated critically and restricted foreign direct private investment. They have however on the whole welcomed foreign private credit flows, often on a large and relatively indiscriminate scale. It therefore seems particularly important to evaluate the effects of such flows on developing countries.

As we shall see, one of the major developments in the world economy over the past decade is that the big multinational banks have come to depend to a great extent on foreign operations for continued growth and profitability; a large

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proportion of these foreign loans goes to developing countries. The crucial role which they play in the financing of developing countries has granted the banks enormous influence over these countries' policies and developments. This is particularly problematic given the rather fundamental difference between private and official flows, in that the private multinational banks are not politically accountable to anyone for the way in which they exercise their influence over the developing countries.

II. GROWTH OF MULTINATIONAL BANKING AND THE EMERGENCE OF THE EUROCURRENCY MARKETS

Since the 1960s, most of the world's major banks have emulated other large corporations by going multinational. They established branches and subsidiaries outside their national borders at an unprecedented rate. In 1960, eight US banks had foreign branches; by 1975, 125 US banks had foreign branches. Total assets of US overseas branches jumped from $3.5 billion in 1960 to $181 billion by June 1976. Other large countries' multinational banking growth started later, but at a very rapid rate. Multinational banks' overseas operations are very concentrated. Thirteen US banks controlled in 1976 over two-thirds of all US bank foreign activity; the international earnings of these banks represented over 95 percent of the increase in their total earnings between 1970 and 1975 [*US Congress, Senate Committee on Foreign Relations, 1977: 9-12*].

It was natural that banks all over the world should have gone multinational to meet the needs of their multinational corporate customers, who were increasingly investing and re-investing their assets abroad. The general expansion of world trade after World War II was an additional demand factor for growth of multinational banking. The role of the dollar as an international currency provided the base on which transnational banking developed.

Most analysts agree[1] that this rapid growth of multinational banking is to a great extent attributable to the asymmetry between the stringent and detailed official regulations governing residents operating their own national currencies, and the great freedom of non-residents to operate in foreign currencies from the same constrained national banking systems.[2] As we shall see, the main centres of transnational banking have developed in countries where the least regulatory restriction was placed on their activity and where more favourable tax treatment was granted.

In the late '50s, two developments had allowed multinational banks to move into Europe. In 1958, Western Europe returned to full current-account convertibility, particularly for non-residents. Authorised banks were allowed to take long and short positions in any currency. Increasing Soviet trade with the West generated dollars which the Soviet government preferred to deposit in Europe, to avoid a possible freeze by the US government.[3]

A far stronger impulse to transnational banking growth was given by several US government regulations, introduced in the sixties to stem US foreign investment, in an attempt to improve the balance of payments. In 1964, the persistent US balance of payments deficit was in danger of increasing even more as a result of the over-heating of the American economy due to the tax cuts accompanied by increased military expenditure abroad, caused by the Vietnam War.

The Interest Equalisation Tax was introduced on foreign stocks or debt obligations acquired by US individuals and corporations. It stimulated US multinational corporations to deposit their earnings abroad instead of repatriating them, and to finance new offshore investments through borrowing abroad by overseas affiliates; this trend was reinforced in 1968 by mandatory controls on capital exports of US multinationals. The 1965 Voluntary Foreign Credit Restraint Program curtailed short-term lending to non-residents located in the US, exempting from these ceilings their foreign branches and subsidiaries. US banks responded by shifting transactions from the home office to branches and subsidiaries abroad. Several Federal Reserve regulations encouraged US banks to hold foreign deposits offshore rather than in the US. Regulations put interest ceilings on time and saving deposits in US banks, again exempting offshore branches.[4]

Even though many of these controls were terminated or diminished by 1974, undoubtedly they did much to expand offshore US banking. As one observer summarised: 'The American attempt to stop the export of capital in the nineteen sixties led to the export of the American banking system instead'.

The main centre of transnational banking activity has been – and to a lesser extent still is – London. The main reason has been that when transnational banking developed, London was one of the world's main financial centres. Its large size was linked basically to the absence of regulation over a long period; banks in the United Kingdom can accept deposits and make loans in any currency but sterling, completely free of regulatory restraint, as no interest ceilings or reserve requirements are imposed. In addition, private banks had confidence in the Bank of England as a successful monetary authority with one and one-half centuries of experience.

Other major centres are a rapidly growing number of 'offshore havens', offering not only the absence of practically any form of banking regulation or oversight, but also strict banking secrecy and no taxation of foreign banks. Most banking transactions are still decided in the head offices of financial centres in the developed world. However, many are registered in the account of the banks' offshore branch (often in offices, with little more than a 'nameplate on the door and a receptionist to answer the phone'). These operations use a mechanism called the interbank market, which makes it easy for banks with a multinational base to minimise tax payments. The banks' 'booking procedures' can be compared with transfer pricing for other multinational corporations. In both cases, profit-taking is shifted from one sovereign tax jurisdiction to another, minimising the corporation's worldwide burden; this operation is simpler for the banks. Finance capital flows more easily from one country to another than physical capital, under changing conditions. Multinational banks have little physical investment and relatively few skilled non-mobile personnel; they can shift their operations and subsidiaries from one country to another, so as to minimise tax payments, with greater ease and speed and smaller costs than productive multinational corporations.

The multinational banking market specialising in borrowing and lending of currencies outside the country of issue is commonly known as the 'Eurodollar' market. However, the term 'Eurodollar' is not very accurate. This market is no longer limited to Europe – the Far East and the Caribbean have a substantial share of operations. Neither does it deal only in dollars, even though this is still the major currency. In fact, a term such as 'transnational currency market' would be more precise.

