

CHAPTER 12

International Banking Issues and Country Risk Analysis

Opening Case 12: Argentina's Currency Crisis

From December 2001 to January 2002, Argentina experienced tumultuous currency devaluation, sovereign debt default, and a freeze on bank accounts that followed a 10-year period during which the country pegged its peso one-to-one with the US dollar. During this period, Argentina took steps to privatize state-owned enterprises and open itself to international trade – especially with Brazil, which became Argentina's largest trading partner through the Mercosur customs union. In the 1990s, foreign companies purchased numerous privatized enterprises and foreign investors acquired large holdings of private and sovereign debt from Argentina. For these foreign owners to repatriate interest and profits, Argentina would have to generate substantial export earnings.

However, one big obstacle to Argentine exports was the appreciation of the dollar, which caused the peso to appreciate against other major currencies since 1995. That is, prices in Argentina, combined with the one-to-one exchange rate with the dollar, made Argentine goods relatively expensive to the rest of the world. Argentina and Brazil were at least in the same boat during the mid-1990s, when Brazil also pegged its real to the US dollar. In contrast to the European Union, however, the Mercosur customs union did not impose exchange rate commitments between the member countries, and Brazil unilaterally devalued the real in January 1999. Depreciation of the nominal exchange rate would have been the most direct way for Argentina also to reduce the high real exchange value of the peso. With the exchange rate straitjacket in place, however, the only way market forces could reduce the real exchange value of the peso was for prices in Argentina to fall relative to prices in the USA. However, it was not easy for prices in Argentina to fall below those in the USA, given the US productivity boom, which held down US inflation and elevated real rates of return.

With the fixed exchange rate, nominal interest rates in Argentina could not fall below those in the USA, although they could be higher due to default risk. This interest rate floor meant that any fall in prices relative to the USA implied correspondingly higher real borrowing costs in Argentina's domestic credit markets. Between November 1994 and September 2001, for example, the price level in Argentina fell 16.2 percent relative to the price level in the USA. The resulting real borrowing costs hindered any economic recovery that would have reduced Argentina's unemployment rate from double-digit levels. Nevertheless, figure 12.1 shows that not even this painful decrease in relative prices between Argentina and the USA was sufficient to prevent substantial appreciation of the real exchange value of the peso relative to the Brazilian real following Brazil's devaluation in January 1999. This evolution of the Argentine economy – one step forward and two steps backward – satisfied no constituency: neither domestic borrowers, labor unions, and exporters, nor foreign creditors. In such circumstances, domestic politics generally holds the trump card, whereupon default and devaluation became the inevitable outcome.

Source: M. J. Dueker, "Argentina Agonists," *International Economic Trends*, Feb. 2002, p. 1.

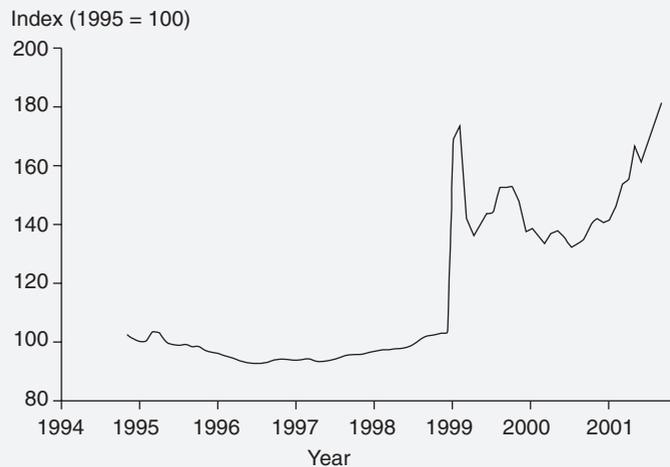


Figure 12.1 The real exchange rate between Argentina and Brazil: higher values indicate that Argentine exports are more expensive

World banking has grown with the unprecedented expansion of economic activity since World War II because banks have followed customers abroad. Recent events in developing countries have compelled analysts and investors to question international bankers about loans to economically risky countries. Consequently, international banks have recently reduced their loans to some developing countries, while developing countries have begun to use capital markets as their main

source of funds since the early 2000s. Bank loans, however, are still the dominant source of funds for most developing countries, because their capital markets are underdeveloped. Thus, international banks must reduce the impact of country risk through systematic assessment and management.

This chapter has three major sections. The first section discusses international banking operations. This section describes the types of foreign banking offices and interbank clearinghouse systems. The second section describes developing-country loans and their problems. This section focuses on causes and policy responses for the two international lending crises: the Latin American debt crisis of the 1980s and the Asian financial crisis of 1997–8. The third section looks at how banks and other investors assess unique risks of their foreign operations and how these risks can be incorporated into routine operations.

● 12.1 International Banking Operations

International banks perform many vital tasks to help international transactions of multinational companies. They finance foreign trade and foreign investment, underwrite international bonds, borrow and lend in the Eurodollar market, organize syndicated loans, participate in international cash management, solicit local currency deposits and loans, and give information and advice to clients. Commercial banks establish multinational operations for a variety of reasons (Rugman & Kamath 1999). First, managerial and marketing knowledge developed at home can be used abroad with low marginal costs. Second, foreign bank subsidiaries have a knowledge advantage over local banks, because they can draw on their parent's knowledge of personal contacts and credit investigations. Third, large international banks have high-perceived prestige, liquidity, and deposit safety that can be used to attract clients abroad. Fourth, foreign bank subsidiaries have a regulatory advantage over local banks, because they are often not subject to the same regulations as domestic banks. Fifth, growth prospects in a home market may be limited by a market that is largely saturated with the services offered by domestic banks. Sixth, international banking operations may reduce risk because greater stability of earnings is possible with international diversification. Seventh, banks follow their multinational customers abroad to prevent the erosion of their client base to foreign banks.

12.1.1 *The world's largest financial companies*

Table 12.1 lists the world's 10 largest financial companies and the world's 10 largest economies as of December 31, 2002. The United States and Japan each claimed three of the world's 10 largest financial companies in terms of assets. The remaining four companies on the top 10 list were from Germany (two), the United Kingdom (one), and Switzerland (one). The so-called G-5 group (the USA, Japan, Germany, the UK, and France) took the first top five spots in rankings of the world's 10 largest economies.

China appears to be on its way to becoming the new center of global economic power. In dollar terms, China's economy is about 10 percent of the US economy and 20 percent of Japan's. However, after adjusting for differences in the cost of living (purchasing power parity), China's economy is more than half as large as the US economy and surpasses Japan to become the world's second-largest economy; in 2002, the gross domestic product was \$10.1 trillion for the USA, \$6

Table 12.1 The world's 10 largest financial companies and the world's 10 largest economies (billions of US dollars as of December 31, 2002)

<i>Financial companies</i>			<i>Countries</i>		
<i>Ranking</i>	<i>Name</i>	<i>Assets</i>	<i>Ranking</i>	<i>Name</i>	<i>GDP</i>
1	Mizuho Financial Group	\$1,128	1	USA	\$10,082
2	Citigroup	1,097	2	Japan	4,166
3	Allianz	894	3	Germany	1,856
4	Fannie Mae	887	4	UK	1,454
5	Sumitomo Mitsui Financial Group	880	5	France	1,310
6	UBS	853	6	China	1,179
7	Mitsubishi Tokyo Financial Group	834	7	Italy	1,074
8	Deutsche Bank	791	8	Canada	689
9	HSBC Holdings	759	9	Brazil	595
10	J. P. Morgan Chase	758	10	Mexico	574

Sources: *The Wall Street Journal*, Sept. 24, 2003, pp. R1–R12 and “Total GDP 2002,” World Bank, www.worldbank.org/GDP.pdf, Sept. 31, 2002.

trillion for China, and \$3.6 for Japan. It grew 7.3 percent in 2001 and by an average of about 9 percent annually between 1980 and 2000. China expects its economy to grow at an annual rate of 6–7 percent over the next 10 years. In 2002, China attracted more foreign direct investment than the USA. China's membership of the World Trade Organization represents another great step as it continues to move toward a more capitalistic economy. It will increase the opportunities for Chinese growth and will help China play an increasingly large role in the global economy. All of these trends together point to the emergence of China as a dominant, if not the dominant, economic power for the coming century.