The main final borrowers on this market are national monetary authorities, state enterprises, multinational corporations and official international organisations; however, most Eurocurrency transactions are between banks. The majority of transactions are above 1 million US dollars. This international capital market offers two different types of finance: large-scale credits and bonds. The main difference is that the latter have fixed interest rates, and are reserved for 'first-class borrowers'.[5]

As can be seen in Table 1, the Eurocurrency market has grown rapidly and steadily since the mid sixties.[6] We have used here statistical series either published by the Bank for International Settlements (BIS) or based on their data; the BIS is recognised as offering the most accurate, official measurement of the Eurocurrency system. It is necessary to point out a problem of these series. Even though inter-bank deposits of foreign currencies are netted out for the inner countries, many inter-bank transactions are still included. This accepted measure of the Eurocurrency market is not comparable to monetary aggregates at a national level, which measures only assets held by non-banks. In fact, attempts to eliminate completely inter-bank transactions from the Eurocurrency market (and thus make it comparable to national macroeconomic aggregates) have necessarily failed, as the very essence of this market is linked to inter-bank transactions.

III. ENTRANCE OF THE DEVELOPING COUNTRIES INTO THE EUROCURRENCY MARKET

At the same time as the Eurocurrency market expanded at a very rapid pace, the proportion of its loans going to countries on the periphery grew substantially. According to the 1978 World Bank Annual Report [*1978a*] non-oil-exporting developing countries represented 54 percent of this total 1977 borrowing.[7] These large flows have led to an increasing 'privatisation' of the structure of the debt of developing countries. In December 1970, of the total external public debt outstanding of the developing countries, 30 percent was owed to private sources (and only 8 percent to private banks). However, by December 1976, 41 percent of this total external public debt was owed to private sources (and 26 percent to private banks).[8]

We shall now examine the factors which determined this rapid increase in Eurocurrency lending to the developing countries, as well as the changes in the mechanisms within this market which have made access easier for them. We shall then study the evolution throughout the '70s of the trends in developing countries' financing in the Eurocurrency market.

Private multinational corporations and public borrowers of the industrial countries were the biggest users of the Eurocurrency markets in the 1960s. In this period, the external sources of finance for the developing countries were suppliers' credits, and official flows (both bilateral and multilateral).[9] In the late 1960s some countries – i.e. Brazil and Mexico – began to obtain large loans from multinational private banks. This trend, which became more important between 1970 and 1973, reached particularly large dimensions after 1974.

Most analysts agree that the rapid rise in Eurocurrency loans to the develop-

TABLE 1

ALTERNATIVE ESTIMATES OF THE SIZE OF THE EUROCURRENCY MARKET, 1964–77

End of year	*Net size of narrowly defined Eurocurrency market*[a]	*Net size of more broadly defined Eurocurrency market*[b]	*Annual per centage change in net size of more broadly defined Eurocurrency market*[b]
	billion US$		*%*
1964	12	17	
1965	13	19	12
1966	16	23	21
1967	21	30	30
1968	20	38	27
1969	44	50	32
1970	57	62	24
1971	71	78	26
1972	92	100	28
1973	132	148	48
1974	177	208	40
1975	205	240	15
1976	247	294	22
1977	300	375	28

[a]*Source*: Bank for International Settlements (BIS). Several *Annual Reports*. Includes all commercial and merchant banks accepting foreign currency deposits in eight European countries. (Benelux, France, Germany, Italy, Netherlands, Sweden, Switzerland and the United Kingdom). A problem of this series is its 'parochial' European nature.

[b]*Source*: IMF [*1978*]. These estimates are comparable to those in the first column but have a far wider coverage. They comprise BIS estimates for the banks accepting foreign currency deposits in the eight European reporting countries, plus the position of banks in Canada and Japan, and of US banks in selected centres (Bahamas, Caymans, Panama, Singapore and Hong Kong). Estimates from this source are comparable to similar estimates that BIS has presented for only a limited number of years in the textual comment of its *Annual Reports* for 1973/74 and 1974/75.

ing countries does not owe so much to changed conditions on the periphery as to developments and changes in the Euro-currency markets themselves.

On the one hand, an increasing number of multinational banks were more and more keen to lend to the Third World. This was determined basically by the rapid rise in Eurocurrency deposits in the later '60s and in the '70s which made the banks willing to lend to borrowers who may have previously been considered as marginal. Intense competition and the search for new borrowers seem to have been intensified by the rapid increase in the number of banks active in the Euromarkets. The Eurobanks' wish to diversify their portfolios geographically (and thus spread risks) was added to the relatively low growth of corporate credit demand in the developed countries. Very high rates of increase for commodity prices and consequent improvements in the trade balance of the countries on the periphery during the early '70s made them attractive clients for these multinational bankers. Furthermore, multinational bankers had become acquainted with some of the peripheral countries during the 1960s and early 1970s, when providing finance to the branches of their multinational corporate clients, based in the periphery.

At the same time, there were factors which made both the public and the private sector in most of the developing countries keen to borrow. Governments were embarking on programmes of expanded public investment, which often contained a high proportion of imported capital goods, and often were not fully financed with the country's own resources. This was accompanied by a relative stagnation in the net flow of official development assistance.[10] There were also certain governmental attitudes in developing countries tending to favour increased borrowing from private banking sources. Governments may have preferred private loans as they seemed to apply hardly any conditionality for disbursement of their loans. Loans could be made effective quickly and, formally, had few strings attached as to how funds were to be employed or how the country's economy should be managed.[11,12] New financial options seemed to provide an additional range of manoeuvre for governments in the periphery. Furthermore, in some developing countries reliance on foreign direct investment was reduced as the governments expressed a political preference for contractor, agency or mixed enterprise arrangements with foreign companies, which generally implied an increase in the demand for private foreign loans.[12] Thus, governments seemed to prefer foreign private loans both to official credits and to direct investment, partly because the former were perceived as generating a lesser degree of dependence and thus allowing greater autonomy for the national government.

The forces described above determined the willingness of multinational banks to lend to the countries of the periphery, as well as these countries' willingness to borrow. The development of new operational techniques in the Eurocurrency market, particularly during the late sixties, allowed a reduction in the individual risk for the Eurobanks making these loans to developing countries.

Several innovations occurred which diminished risks for large loans with long maturities, that is the type of credits required by developing countries. Firstly, the roll-over credit was created, based on a floating interest rate that varies approximately with the cost of the money for the lender, who obtains his funds on the essentially short-term inter-bank market.[13] Thus, although the loan to the developing country may have a long maturity (i.e., ten years), the interest rate is changed every time the credit is rolled-over (usually every three or six months).[14] This floating interest rate, as it is called, is crucial because it passes to the borrower one of the most important risks of the market (it is the borrower who must bear both the cyclical and the long-term changes of the interest rates).

Secondly, a very large part of the transactions on the Eurocurrency markets by developing countries have been through syndicated loans. Syndicated loans, which originated in the late sixties, are credits shared by a large number of Eurobanks.[15] This mechanism has allowed the default risks of large loans to be spread over a great number of banks; it has also allowed smaller banks to participate in the Eurocurrency market.[16]

Thirdly, 'consortium banks' were developed when several multinational banks jointly set up a single institution in the market, which further reduced the limits of individual bank liability in individual loans. Some of these 'consortium banks' had the additional advantage of being specialised in lending to a particular region, and therefore having greater knowledge about it. This was particularly useful in the initial stages of Eurocurrency lending to the periphery.[17]

IV. TRENDS IN EUROCURRENCY FINANCING OF THE DEVELOPING COUNTRIES: 'CREDITWORTHINESS' CRITERIA

The sharp fluctuations in the market which we shall describe below show that to a relatively large degree, the conditions (of cost and maturity) at which countries can borrow are relatively independent of the country's 'performance' or 'creditworthiness' and depend more on the general state of the market at a specific time. This is much more true in situations like the present one, when the market is extremely liquid. As we shall see below, the country's 'performance' or 'creditworthiness' is more influential in determining the level of loans which it can obtain in the market. When the market is as liquid as at present, 'creditworthiness' becomes somewhat less important even for determining the level of loans. However, during times of tighter credit a greater degree of bank discriminating among borrowing countries becomes evident.

First, we shall describe the general trends in Eurocurrency financing to the periphery, emphasising more recent developments. When the developing countries first entered the Euromarkets in the early '70s, conditions were favourable to those who borrowed. Maturities were long; 82.5 percent of the publicised Eurocurrency credits in 1973/74 had a maturity of seven years or more.[18] At that time, spreads were low.[19] However, borrowing was extremely concentrated. In 1973, 15 of the relatively higher-income developing countries owed about 85 percent of the recorded debt to foreign banks of all non-oil-exporting developing countries.[20]

A new phase of the Eurocurrency market was begun after the price of oil increased at the end of 1973. The demand for Eurocurrency credits by developing countries (particularly the higher-income ones) increased sharply, as they wished to finance their large current account deficits. Supply of funds to the Eurocurrency markets increased rapidly as the OPEC countries, in their search for safe investment opportunities, turned primarily to the banking systems of the United Stated and the United Kingdom. One of the main reasons why London and New York were the principal beneficiaries of the 'petromoney recycling' was that they were the only international money markets already large enough and with sufficient links to absorb the vast sums being deposited by the oil producers.[21] The other main reason was that, whereas the oil surplus countries may have been willing to lend directly to safe borrowers like the US and Germany, they wanted to interpose commercial banks as a buffer between themselves and the 'higher-risk borrowers' – the developing countries. Thus, the surplus countries shifted the risk involved in lending to the periphery to the private banks.

Initially, the private banks were unwilling to assume this role fully. The banks were concerned particularly with the very short-term nature of the deposits by the oil-exporting countries, combined with the medium and long-term demand for loans from countries wishing to finance balance of payments deficits partly as a result of the higher oil price. In the case of the developing countries, fears were exacerbated by the publicised inability of certain countries to meet their short-term obligations. Several bank failures (the main one being that of Herstatt) restricted the inter-bank Euromarket for a time.

As a result of these fears, conditions for the countries of the periphery became tighter in the Eurocurrency markets. Maturities were shortened drastically;

in 1974/75 only 31 percent of loans to developing countries were for seven years or more (as opposed to 82.5 percent the year before) [*The Banker, 1977*]. Spreads over the London Inter-Bank Offer Rate (LIBOR) rose, as did management fees. Selectivity was applied in lending to most developing countries; Eurobanks began to scrutinise more closely the purpose of loans, debt service ability and creditworthiness factors.

Since mid 1975, Eurobankers were feeling increasing pressure from the recession and the consequent fall in industrial country borrowing, and from the large new supplies of domestic and international funds. Even though they became keener to lend to developing countries, conditions remained hard.

By 1976, conditions in the international financial markets were in some respects those of a borrowers' market. However, according to the Bank for International Settlements [*1977*], as most of the demand came from countries with a weak payments balance and high levels of foreign indebtedness, there was a shortage of 'first-class borrowers'. As a result, there was sharp competition to accommodate such borrowers, and conditions for them improved quite rapidly throughout 1976. On the other hand, conditions for the countries of the periphery improved only very slightly.[22] According to the Bank for International Settlements 1977 Annual Report, in 1976 borrowers in countries with 'a high level of foreign indebtedness and little prospect of an improvement in their payments balances, found it increasingly difficult to obtain financial accommodation in the international markets and were, if anything, subject to tougher loan conditions than in 1975'.

According to a report published by the US Department of Commerce [*Seiber, 1977*], towards the end of 1976 the market had clearly become a 'borrowers' market'. This report quotes a rather poetic banker who said that 'the Eurobankers were returning with the swallows to the finance of developing countries'. It is interesting that the same US Department of Commerce report says that (towards the end of 1976), 'names that had been unacceptable are returning to the market – Chile, Yugoslavia, Fiji, the Cameroons'.