Leaders of developing countries understand that international banks perform vital tasks for their governments and local companies. Despite this understanding, some critics argue, using a few selected statistics, that host governments are powerless over large international financial institutions. For example, in 2002 only six countries had gross domestic products (GDP) greater than the total assets of Mizuho Financial Group of Japan. Table 12.1 indicates that this statement must be true. In fact, when we compare these two (banks and economies), the grand total assets of the world's 10 largest financial companies are greater than the combined GDP of the eight largest economies, excluding the USA and Japan. However, a nation's GDP and a company's assets are not comparable, because GDP is a measure of value added, while a company's assets are the total book value of all outstanding assets.

12.1.2 *Types of foreign banking offices*

There are six major types of foreign banking offices: representative offices, correspondent banks, branch banks, subsidiaries, agencies, and banking consortia. The list of alternatives also should include Edge Act corporations, international banking facilities, and export trading companies, which are discussed in other chapters.

REPRESENTATIVE OFFICES National banks may establish offices in foreign countries when their parent bank is doing business in these countries or in neighboring countries. These offices do not have traditional banking functions such as deposits, loans, letters of credit, drafts, and Eurodollar markets.

Representative offices obtain information, give advice, and arrange local contacts for their parent bank's business customers. They help local business executives initiate inquiries about the parent bank's services and introduce visiting executives to local banks. They put clients of parent banks in contact with government officials or local business firms. They also provide their parent bank with credit analyses of local firms and political information about the country.

CORRESPONDENT BANKS Most major national banks maintain correspondent banking relationships with local banks in many major foreign cities of the world. The **correspondent banking system** is an informal arrangement in which a bank in a country maintains deposit balances with banks in foreign countries and looks to them for services and assistance.

Local correspondent banks accept drafts and honor letters of credit. They also provide credit information. Finally, they collect or pay foreign funds from import or export transactions.

BRANCH BANKS Foreign **branch banks** do not have a corporate charter, a board of directors, or shares of common stock outstanding. Thus, they are an operational part of the parent bank; their assets and liabilities are, in fact, those of the parent bank.

Foreign branch banks provide a full range of banking services under the name and guarantee of the parent bank. They attract big local borrowers because legal loan limits depend on the size of the parent bank.

FOREIGN SUBSIDIARY BANKS In spite of the fact that **foreign subsidiary banks** have their own charter, their own board of directors, their own stockholders, and their own managers, they are owned completely or in major part by a foreign parent bank. They must comply with the laws of the host country.

Because foreign subsidiary banks maintain their status as local institutions with local ownership and management, they are able to attract additional local deposits and have greater access to the local business community. In addition, they are more likely to appeal to the foreign business community than a local bank because they have permanent relations with their foreign part owner.

AGENCIES Agencies of foreign banks can offer only a limited range of banking services. They cannot accept transaction deposits from residents of their own country, and they must deal exclusively with commercial customers. Their primary function is to finance both exports and imports that originate from companies in their own country. Agencies also actively participate in inter-bank credit markets and some other loans to companies in their own country.

CONSORTIUM BANKS A **consortium bank** is a permanent group of banks that handles large international loans. It has its own charter, but it is a joint venture owned by two or more shareholder-parent banks, usually with different nationalities.

Consortium banks develop their business and take customers that the parent bank suggests. They arrange global syndicates for large international loans. Syndicates in large international loans spread risk and overcome the inability of a single bank to handle a large loan alone. Consortium banks also underwrite corporate securities and arrange mergers and acquisitions.

Table 12.2 Characteristics of US foreign banking offices

<i>Type of bank</i>	<i>Physical location</i>	<i>Accept foreign deposit?</i>	<i>Make loans to foreigners?</i>	<i>Engage in investment banking?</i>	<i>Subject to Federal Reserve requirement?</i>	<i>FDIC insured deposit?</i>	<i>Separate legal entity?</i>
Domestic bank	USA	No	No	No	Yes	Yes	No
Representative office	Foreign	No	No	No	Yes	Yes	No
Correspondent bank	USA	N/A	N/A	Yes	No	No	N/A
Branch bank	Foreign	Yes	Yes	No	No	No	No
Subsidiary bank	Foreign	Yes	Yes	Yes	No	No	Yes
Agency	Foreign	No	No	No	No	No	No
Consortium bank	Foreign	Yes	Yes	Yes	No	No	Yes
Edge Act Bank	USA	Yes	Yes	Yes	No	No	Yes
International banking facilities	USA	Yes	Yes	No	No	No	No

Table 12.2 summarizes the organizational structure and characteristics of foreign banking offices from the perspective of the USA. This table includes Edge Act corporations and international banking facilities, which we will discuss in chapter 15.

12.1.3 Interbank clearinghouse systems

This section describes three key clearinghouse systems of interbank fund transfers. These three systems transfer funds between banks through wire rather than through checks.

The **Clearing House Interbank Payments System (CHIPS)** is used to move dollars among New York offices of about 150 financial institutions that handle 95 percent of all foreign-exchange trades and almost all Eurodollar transactions.

The **Clearing House Payments Assistance System (CHPAS)** began its operation in 1983 and provides services similar to those of the CHIPS. It is used to move funds among the London offices of most financial institutions.

The **Society for Worldwide Interbank Financial Telecommunications (SWIFT)** is an interbank communication network that carries messages for financial transactions. It was founded in 1973 by European and North American banks. Since 1973, its membership has expanded to include many Asian and Latin American banks. The SWIFT network represents a common denominator in the international payment system and uses the latest communication technology. The network has vastly reduced the multiplicity of formats used by banks in different parts of the world. Banks can execute international payments more cheaply and efficiently than ever before, because of the common denominator in the international payment system and the speed of electronic transactions. Currently, 6,000 live network users send 10 million messages daily through the SWIFT; its usage increases at an annual average growth rate of 15 percent. Messages transferred through this system include bank transfers, customer transfers, and special messages.

● 12.2 International Loans

Large international loans to developing countries have become extremely important for European, Japanese, and US banks. For some banks, international loans have become as impor-

tant as their domestic banking operations. On the other hand, recent global debt problems have raised serious questions about large loans to developing and former Eastern-bloc countries.

12.2.1 *The international debt crisis of the 1980s*

Developing countries dramatically increased their borrowing from lenders in the Western industrial countries from 1973 to 1982. The total external debt of those developing countries that are not oil-producing increased from \$130 billion in 1973 to \$840 billion in 1982, a 6.5-fold increase. Over this 10-year period, the debt grew at an average compound rate of 20 percent per year. At the outset, few people worried as the external debts of these countries mounted in the 1970s. Several poor countries in Africa experienced difficult servicing problems. Yet, by the early 1980s, more developed borrowers such as Poland, Mexico, Brazil, and Argentina had difficulty in servicing their huge external debts.

The first major blow to the international banking system came in August 1982, when Mexico announced that it could not meet its regularly scheduled payments to international creditors. Shortly thereafter, Brazil and Argentina were in the same situation. By spring 1983, about 25 developing countries could not make regularly scheduled payments and negotiated reschedulings with creditor banks. These countries accounted for two-thirds of the total debt owed to private banks by those developing countries that do not produce oil.

A worldwide recession compounded the lending crisis. It put downward pressure on oil prices and on OPEC's revenues. OPEC – the Organization of Petroleum Exporting Countries – is an organization established by a number of oil-exporting countries to formulate uniform policies, such as selling prices on their oil-export sales. In 1980, OPEC contributed almost \$42 billion to the loanable funds of the international banks, but by 1982, OPEC nations had withdrawn \$26 billion from these loanable funds.