Different analysts agree about the trends prevalent in 1977. According to the 1978 Bank for International Settlements Report, in 1977 'under the impact of the liquidity-creating effects of the US external payments deficit, the market has become increasingly supply-determined'. In fact, this report is concerned about the degree to which lending margins have been squeezed, which can 'hardly be considered in the interest of the stability of the market as a whole'. Furthermore, 'even the margins asked of some borrowing countries of lower credit standing declined in 1977 to levels that can hardly have left very much room for the banks to build up adequate reserves against losses. Moreover, the list of eligible borrowers and borrowing countries has tended to lengthen, as have maturities, and the average size of individual loans has risen again.'[23] This process has continued into 1978, with the financial institutions and publications expressing increasing concern about the extremely favourable conditions to borrowers.[24] Average maturities have continued to rise, the fall in spreads over LIBOR has become increasingly generalised to borrowers of different credit standings. (This contrasts with the 1976 situation, when conditions improved mainly for prime borrowers.)

What is particularly interesting is that in fact, in 1977, non-oil developing countries became net suppliers of funds to the Eurocurrency market. Not only did new lending to non-oil developing countries, by banks in the Group of Ten countries and Switzerland and the offshore branches of US banks, fall from nearly $18 billion in 1976 to $11.3 billion in 1977; new deposits in 1977 received from developing countries by these banks equalled to $12.9 billion. As a result, the non-oil developing countries, which had borrowed a net amount of nearly $30 billion in the three years from 1974 to 1976, became net suppliers of new funds to the banks in the international markets, to the extent of $1.6 billion in 1977 [*Bank for International Settlements, 1978a*]. The above-described process is explained by the fact that in 1977 borrowing from private multinational banks – particularly by non-oil developing countries – was not solely dependent on current balance of payments financing requirements. In fact, there was much borrowing to increase foreign exchange reserves, either to replace the sharp falls in previous years or to obtain a larger cushion of reserves than the countries had previously. It is interesting that practically all these reserve increases were deposited in the above-defined 'reporting banks'. Thus, the $25.7 billion total of new deposits received by the reporting banks from non-oil developing countries during 1976 and 1977 compares very closely with a simultaneous increase of US $20.3 billion in these countries' official foreign exchange holdings. Naturally, the improvement in balance of payments and reserve positions of many of these countries has been an important factor in whetting the banks' appetite for further lending.

The above analysis led the Bank for International Setttlements to conclude rather approvingly that recent developments seem to suggest that, 'despite many doubts, international bank lending did not discourage serious balance of payments adjustment efforts. In fact, it appears that those developing countries that have been the largest borrowers of funds from the international banking sector showed the strongest improvement in current-account balance in 1976 and 1977.'

Although this correlation may seem very praiseworthy from the BIS point of view, it does raise several important questions. How do these countries adjust their balance of payments so rapidly? Who pays the 'costs'? To what extent did the banks demand such rapid balance of payments adjustment before granting further loans? Or, perhaps, to what extent did the countries themselves impose 'financial self-discipline' so they could have easy access to the private multinational banks? Case studies should be particularly useful to answer such questions.

We shall now briefly examine the criteria of 'creditworthiness' or 'performance' applied by multinational banks to the developing countries. These criteria are important partly in that they determine differentials in conditions (of cost and maturity) granted to different borrowers at one moment in time. Mainly these criteria are important in allowing individual banks to fix quantitative limits of maximum lending to individual countries, often called country exposure or country limits.

The task of quantifying the elements which determine banks' assessment of a 'country's creditworthiness' seems an almost impossible one. It is still relatively difficult to obtain reliable and complete data on the magnitude of Eurocurrency finance going from specific banks to specific countries.[25] Furthermore, given the confidential nature of the transactions involved, international bankers are somewhat reluctant to reveal the exact factors that determine finance to individual countries – even though there is an increasing volume of literature published by banks and bankers related to this subject. Even when bankers wish to qualify precisely the elements which determine a country's creditworthiness, subjectivity (or 'gut feel' as the bankers call it) inevitably plays a major role.[26] Finally, the behaviour of individual banks varies substantially, according to their size, country of origin, and other factors. For this, econometric studies[27] on the subject, although interesting, seem to be of limited usefulness, offering only very broad indicators of the variables determining banks' evaluation of a country's creditworthiness. A few general conclusions can be deduced from these empirical analyses, as well as from the documents produced by the bankers themselves.

'Creditworthiness' is commonly defined as the bank's perception of the country's ability and willingness to meet future interest and principal payments on the loan. The type of evaluation is naturally derived from the traditional functions of commercial banking. As in their loans to enterprises, when lending to countries, banks stress the financial and short-term criteria. As they are basically interested in the country's ability to pay back its loan, in foreign exchange, they particularly emphasise balance of payments analysis and availability of foreign exchange reserves.

The great emphasis on foreign exchange availability and flows is reflected very clearly in the literature on creditworthiness analysis;[28] it has also been confirmed in interviews with bankers themselves. Perhaps it is expressed most clearly and logically in a speech by H.D. Schuler, Director of International Operations Division, in the US Comptroller of the Currency Office. Schuler's views have a large and increasing influence, as the role of the Comptroller of the Currency in evaluating foreign lending by United States banks is growing:

> 'The Committee [formed by officers from his department] first looks to external economic information; e.g., balance of payments trends over the last few years, the expected results for the next twelve months (the short-term) and the external debt structure as well as the service requirements for the same period. Secondly, the Committee's evaluation of medium and long-term loans places greater emphasis on the social, political effects of prevailing economic trends, and their impact on prospective cash flows for external debt service' [*Schuler, 1977*].

General economic trends and policies of a country are also evaluated by the bankers from the perspective of their impact on financial variables, with a large emphasis on balance of payments. The quality of a country's economic management is associated with factors such as 'the relative strength of its central bank and/or finance ministry'.[29] 'The promptness of current account adjustment in response to higher oil prices and world recession has been a good test of the quality of the economic teams throughout the world. Competent and appropriate policies also assure good relationships with the International Monetary Fund and the World Bank.' [*Brackenridge, 1977*]

In fact, the private multinational banks have increasingly linked their evaluation of a country's 'creditworthiness' to its 'good relations with the IMF'. As the International Monetary Fund also gives priority to financial (and particularly balance of payments) equilibrium and has both experience and direct leverage to impose such priorities on individual countries, multinational banks have increasingly linked or even conditioned their loans to a country's previous signing of a stand-by agreement with the IMF and/or compliance with its performance clauses. Even though these parallel operations have been taking place for a long time, they are becoming increasingly widespread. In fact, many countries now seek stand-by arrangements with the IMF, mainly or exclusively so that, once given 'this certificate of good behaviour', they can obtain credits from the private multinational banks or renegotiate existing loans.[30] During recent years, there has been continued pressure – particularly from the banks themselves – to further increase and formalise links with the IMF.

Another element which conditions strongly the evaluation of a country's creditworthiness is the size of a country's per capita Gross Domestic Product as well as its recent growth record.[31] Although the large excessive liquidity dominating the market in the past years has allowed even poor countries with low growth rates to enter the market, their participation is still very small. Furthermore, total net debt outstanding of the non-oil developing countries to the multinational banks is still very concentrated in a few countries, who either have relatively higher per capita GDP, whose GDP per capita is growing rapidly, or who fulfil both conditions. Thus, the debts of seven countries (Brazil, Mexico, South Korea, Argentina, Peru, Philippines and Taiwan) constituted 70 percent of total net debt of non-oil developing countries to transnational banks in December 1977.[32]

V. CONCLUDING OBSERVATIONS ON EFFECTS OF THE EUROCURRENCY MARKET'S RAPID GROWTH IN THE DEVELOPING COUNTRIES

Without a doubt, the large volume of Eurocurrency funds flowing to the developing countries during this decade has implied an important short and medium-term transfer of real resources to them.[33] This transfer of resources may be used for any kind of expenditure; it has been useful both in helping many developing countries attenuate short-term problems (i.e., maintain levels of economic activity even though they had large balance of payments deficits derived from the oil price rise and the recession in the developed countries after 1973), and in providing funds for long-term growth (i.e., via finance for investment). If a country deliberately decides not to enter these private international capital markets, it rejects the possibility of these large transfers of financial and real resources. Furthermore, the vast private financial flows in this decade had an important effect on helping sustain economic activity in the developed countries, by maintaining demand from the Third World for their exports.[34]

As we saw above, access to the resources of the Eurocurrency market is not equally easy for different types of developing countries. Some are too poor (both in income levels and/or natural resources) to be sufficiently 'creditworthy' to attract significant flows from this market. Clearly it is the semi-industrialised and the rapidly developing countries which have absorbed a very large amount of resources flowing from the Eurocurrency market. In fact, the flows from this market may contribute to increased heterogeneity and inequality within the developing countries.

The effects on the developing world of large Eurocurrency financing will vary significantly from country to country, and can most precisely be evaluated in case studies. However, we shall try here to outline briefly some of the main problems and dangers which large Eurocurrency financing pose to the developing countries.

(a) Variable Cost of Loans

The interests charged on these Eurocurrency loans are on average higher than those paid by the developing countries to other sources of finance (i.e., bilateral or multilateral official credits); however, it is true that the rapid fall in the value of the dollar (currency in which the majority of these loans are still denominated) has implied that real interest rates have recently been relatively low. Perhaps more problematic is the variability of the interest rate, which changes every three to six months following the fluctuations of the London Inter-Bank Offer Rate (LIBOR). This variability adds an additional element of uncertainty in the developing countries' attempt to predict and plan their future balance of payments flows. Due to the many uncertainties prevalent in the international monetary system, it is practically impossible for countries to predict real interest rates.[35]

The large magnitudes involved in interest rate fluctuations can be well illustrated by recent developments. The Eurodollar interest rates (LIBOR) have increased by over 4.5 points during 1978; this increase has added an additional unplanned burden of interest payments to the non-oil developing countries of over US$ 4 billion alone;[36] Brazil's unplanned additional yearly burden, as a result of this increase, is over US$ 1 billion.

(b) New Nature of Conditioning

The conditioning of developing countries' economic policies by the multinational banks is on the whole less explicit and formalised than that exercised by multilateral agencies (such as the IMF or the World Bank) or bilateral agencies (i.e., United States AID). This however does not imply, as the governments of many developing countries initially believed, a necessary reduction of dependency, but a change in its nature.

As we saw, multinational banks operate basically on commercial criteria. When evaluating a country's creditworthiness, they stress its capacity to repay them (which explains their emphasis on financial and balance of payments indicators). A country already largely dependent on – or wishing to attract – large sums of credit from the multinational banks may be tempted to pursue a style of development in which its external solvency indicators are given such exaggerated priority, that they are carried out at the expense of other development objectives.

These attitudes of developing countries' governments may lead to very specific distortions. Recently, many developing countries have accumulated larger gross foreign exchange reserves than they require for trade purposes, with the sole purpose of being more 'creditworthy' and thus attracting larger loans.[37] Thus, developing countries may be borrowing mainly to improve their foreign exchange reserve position, so that they can then borrow more.[38]

However, situations may arise in which a large cushion of foreign reserve assets grants a larger degree of autonomy to countries, when attempting significant economic or political structural changes or when facing unfavourable conditions in the international environment. If prudently used, the existence of such reserves would allow the country to take important economic and political decisions, without needing to satisfy the criteria of private banks or the IMF, particularly while no substantial additional finance was needed and while the country was able to service its debt.