THE MAJOR CAUSES OF THE DEBT CRISIS Officials of developing countries often argue that the international lending crisis arose solely because of global economic dislocations. Still, policy-makers of the creditor countries suggest that mismanagement by the debtor countries caused the crisis. The truth is, of course, somewhere in the middle of these positions.

Several developments in the 1970s turned banks into the predominant suppliers of funds to those developing countries that do not produce oil and to Eastern-bloc nations. First, there were growth and investment opportunities in these countries, because economies began to open and to rise in the second half of the 1960s. Second, the 1973–4 oil shock, when higher oil prices and the subsequent world recession skyrocketed the current-account deficit of the borrowing nations, accelerated bank loans to these countries. Third, many developing countries began to incur large balance-of-payments deficits during the early 1980s, because the worldwide recession of 1979–82 compelled industrial countries to reduce their imports from developing countries. Fourth, observers argue that capital flight, prompted by political and economic uncertainty, caused the debt crisis. The World Bank estimates that capital flight from Latin American debtor countries to industrial countries exceeded \$70 billion between 1979 and 1982.

SOLUTIONS Observers feared that the debt crisis would provoke an international banking crisis and a global depression. Thus, lenders, borrowers, the International Monetary Fund (IMF), and the World Bank worked together to overcome this crisis through rescheduling, refinancing, addi-

tional loans, and restrictive economic policies. The management of this debt crisis exemplified successful international policy coordination.

The international lending problem faced attacks on many fronts. First, international banks took steps to reduce their burden of developing-country debts. They increased their equity-capital base, raised loan-loss reserves, avoided new loans to developing countries, and sold exposed loans at a big discount to investors.

Second, many debtor countries took steps to alleviate their external debt problems. They increased exports, reduced imports, attracted more foreign investment, adopted restrictive economic policies, and used debt–equity swaps. In **debt–equity swaps**, creditors exchange their loans for equity in local companies.

Third, the policy-makers of the creditor nations, the World Bank, and the IMF have worked together to provide partial debt relief for countries in the most extreme difficulties. Under this plan, a portion of a country's external debt was forgiven permanently. The country received new concessionary loans from commercial banks and international financial institutions by promising to pursue sound growth and reform-oriented policies. Between 1982 and 1993, official creditor nations canceled a total of \$20 billion.

BRADY BONDS The above three measures were not sufficient to solve the 7-year-old debt crisis completely. In 1989, US Treasury Secretary Nicholas Brady put forth a set of principles, known as the Brady Plan, to resolve the problem. The Brady Plan offered three options to the creditor banks: (1) convert their loans to marketable bonds with a face value equal to 65 percent of the original loan amount; (2) convert their loans into new guaranteed bonds with a reduced interest rate of 6.5 percent; or (3) keep their old loans, but provide additional funds equal to 25 percent of their original loan amount. As you might imagine, most banks chose either the first or the second option, while only a few banks took the third option.

Those bonds that originated from the second option under the Brady Plan have come to be called Brady bonds. This option included the following provisions: (1) extend the debt maturities by 25–30 years; (2) compel the debtor countries to purchase zero-coupon US Treasury bonds to guarantee the bonds; and (3) make these bonds marketable. In 1992, 20 debtor nations, including Argentina, Brazil, Bulgaria, Mexico, Nigeria, Poland, and the Philippines, had issued Brady bonds. These debtor countries had converted approximately \$100 billion in bank debt into Brady bonds. These Brady bonds are largely credited with solving the decade-long global debt crisis of the 1980s.

12.2.2 *The Asian financial crisis of 1997–8*

Despite prompt and concerted action by developing countries, industrialized countries, and international organizations to contain it, the Asian crisis of 1997–8 spread quickly and ferociously to north Asian, Latin American, and Eastern European economies to varying degrees. In fact, the Asian crisis pushed one-third of the globe into recession during 1998. The Asian crisis is the third developing-country financial crisis. The first major blow to the international financial system took place in August 1982, when Mexico announced that it could not meet its regularly scheduled payments to international creditors. The second crisis came on December 20, 1994, when the Mexican government announced it would devalue the peso against the dollar by 14 percent.

All three crisis episodes occurred under fixed exchange rate regimes. Economic theory suggests that a pegged exchange rate regime can become vulnerable when cross-border capital flows

are highly mobile. A central bank that pegs its exchange rate to a hard currency implicitly guarantees that any investors can exchange their local currency assets for that hard currency at the prevailing exchange rate. If investors suspect that the government will not or cannot maintain the peg, they may flee the currency; this capital flight, in turn, depletes hard-currency reserves and forces the devaluation that they fear.

A THAI CRISIS SPREAD THROUGHOUT THE WORLD International capital flows have caused “booms and busts” for Thailand’s economy. How could an economic crisis in an emerging economy, such as that of Thailand, spread throughout the world? Thailand’s economy surged until early 1997, partly because the Thais found they could borrow dollars at low interest rates overseas more cheaply than they could the baht at home. By late 1996, foreign investors began to move their money out of Thailand, because they were worried about the Thais’ ability to repay. In February 1997, foreign investors and Thai companies rushed to convert their baht to dollars. The Thai central bank responded by buying baht with its dollar reserves and raising interest rates.

The rise in interest rates drove prices for stocks and land downward. This dynamic situation drew attention to serious problems in the Thai economy: a huge foreign debt, trade deficits, and a banking system weakened by the heavy burden of unpaid loans. The Thai central bank ran out of dollars to support the baht. On July 2, 1997, the central bank stopped the baht’s fixed value against the dollar. And then the currency lost 16 percent of its value in a single day.

Investors and companies in the Philippines, Malaysia, Indonesia, and Korea realized that these economies shared all of Thailand’s problems. So, investors and companies rushed to convert local currencies into dollars. And then, the peso, ringgit, rupiah, and won toppled in value like dominos in a row. In the fourth quarter of 1997, the IMF arranged emergency rescue packages of \$18 billion for Thailand, \$43 billion for Indonesia, and \$58 billion for Korea.

By the end of 1998, the Asian crisis of 1997 had spread to Russia, Brazil, and many other countries. Again, the IMF arranged bailout packages, of \$23 billion for Russia in July 1998 and \$42 for Brazil in November 1998. This means that from fall 1997 to fall 1998, IMF-led rescue packages for Asia, Russia, and Brazil racked up some \$184 billion to keep world markets safe.

In theory, capital is a boon, enabling developing countries to reduce poverty and raise living standards. But the theory does not always work smoothly. Countries can mismanage their inflows. Banks can be rife with favoritism or incompetence; bad loans are made. Moreover, multinational companies may build too many factories. Speculation may also propel stock prices to unrealistic heights. Finally, ample foreign exchange provided by overseas investors may support a spending spree on imports.

If capital inflows slow or reverse, a boom may collapse. This is precisely what happened in Thailand, where the Asian crisis started. The construction of unneeded office buildings was halted; bad loans mushroomed at finance companies and banks; and the stock market took a dive. Similar problems afflicted other Asian economies, and losses extended to their foreign trading partners and investors beyond Asia.

A number of plausible answers come to mind when we ask why the dominos toppled in rapid succession, even though in some cases they were nowhere near each other (Phillips 1999). Countries are increasingly connected by trade and investment, so a downturn in one hurts exports and investment in another. Countries also compete against one another. When one country devalues its currency, others may feel pressured to do the same in order to keep their exports and inward investment competitive. Commodity prices provide another link among troubled economies. For example, as Asia sank into recession, its businesses and consumers cut their pur-

chases of oil. That, in turn, accelerated the collapse in the price of crude oil and slashed the revenue for oil-exporting countries such as Russia.