At a broader level, the wish to attract large private foreign loans may encourage a policy model which puts excessive priority on financial (and particularly balance of payments) variables, excessively conditioning or even determining all other aspects of economic policy. The need to maintain the country's 'creditworthiness' is often used by certain social groups or by certain governments to increase their strength and to help impose this kind of policy. It is also maintained by some governments that certain structural changes in their economy, such as diminishing the role of the state and the opening up of the economy to foreign trade and investment help improve the country's 'creditworthiness'. A good example can be found in the opinions expressed in a recent editorial of Chile's main newspaper *'El Mercurio'*:[39] 'Chile has recently obtained from the international banking community a treatment similar to that of serious and important countries. This asset of incalculable value must be maintained at all cost, and for this it is basic to sustain an economic policy of stabilisation, which will reduce public expenditure and will moderate excessive increases in real wages.'

The use of large sums of Eurocredits does not, of course, necessarily lead countries to follow this kind of policy pattern, as is shown by the variety of countries (and of policy models they pursue) which obtain significant levels of these loans. Distinctions should be made between different types of borrowing countries. The private banks seem willing to extend loans to developing countries with mixed economies and particularly to well-established socialist regimes, without necessarily demanding changes such as an increase in privatisation of ownership and an opening up of the economy. This occurs as long as the developing country's government is willing to defend national interests and while there is no serious political or financial crisis threatening. It is in countries where private interests closely linked to the international financial system are very influential or dominant, where obtaining large sums of private credit increases the power of such interest groups and helps impose policies which favour them and may distort the country's development.

Similarly, within each country a distinction should be made between types of borrowers, particularly between public and private ones. Special problems and policy issues arise when the borrowers are branches of multinational enterprises, often linked in their home country with some of the banks acting as lender.[40] If the government itself is the main borrower and/or carefully supervises the flows of finance going to the private sector – according to a set of national priorities – the negative effects of foreign credits may be attentuated; in such cases, foreign loans may prove a useful complement to domestic savings.

In any country, however, easy access to international credit may cause some distortions. One could be the weakening of the central government's attempts to regulate the economy; this refers both to planning authorities trying to implement long-term programmes and to financial authorities trying to plan short-term economic policies. The central government may be unable to assert its control over large semi-autonomous state enterprises, who can borrow abroad without the government's help and often without its knowledge or approval. In this case, the investment decisions are taken by enterprises with direct access to external credit, escaping the central government's control.

As described above, it was the vast liquidity available to the transnational banks which led to their keenness to lend large sums to developing countries, often with relatively little evaluation. The developing countries' governments frequently welcomed these loans, without clearly evaluating their future effects on their economies. This has increasingly led to difficulties for the debtor countries in repaying the growing debts and interests. The difficulties may be caused either by unexpected changes in the international environment, or by insufficient planning by the developing countries to generate with the required speed the necessary foreign exchange. An unfavourable international environment or financial irresponsibility may lead countries to debt crises. In such situations, banks are very unwilling to force repayment of their loans which could provoke costly defaults; this is particularly true in countries where the banks already have large exposure. Unless the debtor country nationalises foreign bank branches without compensation and refuses ever to meet its foreign debt, banks necessarily prefer a compromise that would maximise their profits or minimise their losses. For this reason, debtor countries have a certain degree of bargaining power over their private creditors on the terms of renegotiation and the availability of new loans.

To overcome their weakness in such negotiations, and increase their influence over the debtor countries, private multinational banks increasingly fall back on the IMF. The renegotiation of loans or the granting of new credits by the banks is often made conditional on the signing of a stand-by agreement with the IMF.[41] The developing country may be forced to request a standby from the IMF, when it is in a situation of serious external disequilibrium. This makes the IMF conditioning tougher both because the disequilibria are large and because the government has little bargaining power to resist IMF conditionality.[42] Thus, excessive access to international banking credit may in some cases in the medium-term reinforce, instead of weaken, dependency on IMF conditionality. The International Monetary Fund has recently stressed the need for countries to adopt 'corrective measures' at an early stage of their balance of payments difficulties, in consultation with the Fund.[43] However, the underlying problem is that many developing countries often prefer to delay their application to the Fund for assistance until the last possible moment because they believe that the Fund's conditions for drawings on the upper credit tranches are stringent at all times. In fact, some developing countries, notably Brazil, have taken an explicit policy decision to avoid drawings on the Fund's upper credit tranches because of their fear that the conditions that could be applied would be unacceptable to them [*UNDP-UNCTAD, 1979*]. Naturally, the poorer, 'less creditworthy' developing countries could probably not follow Brazil's example and still maintain any access to private international capital markets.

As we have seen, the balance of payments assistance provided by the Fund plays a crucial role in the international credit system principally because of its most distinctive feature – the conditionality attached to it.

The problems raised by IMF conditionality, particularly for developing countries, are being increasingly discussed.[44] We shall here only very briefly outline the main issues. A generalised criticism is that the Fund's influence over the economic policies of member countries is heavily concentrated on the deficit countries; this tends to impose a deflationary bias on the world economy as a whole, and in particular on those countries which need Fund assistance and/or its 'certificate of good behaviour' for private funding. Furthermore, case studies seem to show that the Fund's emphasis on short-term balance of payments equilibrium has often led to a decline in investment, damaging long-term growth [*UNDP-UNCTAD, 1979: chapter II*]. Even though the IMF claims that its recommendations are neutral as regards the burden of adjustment, its stress on measures such as reductions of state subsidies and real wage controls often have negative effects on income distribution. Finally, the IMF admits to having a marked preference for 'market mechanisms' and 'unrestricted flows of foreign investment' and a dislike of direct policy tools, such as price controls and restrictions on foreign exchange and trade. The Fund attempts to impose its own preferred policy framework on governments seeking a stand-by arrangement, thus curtailing their autonomy.[45]