THE CAUSES OF THE CRISIS During the second half of 1997, currencies and stock markets plunged across East Asia, while hundreds of banks, builders, and manufacturers went bankrupt. More specifically, figures 12.2 and 12.3 show that currency values and stock prices of Thailand, the Philippines, Malaysia, Indonesia, and Korea fell from 40 percent to 80 percent apiece from July 1997 to early 1998. This crisis in Asia caught nearly everyone by surprise, because Asia's fundamentals looked very good.

Although many explanations have been offered on the causes of the Asian crisis, Neely (1999) argues that most views fall into one of two theories: the "fundamentalist" view and the "panic" view. The fundamentalist view focuses on how borrowing countries' policies and practices fed the crisis, whereas the panic view focuses on the role that lenders played (see *Global Finance in Action* 12.1).

THE FUNDAMENTALIST VIEW The fundamentalist view holds that flawed financial systems were at the root of the crisis and its spread. The seeds of the financial crisis were actually sown several years before currency pressures began. Most East Asian countries had tied their currencies to the dollar. This tie served them well until 1995 because it promoted low inflation, supported currency stability, and boosted exports. However, the appreciation of the dollar against the yen and other major currencies after 1995 meant that East Asian countries began to lose their competitiveness in export markets.

Meanwhile, the maturity mismatch and the currency mismatch – the use of short-term debt for fixed assets and unhedged external debt – made banks and firms vulnerable to sudden swings in international investors' confidence. Many economists believe that these two types of mismatch were caused by moral hazard, because most East Asian companies and financial institutions operated with implicit or explicit government guarantees.

An increasing portion of foreign capital inflows to the region consisted of liquid portfolio investment (short-term bank loans and security investment) rather than long-term direct investment. Most of these liquid capital flows were directed into long-term, risky investments, such as real estate. Frequently, these same assets were used for collateral and investment, driving the value of existing collateral up, which in turn spurred more lending and increased asset prices. Risk was further heightened when local banks – in response to low interest rates abroad and fixed exchange rates at home – began to borrow foreign exchange abroad. These local banks converted the foreign exchange to domestic currency and lent the proceeds to their domestic customers in domestic currency, thereby assuming all the exchange rate risk.

The fundamentalist view holds that such a bubble was about to burst in the face of a shock. By late 1996, asset prices fell, causing nonperforming loans to rise and the value of collateral to fall; domestic lending then declined and asset prices fell yet again. When capital started to flow out of the region, monetary authorities raised interest rates to defend their currency pegs. However, these higher interest rates boosted the cost of funds to banks and made it more difficult for borrowers to service their debts. These monetary authorities soon ran out of hard currencies, thereby causing them to abandon the pegs. The currency depreciations led to widespread bankruptcies and slow economic growth, because practically none of some \$275 billion in foreign loans owed by Thailand, the Philippines, Malaysia, Indonesia, and Korea was hedged.

The loss of export competitiveness and the moral hazard in lending combine to explain the severity of the Asian crisis. Appreciation of the dollar and depreciation of the yen and yuan slowed

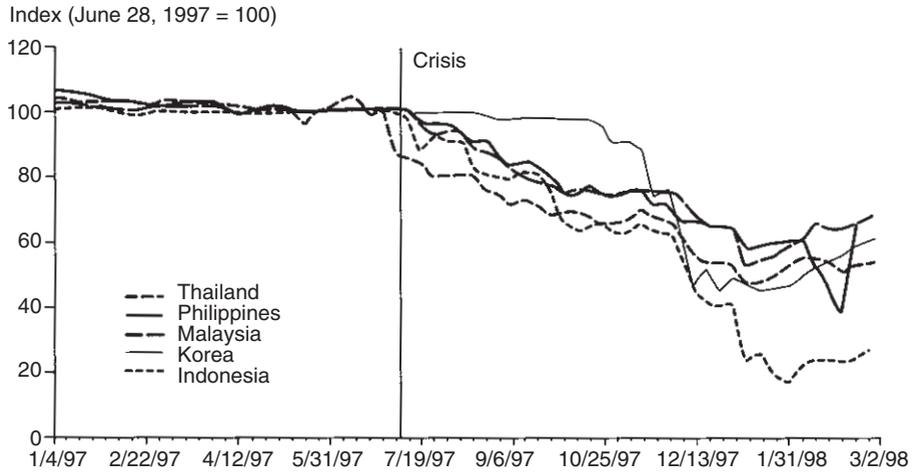


Figure 12.2 Currency devaluations for five crisis countries

Source: "What Does the Asian Crisis Mean for the US Economy?" *Southwest Economy*, The Federal Reserve Bank of Dallas, Mar./Apr. 1998, p. 2.

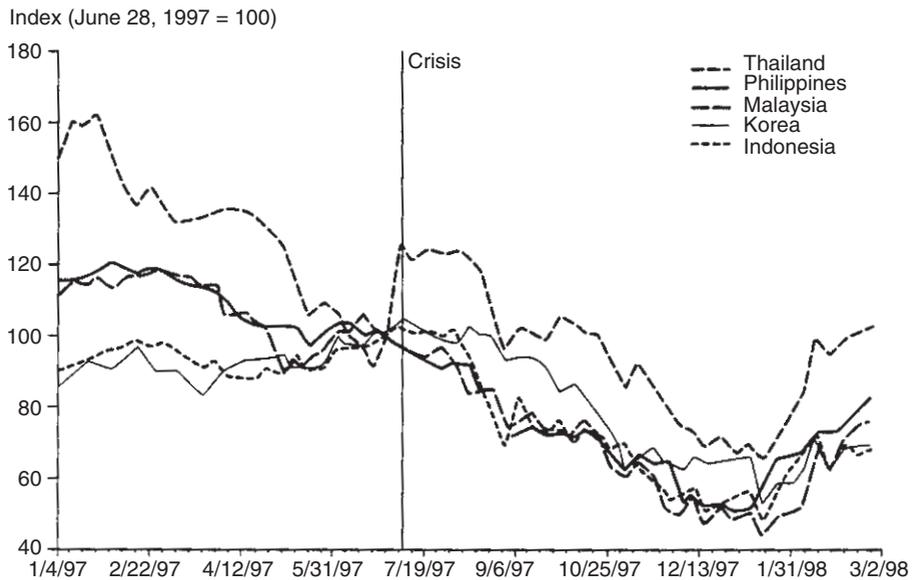


Figure 12.3 Stock market drops for five crisis countries

Source: "What Does the Asian Crisis Mean for the US Economy?" *Southwest Economy*, The Federal Reserve Bank of Dallas, Mar./Apr. 1998, p. 2.

Global Finance in Action 12.1

The Asian Financial Crisis and the International Monetary Fund (IMF)

Between 1990 and 1996, capital inflows to emerging market countries rose from \$60 billion to \$194 billion. No one carefully monitored these capital flows. When problems developed in Asia in 1997, neither the IMF nor the private lenders knew the true magnitude of the debts of some of these countries. Firms borrowed directly and through their subsidiaries. Often, the total was not shown on any balance sheet. The provision of the IMF Articles of Agreement requiring surveillance and the decision to strengthen surveillance following the 1995 Mexican crisis proved to be of little use. Though important, the IMF's failure to monitor seems small beside the elementary mistakes of private lenders. The lenders ignored three principles of prudent behavior that history has shown repeatedly to be a major reason for financial failure.

First, Asian banks and other Asian borrowers used short-term renewable credits from foreign banks to finance long-term loans (maturity mismatch). All banks do this to some extent, but the extent matters a great deal. When foreign loans were not renewed, the Asian banks and corporations faced large defaults. Second, Asian banks and corporations borrowed in foreign currencies and loaned in local currency (currency mismatch). They accepted the exchange risk without hedging. They failed to realize that the difference in interest rates included the risk of currency depreciation. Third, many international bankers did not ask to see consolidated balance sheets. They did not monitor the total assets and liabilities of the borrowers.