(c) Timing of Availability of Funds in the Eurocurrency Market

The offer of funds tends to be much larger for individual developing countries when they need them the least – that is, when their balance of payments and foreign exchange reserves are in a favourable situation.[46] It is in these circumstances that the countries could more easily use their own resources for development. The availability of large external credits at that time may induce them instead to reach unreal levels of consumption and investment, difficult to reduce later on. If the balance of payments situation deteriorates, the country stops being 'creditworthy' and the availability of external funds may be sharply curtailed at a time when the country needs it most. Unless the country can renegotiate its debt, it must continue to service and repay its past loans, probably causing a net outflow of foreign exchange for this item.[47]

As we have seen, at an aggregate level, the flow of international private credits to the developing countries depends on unpredictable factors, largely outside the countries' control. The availability of credits to the developing countries at a certain period of time in no way guarantees continued availability at similar levels in the medium term. This is an important – although not the only – reason to encourage governments of developing countries to rely as much as possible on their own resources.

NOTES

1. See, for example, sources with such different analytical frameworks as the US Congress, Committee on Foreign Relations [*1977*]; M.J. Seiber [*1977*]; R.I. McKinnon [*1977*] and Aronson [*1977*].
2. This would explain the fact that the transnationalisation of finance has outstripped that of production. Since the early sixties, the proportion of foreign profits in total profits of US transnational banks has risen much faster than this same proportion for US transnational productive corporations.
3. For more details, see Robinson [*1972*].
4. For more details, see Aronson [*1977: 69-95*]. For the links between US policy actions,

the development of US banks' international activity and the growth of the Eurodollar market, also see the excellent article by de Cecco [*1976: 392-9*].

5. The participation of developing countries in the international bond market is quite small and highly concentrated (borrowers in Brazil and Mexico raised about 50 per cent of the total going to developing countries). [*World Bank, 1978a*]. Here we will concentrate only on the Eurocredits.
6. Thus, the rapid development of the 'Eurodollar' market cannot be mainly attributed – as some analysts claim – to 'petrodollars' recycling; although, naturally, the higher growth rates of the Euromarket in 1973 and 1974 were largely due to the strong impulse given by its recycling of OPEC surpluses.
7. Comparisons are difficult. It is estimated that non-oil developing countries' share of Eurocurrency credits was 6.3 per cent in 1970 [*D'Arista, 1979*].
8. These are the latest available World Bank statistics [*World Bank, 1978a*]. Even though the World Bank statistics are considered as the most comprehensive statistical series available on total debt of the developing countries, they have several limitations, which in fact causes them to underestimate the growth of the proportion of debt owed to private sources (and particularly to banks). Firstly, countries are only asked to report public or publicly guaranteed debts which have a maturity of one year or more; this excludes short-term credits and non-guaranteed medium and long-term borrowing by the private sector, which is a very important part of the borrowing from the private international markets by bigger developing countries, such as Brazil or Mexico. Secondly, only countries which have borrowed from the World Bank have to report on their other debts. Finally, these public debt figures reported by a government to the World Bank may be inaccurate as the government may not know or may not wish to reveal exactly how much it and its state enterprises have borrowed from the foreign banks.
9. Some authors who write about recent developments seem to believe that never before the late 1960s had the developing countries borrowed extensively from private banks. This is clearly wrong, as before 1930 private bank loans played a major role in external financing of developing countries. The main difference is that, before 1920, European banks provided finance to their countries' colonies and allies (see the classic study by Feis [*1965*]. Since the late 1960s, US, Japanese, Canadian and European banks have competed with each other to lend to nearly all the countries in the world.
10. Expressed in real terms, the total volume of official development assistance from the members of the Developed Assistance Committee of the OECD (the industrialised market economies) to the developing countries has hardly increased since the beginning of the sixties; it went up from US $11.9 billion in 1961 to US $13.6 billion in 1975 (both figures are in 1975 US $). Aid from the socialist countries seems to have declined in real terms during the '70s [*Voorhoeve, 1977*]. There seems to be a serious kind of 'money illusion' among politicians and their constituencies which has made it difficult to increase the nominal value of aid programmes.
11. This was perceived as contrasting with the behaviour of international lending institutions or bilateral aid donors which have traditionally applied a high degree of formal conditionality of loans. For an analysis of official aid to Chile in the sixties, see Griffith-Jones [*1979*]. It has been reported that, for example, Colombia planned to seek independence in domestic economic planning and policy from the influence of bilateral and multilateral assistance institutions, by raising large commercial credits [*Wellons, 1977*]. (This is one of the few studies on the subject, as very little analytical work on transactions of the countries of the periphery in the Eurocurrency market has been done. Practically no research has been done on the effects the transactions have had on these countries).
12. The preference of governments often coincided with that of the transnational corporations themselves; mainly due to their desire to minimise risk, these corporations often preferred to reduce their equity investment and increase finance by loans.
13. The base rate for these loans to the developing countries is usually LIBOR (London Inter-bank Offer Rate), which is a measure of the cost of funds to the bank or banks. In addition to this variable base rate, a 'spread' or margin over LIBOR is charged; it reflects both the liquidity in the market at the time and the creditworthiness of the borrower. The cost of the credit also includes a 'management fee' (increasingly

important now as spreads are falling) and a 'commitment fee', charged on the unused portion of the funds.