The IMF and the principal governments lent a total of \$119 billion to Indonesia, Korea, and Thailand so that they could pay the interest on the existing bank loans or repay the principal. Extending new credit helped the Asian banks to avoid default, but money went to the foreign banks. International bank loans were in dollars, yen, and other hard currencies. Instead of taking large losses like the holders of currency, stocks, and bonds, the international banks collected their loans with relatively small losses. And in exchange for extending repayment, the banks collected fees for renegotiating the loans. They demanded government guarantees of the loans they made to banks, financial institutions, and private companies. Allen Metzger believes that this policy is the fourth mistake, because it may invite a larger financial crisis in the future.

Source: Allen H. Metzger, "Asian Problems and the IMF," *The Cato Journal*, Winter 1998, pp. 267–8.

Asian economic growth and hurt corporate profits. These slow economic growth and low corporate profits turned ill-conceived and overleveraged investments in property developments and industrial complexes into financial disasters. The crisis was then touched off when local investors began to dump their own currencies for dollars and foreign lenders refused to renew their loans. It was aggravated by politicians in these affected countries, who preferred to blame foreigners for their problems rather than seek structural reforms of their economies. Both domestic and foreign investors, already nervous, lost yet more confidence in these nations and dumped more of their currencies and stocks, driving them to record lows.

THE PANIC VIEW Subscribers to the panic view admit that there were vulnerabilities: increasing current-account deficits, falling foreign-exchange reserves, fragile financial systems, highly leveraged corporations, and overvaluation of the real exchange rate. Still, these vulnerabilities were not enough to explain the abruptness and depth of the crisis. They argue that economic fundamentals in Asia were essentially sound.

Developing countries that had experienced financial crises in the past, such as the Mexican peso devaluation of 1994 and the Latin American debt crisis of the 1980s, typically shared a number of common macroeconomic imbalances. These imbalances included large budget deficits, large public debt, high inflation caused by a rapid growth in money supply, slow economic growth, low savings rates, and low investment rates. By contrast, most Asian economies engulfed by the crisis had enjoyed low budget deficits, low public debt, single-digit inflation rates, rapid economic growth, high savings rates, and high investment rates. In other words, the Asian crisis differed from previous developing country crises in which financial decisions in the public sector were the main sources of difficulties. Public borrowing played a limited role in the Asian crisis.

The absence of the macroeconomic imbalances typical of past crises led some to argue that the Asian crisis was not caused by problems with economic fundamentals. Rather, a swift change in expectations was the catalyst for the massive capital outflows that triggered the crisis. The panic view holds that problems in Thailand were turned into an Asian crisis because of international investors' irrational behavior, and because of overly harsh fiscal and monetary policies prescribed by the IMF once the crisis broke.

Several factors support the premise that the crisis was panic-induced. First, no warning signs were visible, such as an increase in interest rates on the region's debt, or downgradings of the region's debt by debt-rating agencies. Second, prior to the crisis, international banks made substantial loans to private firms and banks even though they did not have government guarantees or insurance. This fact alone contradicts the idea that moral hazard was so pervasive that investors knowingly made bad deals, assuming that they would be bailed out. It is consistent, however, with the notion that international investors panicked in unison and withdrew money from all investments – good or bad.

Third, once the crisis was under way, the affected countries experienced widespread credit crunches. For example, even viable domestic exporters with confirmed sales could not obtain credit, again suggesting irrationality on the part of lenders. Finally, the trigger for the crisis was not the deflation of asset values, as fundamentalists argue; instead, the sudden withdrawal of funds from the region triggered the crisis. Radelet and Sachs (1998) state that some of the conditions the IMF imposed on these crisis countries for financial assistance added to, rather than alleviated, the panic. A key feature of the financial crises since the 1980s has been the existence of contagion. The panic view is consistent with the concept of **financial contagion**, which occurs

when: (1) events in one financial market trigger events in other markets; and (2) the magnitude of the response in the other markets appears unfounded in economic fundamentals. In all three crisis episodes discussed above, a crisis that began in one country quickly spread beyond its borders. In some cases, the next victims were neighbors and trade partners; in others, they were countries that shared similar policies or suffered common economic shocks. At times, as in the summer of 1998, changes in investor sentiment and increased aversion to risk contributed to contagion within and across regions.

POLICY RESPONSES Just like the previous developing-country crises, lenders, borrowers, and international financial institutions worked together to overcome the crisis. External payments were stabilized through IMF-led aid programs, the rescheduling of short-term foreign debts, and reductions in foreign borrowings through painful reversals of current-account deficits. The IMF has established new financing packages to encourage the adoption of policies that could prevent crises in selected developing countries.

East Asian countries closed many ailing banks, cleaned up nonperforming loans, encouraged surviving banks to merge with other banks, and compelled these banks to meet the capital adequacy ratio set by the Bank for International Settlements. Corporate-sector reforms included capital structure improvement through debt reduction, business restructuring to remove excess capacity, the reorientation of conglomerates on core specialists, and the upgrading of corporate governance standards. These countries also implemented market-opening measures to facilitate foreign investment.

These and other policy responses strengthened financial systems, enhanced transparency of policies and economic data, restored economic competitiveness, and modernized the legal and regulatory environment for more stringent regulatory oversight and consistent application of accounting standards. A modest rebound in exports, stock market prices, and capital investment began to take place in 1999 as a result of these policy responses to the Asian crisis.

12.2.3 *Syndicated loans*

A **syndicated loan** is a credit in which a group of banks makes funds available on common terms and conditions to a particular borrower. Perhaps one of the most important developments in the field of international lending for the past two decades (the 1980s and 1990s) has been the rapid growth of syndicated loans. In the Euromarket, syndicated loans compose almost half of bank lending to nonbank borrowers. Syndication is the device a group of banks adopt to handle large loans that one bank is unable or unwilling to supply. In other words, syndication differs from a direct commercial loan in that several banks participate at the outset. For example, Kuwait signed a \$5.5 billion loan accord with 81 banks from 21 countries on December 13, 1991. This 5-year reconstruction deal was described as the largest syndicated loan ever extended to a sovereign borrower.

A syndicated loan must, therefore, be structured and packaged so that it satisfies the demands of the lenders and the needs of the borrowers. This type of loan has become increasingly popular because of: (1) the increasing size of individual loans; (2) the need to spread risks in large loans; (3) the attractiveness of management fees; (4) the publicity for participating banks; and (5) the need to form profitable working relationships with other banks.

Table 12.3 International syndicated loans (billions of US dollars)

<i>Year</i>	<i>Amount</i>	<i>Year</i>	<i>Amount</i>
1994	502	1998	820
1995	703	2000	1,465
1996	893	2001	1,398
1997	1,081	2002	1,343

Source: *Global Financial Stability Report*, The International Monetary Fund, Washington, DC, Mar. 2003 and Mar. 2004 issues.

Table 12.4 The total external debt of 138 developing countries (billions of US dollars)

<i>Year</i>	<i>Total external debt</i>	<i>Year</i>	<i>Total external debt</i>
1980	609	1998	2,395
1990	1,460	2000	2,364
1993	1,812	2002	2,339
1996	2,126	2003	2,433

Source: The World Bank, *Global Development Finance*, Washington, DC, various issues.

As shown in table 12.3, the total value of syndicated loans increased from \$502 billion in 1994 to \$1,081 billion in 1997, with an annual growth rate of 29 percent. The ample supply of funds in securities markets in 1997 intensified competition and maintained thin margins in international loan markets. Nevertheless, international syndicated credits rose 21 percent in 1997, driven by refinancing operations, mergers and acquisitions, and project financing. However, the Asian financial crisis of 1997–8 caused syndicated loans to fall by 24 percent in 1998 on a gross basis. Table 12.3 indicates that the total value of syndicated loans since 1999 appeared to recover from its big drop in 1998.

12.2.4 *The evaluation of international loans*

Traditionally, banks have been the dominant source of funds for developing countries, but bond markets have been an increasingly important source of funding in recent years (see Global Finance in Action 12.2). Nevertheless, the international banking community still seems fragile and vulnerable because of the sheer magnitude of the global debt outstanding. As shown in table 12.4, the external debt of 138 developing countries reached a total of \$2,433 billion at the end of 2003. Loans from the world's private banks to more than 100 developing countries that do not produce oil represent half the total external debt of these countries. The number of banks holding this debt ranges from 800 to 1,000, and includes most of the major banks in the industrial countries.

Global Finance in Action 12.2

Asian Companies Turn to Capital Markets for Funds

Traditionally, capital markets have been the main source of funds for US and British companies, while banks have been the main source of funds for Asian companies. However, Asia appears to be growing less dependent on bank loans for funding as companies have increasingly turned to the stock and bond markets to raise money. Primary figures for 1999, for example, suggest a decided shift in the way Asian companies and governments obtain financing in the wake of the Asian financial crisis.

As of December 16, 1999, Asia-Pacific companies had raised more than \$102.5 billion in share offerings in 1999, compared with a meager \$68.6 billion in 1998, \$94.5 billion in 1997 – the year the crisis broke out in Asia – and \$67.8 billion in 1996. The bumper crop for 1999 included a \$15 billion placing of shares in Japan's Nippon Telegraph & Telephone, a \$10.3 billion placement by Australian phone company Telstra, and a \$4.3 billion share offering by a fund run by the Hong Kong government.

The volume of new bonds for Asia-Pacific issuers rose to \$98.1 billion in 1999 as of December 16, 1999, from \$70.9 billion in 1998. The 1999 total is much less than 1997's \$111.5 billion, but surpassed for a second straight year the amount that Asian companies raised through syndicated bank loans. The big bond issues in 1999 from outside Japan included a \$1 billion deal for Korea Development Bank, a \$1 billion deal for Malaysia, and a \$1.6 billion deal for Thailand's Ministry of Finance.

Syndicated loans totaled \$88 billion in 1999, well below the 1997 peak. Syndicated lending in the region for 1999 was about the same level as the previous year, but about half of 1997's level.

Of course, this shift away from bank lending has been born partly of necessity. For years, companies in Asia borrowed heavily from local and international banks. But a wave of Asian currency depreciations in 1997 and 1998 left many companies in the region unable to service their debts. Banks in the region were saddled with a mountain of nonperforming loans. Foreign lenders have been reluctant to lend money to Asian companies since the Asian financial crisis of 1997–8. With bankers still working out how to restructure or recoup these loans, plenty of banks are cautious about making new commitments.

Source: "More Asian Companies Turn to Markets for Funds and Away from Bank Loans," *The Wall Street Journal*, Dec. 30, 1998, p. C14.

On the one hand, international loans have some advantages for banks:

- 1 International loans have been very profitable for many large banks, and have had a significant impact on the earnings of these international banks.
- 2 Many banks have improved risk–return performance because they can diversify international loans by country, by type of customer, and by currency.

- 3 Several safeguards have reduced the risk of international loans. They include credit insurance programs in the lenders' own countries, guarantees by parent companies on loans to affiliates, and guarantees by host governments on loans to private companies within their country.

On the other hand, international loans have many disadvantages for banks:

- 1 Country risk analysis is extremely complex, because it depends on many variables.
- 2 International bankers recently did not anticipate dramatic increases in country risk.
- 3 Critics question the ability of debtor countries to service their external debt, because many loans are short-term variable loans.
- 4 If borrowing countries are unable to meet their obligations on time, banks will be forced to roll over their loans indefinitely.
- 5 The ultimate purpose of some loans is to finance balance-of-payments deficits. This type of loan does not improve the debtor country's ability to generate foreign-exchange earnings.

● 12.3 Country Risk Analysis

Sovereign or **country risk** refers both to the possibility of default on foreign loans and to unanticipated restrictions of cash flows to the parent country. There are two major differences between domestic loans and foreign loans. First, because repayment of international loans must go through the exchange market, international banks must assess prospects for exchange rates and for controls on capital flows. Second, a common legal system or an ultimate arbitrator does not exist to settle disputed claims. Under this condition, some debtor countries are unlikely to accept the decisions of Western-oriented international legal frameworks. Thus, country risk assessment is critical for commercial banks to safeguard their international loans against country risk.

12.3.1 *The nature of country risk assessment*

Many international bankers have undertaken country risk analysis for many years. They are now working on a second or third generation of country risk models. These bankers have modified the original models on the basis of experience and their knowledge of other banks' procedures. These modified models could result in better decisions by more informed businesspersons and less risk in international loans than before.

Country risk is nothing more than an assessment of economic opportunity against political odds. Thus, country risk assessment requires that international bankers analyze political and economic indicators. While political factors reflect a country's willingness to pay its debt, economic indicators measure the country's ability to pay its debt. This means that any rating system of a country's risk must combine both economic and political risks.

Several country risk assessment models are available in academic journals or from commercial sources. Yet factors to be considered in country risk analysis vary from forecaster to forecaster. The country risk rating system should meet several criteria for use at a bank. First, lending officers should be able to understand and use the system easily. Second, the system should rank all developing countries with foreign loans. Third, the system should have both short-term and

medium-term horizons. Fourth, the system should be effective in forecasting which countries are likely to reschedule their debts.

Country risk assessment serves a number of useful purposes for international banks. First, it permits international banks to assess relative conditions of diverse countries on the basis of common criteria. Second, because it is based on a common set of criteria, it often offsets individual biases. Third, a country's risk ranking is a useful "straw vote" rating.

12.3.2 *How to assess country risk*

Country risk is the possibility that borrowers in a country will not honor past obligations. Bank managers must develop a systematic approach for evaluating country risk. Approaches now depend on the type of borrower, such as the host government, an industrial firm, or a private bank. The same variables apply to all three types of clients, although the relative weight assigned to each variable may differ considerably. Country risk may be assessed by various debt ratios, the general creditworthiness of a country, and sovereign-government bond ratings.

DEBT RATIOS Debt burdens vary from one developing country to another. For some countries, external debt and debt-service payments are insignificant both in absolute amounts and in relation to gross national product (GNP) or exports of goods and services. In these countries, therefore, the burden of external debt does not cause hardship in the economy. For other countries, the debt burden is so large that it hampers growth-oriented policies. Developing countries that fall between these two categories are not seriously burdened by their external debt, but remain vulnerable.

The World Bank classifies the debt burden of developing countries according to a set of two ratios: (1) the ratio of present value of total debt service in 2001 to average GNP in 1999, 2000, and 2001; and (2) the ratio of present value of total debt service in 2001 to average exports in 1999, 2000, and 2001.

According to *Global Development Finance*, issued in 2003 by the World Bank, the ratios of many developing countries are extremely high. This report focuses on the policy implications of heavy burdens for three groups: severely, moderately, and less indebted countries. A country is classified as severely indebted if either of these two ratios exceeds a critical value: 80 percent for present value of debt service to GNP and 220 percent for present value of debt service to exports. A country is classified as moderately indebted if either ratio exceeds a critical value: 48 percent for present value of debt service to GNP and 132 percent for present value of debt service to exports. A country is classified as less indebted if neither is true. Countries are further classified as low-income countries if their GNP per capita was no more than \$745 in 2001 and as middle-income countries if their GNP per capita was somewhere between \$745 and \$9,205 in 2001. Low- and middle-income countries are usually called **developing countries**.

Using these ratios, the World Bank identified 37 severely indebted low-income countries (SILICs), 13 severely indebted middle-income countries (SIMICs), 15 moderately indebted low-income countries (MILICs), 26 moderately indebted middle-income countries (MIMICs), 14 less indebted low-income countries (LILICs), and 33 less indebted middle-income countries (LIMICs). Table 12.5 shows five countries in each of these six classes.