14. These roll-overs occur automatically. However, within these credit contracts there are often clauses which state that if a bank cannot raise funds, the loan becomes due immediately. This kind of clause, if applied, could have very negative consequences for the developing countries. Often those who negotiate these loans are unaware of the full implications of such clauses.
15. The high-water mark was reached in 1978, when more than 500 banks participated in a syndication for Mexico [*Financial Times, 19 March 1979*].
16. The larger banks make much of their profit on these loans by managing the syndication and charging a large management fee, and then placing a large part of the loan with smaller banks who are eager to participate in this market, but who lack resources to manage such large transactions on their own, or are unable to assess a foreign borrower's creditworthiness.
17. As today nearly every multinational bank has become acquainted with Eurocurrency lending, the role of the consortium banks seems to be declining. See *Financial Times* [*19 September 1978*]. For a detailed analysis of consortium banks, see Harwich [*1974*].
18. Source: *The Banker* [*1977*].
19. For prime Latin American borrowers, in 1973/74, the average spread was well below 1 per cent. At the time, prime COMECON borrowers had even lower spreads [*Euromoney, March 1978*].
20. Source: I. Kapur [*1977*]. Based on World Bank data.
21. The overall impact of the oil price rise on the world economy is naturally too complex to be adequately studied here. Its links with the evolution of the international financial markets are only outlined. See also, US Congress, Senate Committee on Foreign Relations [*1977*], for a much more complete (if somewhat anti-OPEC) account.
22. For example, the proportion of total Eurocredits with maturities for developing countries of over five years grew from 29 per cent in 1975 to 35 per cent in 1976 [*World Bank, 1978b*].
23. Thus, during 1977, 72 per cent of the loans to developing countries had a maturity of 5 years or more (as opposed to 35 per cent in 1976) [*World Bank, 1978b*].
24. See, for example, several articles in *Euromoney* [*October 1978*].
25. A good discussion of available statistics and their limitations can be found in Wionczek [*1979*]. See also the article by Federal Reserve Bank of New York [*1978*].
26. This subjectivity was expressed by Walter Wriston, Chairman of First National City Bank, when he said that 'in the last analysis credit is not numbers. It's people. So in the management of a country, as in that of a company, the determinative force is the ability of a government to react to circumstances' [*The Banker, 1974*].
27. See for example, the articles by I. Kapur [*1977*] and I.H. Giddy and R. Ray [*1976*].
28. Besides the above-quoted empirical studies, see for example the article by R. Puz [*1977*] (Senior Vice-President, Bank of America), 'How to Find Out When a Sovereign Borrower Slips From A-1 to C-3', and speech by B. Brackenridge (Senior Vice President of Morgan Guaranty Trust Co.), on 'Country Exposure, Country Limits and Lending to LDC's' [*1977*]. The opinions of the Senior Executives of these banks are important as both banks rank amongst the 20 top managing banks in syndicated loans in the world during the first ten months of 1978, ranking third and fourth in the number of involvements as lead managers [*International Herald Tribune, 1978*].
29. See article by R. Puz [*1977*] in *Euromoney*.
30. Based on interview material. The confidence of international banks in the IMF is very well illustrated by this statement in a *Financial Times* leading article, on 20 March 1979: 'Zaire's agreement to an I.M.F. stabilisation programme would go a long way to reassuring western investors and creditors of the long-term security of the country . . . .' Given the magnitude of the problems facing Zaire, this faith in the agreement with the IMF is particularly meaningful.
31. See quoted literature above; also based on interview material.
32. Own estimate based on recently published figures by the Bank for International Settlements [*1978b*]. These figures represent a substantial qualitative improvement (on claims for individual countries) over former figures published by BIS. They offer

more recent and apparently more complete coverage than the World Bank data. Unfortunately, there are no comparable figures for previous years.

33. The extent to which these flows will imply a net transfer of resources in the long term will depend on such elements as interest rates, inflation rate of the currencies in which the loans are denominated, and proportion of the debt which will be rolled over indefinitely.
34. Some authors have also maintained that the recent rapid growth of international financial flows has increased global inflationary pressures. This interesting debate escapes the scope of this paper.
35. The market's effective transfer of risk to developing countries through floating interest rates differs substantially from the modality used by international capital markets before the 1930s. During that period, the transfer of funds was carried out largely by the purchase of bonds, with fixed interest rates. See Feis [*1965*].
36. We use here the somewhat underestimated figure of debt for non-oil developing countries given by BIS.
37. Bankers generally look at figures of gross foreign exchange reserves, which are usually the only ones publicly available, instead of net foreign exchange reserves. Based on interview material.
38. A well-informed Chilean magazine of economic analysis, *Gemines* [*1978*], expressed this view recently: 'The Central Bank is ready to increase its foreign exchange assets even more because the concentration of debt to banks and financial institutions in a way obliges it to maintain available a relatively high level of reserves' (The translation is mine).
39. *El Mercurio* [*1978*] (The translation is mine).
40. For a discussion of these cases, see Vaitsos [*1978*].
41. For an interesting analysis of this issue and of the private banks' initial attempt to monitor the Peruvian economy themselves, followed by their leaving this role to the IMF, see B. Stallings [*1979*].
42. Even though the IMF claims that its rules are uniform for everyone, in practice 'creditworthy' developing countries are treated more gently than the needy ones.
43. See *IMF Survey* [*1979: 2-3*].
44. For recent critical analysis of the IMF see *UNDP-UNCTAD* [*1979*] and E.A. Brett [*1979*]. For a lucid defence of the Fund's conditionality, see *IMF Survey* [*1978: 1-4*].
45. The IMF has recently (March 1979) somewhat reviewed its guidelines of conditionality. It is too early to say whether they will imply any qualitative change in the Fund's conditionality.
46. Interview material.
47. In this sense, it has been said that equity (direct investment) would be preferable to foreign loans to finance investment in the export sector. When export earnings fall, so would the dividend repatriated abroad. However, the problems and costs related to foreign direct investment in the export sector would seem to outweigh any such possible advantages. For an early discussion of these issues, see Adler and Kuznets [*1967*]. An alternative which may occur with increasing frequency is that the governments of the developed countries will come to the rescue, as they will not wish to see either the debtor country or their own large banking institutions go bankrupt. Although it would seem that they were 'bailing out' the country, in fact the governments would be basically transferring resources to their own private banks.

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