Ratio analysis is sometimes problematic. For example, debt ratios must be used carefully when a country's debt situation is examined, because debt ratio analysis has its limitations. The two

Table 12.5 Classification of developing countries by debt ratios

<i>Classification</i>	<i>Countries</i>
SILICs	Angola, Ethiopia, Indonesia, Nigeria, and Pakistan
SIMICs	Argentina, Brazil, Jordan, Peru, and Yugoslavia
MILICs	Ghana, Haiti, Cambodia, Uganda, and Zimbabwe
MIMICs	Bulgaria, Chili, Hungary, Malaysia, and Russia
LILICs	Armenia, Eritrea, Georgia, India, and Vietnam
LIMICs	China, Czech Republic, El Salvador, Mexico, and Poland

Source: The World Bank, *Global Development Finance*, Washington, DC, 2003, p. 235.

debt ratios used by the World Bank have at least two drawbacks. First, they present the debt situation of a country in a particular reference year. The economic measures of that reference year may not be representative. For example, a temporary rise in commodity prices may increase the value of exports and therefore lower the debt-service ratio, but it will not significantly improve a country's long-term creditworthiness. Second, these ratios are static. The debt ratios developed for a particular country at a given time have little meaning unless they are compared with some standards.

Historical (future) standards and world standards are two criteria used. To analyze the debt situation of a country, one should compare its current ratios with its past or future ratios. A ratio may fluctuate considerably over time, so that sole reliance on a single ratio may at times give a misleading indication of a country's debt situation. When ratios are calculated over several years and compared with one another, analysts may find whether the country's debt situation is improving or worsening. To alleviate this problem, since 1999 the World Bank has used the average of GNP and exports for the last 3 years.

The second standard that analysts can use to examine a country's debt situation is world average ratios. It is important to remember that countries of the same size with the same income should be compared. The increasing diversity of national economies, the accelerated tempo of changes in technology and product development, and rapid changes in income level have made it extremely difficult to identify a particular country with a given country-group of about the same size. Proper classification by country and size is necessary for ratio analysis because the ratios vary from country to country and from size to size. To minimize this problem, the World Bank calculates the average ratios by country groups based on region and income.

OVERALL COUNTRY CREDITWORTHINESS The combined impact of economic, political, and other indicators may be used to rate country risk. For example, *Euromoney* country risk rankings are based on the following nine categories: political risk, economic performance, debt indicators, debt in default or rescheduled, credit ratings, access to bank finance, access to short-term finance, access to capital markets, and discount on forfaiting. These views based on historical data are supplemented by two subjective risk factors: economic and political. The economic risk factor is the prospective view of economic performance for each country by a panel of economists. The political risk factor is the prospective view of political stability for each country by a panel of political risk specialists.

Table 12.6 Country risk rankings

Ranking	Least risky country	Score	Most risky country	Score
1	Luxembourg	99.4	Congo	18.4
2	Norway	97.7	New Caledonia	18.2
3	Switzerland	97.5	Micronesia	13.9
4	USA	96.6	Somalia	13.2
5	Denmark	95.3	Cuba	12.0
6	UK	93.9	Liberia	11.6
7	Finland	93.8	Marshall Islands	10.7
8	Sweden	93.8	Afghanistan	7.8
9	The Netherlands	93.5	Iraq	4.3
10	Austria	92.4	North Korea	3.2

Source: www.euromoney.com, Mar. 2004.

Table 12.7 Bond ratings by Moody's and Standard & Poor's

Moody's	S&P	Description
Aaa	AAA	Highest quality
Aa	AA	High quality
A	A	Upper medium grade
Baa	BBB	Medium grade
Ba	BB	Lower medium grade/some speculative elements
B	B	Speculative
Caa	CCC	
Ca	CC	More speculative; higher risk of default
C	C	
–	D	In default

Table 12.6 presents a portion of *Euromoney's* country risk ratings in March 2004: the 10 least risky countries and the 10 most risky countries. The lowest-ranking countries are those that have experienced war (Iraq and Afghanistan) or civil unrest (Congo), current communist countries (Cuba and North Korea), and countries facing economic difficulty (Somalia and Liberia).

SOVEREIGN-GOVERNMENT BOND RATINGS There are several ways to analyze or compare the quality of bonds. Two financial service firms – Standard & Poor's (S&P) and Moody's Investor Service – assign letter ratings to indicate the quality of bonds. Table 12.7 shows bond ratings by these two firms.

Triple A and double A are extremely safe. Single A and triple B bonds are strong enough to be called “investment grade”: these bonds are the lowest-rated bonds that many banks and other institutional investors are allowed by law to hold. Double B and lower bonds are speculative; they are **junk bonds**, with a fairly high probability of default. Many financial institutions are prohibited from buying these junk bonds. During the peak of Asian currency crisis in December 1997, S&P and Moody's downgraded the credit ratings on Thailand, Indonesia, and South Korea to junk-bond status. This move sparked widespread sales of Asian bonds by portfolio man-

Table 12.8 Sovereign ratings by Moody's and Standard & Poor's

<i>Moody's</i>		<i>Standard & Poor's</i>	
Canada	Aaa	Canada	AAA
Liechtenstein	Aaa	Liechtenstein	AAA
Norway	Aaa	Norway	AAA
UK	Aaa	UK	AAA
USA	Aaa	USA	AAA
Indonesia	B3	Indonesia	B–
Lebanon	B2	Lebanon	B–
Romania	B1	Romania	BB
Pakistan	B3	Pakistan	BB–
Turkey	B1	Turkey	B

Sources: www.moody.com and www.standardpoor.com, May 2004.

agers, because they are restricted to holding only investment-grade debt securities. Bond ratings are important to both investors and issuers, because they have a direct, measurable influence on the bond's interest rate and the borrower's cost of debt.

Since the early 1900s, US domestic bonds have been assigned quality ratings by S&P and Moody's that reflect their probability of default. These two rating agencies now provide credit ratings on many international bond issues. Sovereign-governments issue a sizable portion of all international bonds. In rating a country's credit risk, their analysis centers on an examination of economic risk and political risk.

Economic risk is assessed on the basis of a country's external financial position, balance of payments, economic structure and growth, economic management, and economic prospects. Political risk is assessed on the basis of the country's political system, social environment, and international relations.

Country credit ratings usually represent the ceiling for ratings that S&P and Moody's will assign obligations of all entities domiciled within that country. For example, 20 Korean banks lost investment-grade status of their bonds in late December 1997 as S&P and Moody's cut Korea's rating to junk-bond status. Table 12.8 shows sovereign ratings by these two rating agencies for selected countries: five countries with the highest credit rating and five countries with junk-bond status.

A SUMMARY OF COUNTRY RISK RATINGS Recent developing-country debt crises – the debt crisis of the 1980s, the Mexican peso crises of 1994 and 1995, and the Asian crisis of 1997–8 – have dramatized the importance of country risk analysis. Thus, we can understand why international bankers have searched for more systematic means of evaluating and managing country risk. They have recently increased resource commitments, employed more qualified analysts, and adopted more sophisticated methods to assess country risk. Although country risk will never disappear, its systematic assessment and management can significantly decrease its impact. A variety of ratios, country-credit ratings by some consulting companies, sovereign-government bond ratings by Moody's and S&P, and procedures established by an individual bank may be used to reduce the possibility of defaults on foreign loans and interest.

SUMMARY

This chapter has discussed international banking operations, international loans, and country risk analysis. The management of international banks is more complex than that of domestic banks. Country risk analysis illustrates this problem. Recent events in many debtor countries have brought analysts and investors to question international bankers about loans to economically risky countries. For some banks, international lending can be as important as their domestic operations. Thus, international banks must reduce the impact of country risk through systematic assessment and management.

Questions

- 1 Discuss the types of functions that international banks perform.
- 2 Discuss the types of foreign banking offices.
- 3 What were the two major causes of the Asian financial crisis of 1997–8?
- 4 What are major differences between domestic and foreign loans?
- 5 What were the major causes of the international debt crisis of the 1980s?
- 6 Explain the various steps taken by debtor countries and international banks to solve the international debt problems of the 1980s.
- 7 What is syndicated lending? Why do banks sometimes prefer this form of lending?
- 8 What is country risk? How can we assess country risk?
- 9 Describe policy responses to solve the Asian crisis.

Problems

- 1 In addition to the two debt ratios described in this chapter, the World Bank recommends the use of four additional debt ratios in assessing a country's risk: the ratio of total external debt to GNP, the ratio of total external debt to exports, the debt-service ratio (accrued debt service to exports), and the interest-service ratio (accrued interest service to exports). In 1998, Mexico had \$380 billion in gross national product (GNP), \$160 billion in total external debt, \$140 billion in exports, and \$29 billion in accrued debt service, and \$13 billion in accrued interest service. Calculate the above four debt ratios for Mexico.
- 2 In 1998, Poland had \$157 billion in GNP, a debt-to-GNP ratio of 0.32, a debt-to-export ratio of 1.12, a debt-service ratio of 0.11, and an interest-service ratio of 0.06. Calculate

- Poland's total external debt, exports, accrued debt service, and accrued interest service for 1998.
- 3 Assume that the total external debt of 138 developing countries increased from \$609 billion in 1980 to \$2,332 billion in 2001.
 - (a) Determine the annual compound growth rate of the total external debt for these 138 developing countries from 1980 to 2001.
 - (b) Determine the annual simple growth rate of the total external debt for these 138 developing countries from 1980 to 2001.
 - 4 Table 12.3 shows that syndicated loans increased from \$502 billion in 1994 to \$1,398 billion in 2001.
 - (a) Determine the annual compound growth rate of the syndicated loans from 1994 to 2001.
 - (b) Determine the annual simple growth rate of the syndicated loans from 1994 to 2001.

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Case Problem 12: The World Bank

Representatives of 44 governments founded the World Bank on July 1, 1944, during their conference at Bretton Woods, New Hampshire. The Bank is a sister institution to the International Monetary Fund (IMF), but has a separate, distinct objective. The Bank was largely the brainchild of the economist John Maynard Keynes, who envisioned an institution that would initially focus on postwar reconstruction in Europe and Asia and then shift to focusing on development of poor countries. As such, the Bank's overriding modern purpose is to spur development worldwide through loans and grants to underdeveloped countries. To help stress this goal, the mission statement of the Bank is the elegant and simple sentence: "Our dream is a world free from poverty."

The Bank consists of 184 countries that all share this goal. Membership of the Bank is only allowed for countries that are first members of the IMF. Typically, countries join both organizations. Member countries are shareholders who carry ultimate decision-making power in the World Bank. Each member nation appoints a Governor and an Alternate Governor to carry out these responsibilities. The Board of Governors, who are usually officials such as Ministers of Finance or Planning, meets annually at the Bank's Meetings each fall. The chairperson of the Board of Governors is the President of the World Bank. The governors decide on key Bank policy issues, admit or suspend country members, decide on changes in the authorized capital stock, determine the distribution of income, and endorse financial statements and budgets.

Specifically, their policy discussions during the annual meetings cover a variety of issues, such as poverty reduction, international economic development, and global development finance. This annual gathering provides a forum for international cooperation and enables the Bank to better serve its member countries. The meetings are traditionally held in Washington two years out of three and, in order to reflect the international character of the two institutions (the World Bank and the IMF), every third year in a different member country.

Because these ministers meet only once a year, the bulk of the Governors' powers are delegated throughout the year to the Board of Executive Directors. Every member government of the World Bank Group is represented at the Bank's headquarters in Washington, DC, by an Executive Director. The five largest shareholders – France, Germany, Japan, the UK, and the USA – each appoint an Executive Director, while the other member countries are represented by 19 Executive Directors who are elected by groups of countries (constituents). Some countries – China, Russia, and Saudi Arabia – have formed single-country constituencies, while others have joined together in multi-country constituencies. The 24 Executive Directors normally meet twice a week to oversee the Bank's business, such as loan applications and guarantees, new policies, the administrative budget, country assistance strategies, and borrowing and financial decisions.

The World Bank is part of a larger organization, the World Bank Group. The World Bank Group consists of five closely associated institutions, all owned by member countries that carry ultimate decision-making power. As explained below, each institution plays a distinct role in the mission to fight poverty and improve living standards for people in the developing world.

The term “World Bank Group” encompasses all five institutions. The term “World Bank” refers specifically to two of the five, the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). Table 12.9 shows a brief summary of each organization that makes up the World Bank Group.

The Bank has taken some specific actions that it rightly boasts about. It has become the world’s largest external funder of education. Since its education funding began in 1963, the World Bank has provided some \$31 billion in loans and credits, and it currently finances 158 education projects in 83 countries. It is also the largest external funder of the fight against AIDS/HIV. As a co-sponsor of UNAIDS, which coordinates the global response to the epidemic, the Bank has committed more than \$1.7 billion to combating the spread of HIV/AIDS around the world. The Bank has pledged that no country with an effective HIV/AIDS strategy will go without funding and, in partnership with African governments, it has launched the Multi-Country HIV/AIDS Program (MAP), which makes significant resources available to civil society organizations and communities.

Case Questions

- 1 Table 12.9 summarizes the five organizations of the World Bank Group, and this chapter has discussed the Asian financial crisis. How might each part of the World Bank Group have helped after the crisis started?

Table 12.9 The organization of the World Bank Group

<i>Title</i>	<i>Start date</i>	<i>Cumulative lending</i>	<i>Mission</i>
The International Bank for Reconstruction and Development (IBRD) (184 members)	1945	\$360 billion	The IBRD aims to reduce poverty in middle-income and creditworthy poorer countries by promoting sustainable development, through loans, guarantees, and analytic and advisory services.
The International Development Association (IDA) (162 members)	1960	\$135 billion	The IDA provides interest-free credits to the world’s poorest countries. These countries have little or no capacity to borrow on market terms. Each year, the cutoff to qualify for IDA credits is determined. In 2002, the operational cutoff for eligibility was a 2000 GNI (gross national income) per capita of \$885.

Table 12.9 (continued)

<i>Title</i>	<i>Start date</i>	<i>Cumulative lending</i>	<i>Mission</i>
The International Finance Corporation (IFC) (175 members)	1956	N/A – has a committed portfolio of \$21.6 billion	The IFC's mandate is to promote economic development through the private sector. Working with business partners, it invests in sustainable private enterprises in developing countries and provides long-term loans, guarantees, and risk management/advisory services.
The Multilateral Investment Guarantee Agency (MIGA) (157 members)	1988	\$10.34 billion in guarantees	The MIGA helps encourage foreign investment in developing countries by providing guarantees to foreign investors against losses caused by noncommercial risks, such as expropriation, currency inconvertibility and transfer restrictions, and war and civil disturbances.
The International Center for Settlement of Investment Disputes (ICSID) (134 members)	1966	N/A – 103 cases registered	The ICSID helps to encourage foreign investment by providing international facilities for conciliation and arbitration of investment disputes; in this way, it helps to foster an atmosphere of mutual confidence between states and foreign investors.

- 2 Many critics claim that the World Bank Group is too large and attempts to do too much. Additionally, they claim that many of the Bank's activities overlap with the work of the World Trade Organization, the International Monetary Fund, and the United Nations. How valid do you find this criticism?
- 3 Imagine that you are the President of the World Bank. Who are your most powerful constituents? How much power do you have? Would you want this job?
- 4 What are the major differences between the IMF and the World Bank?
- 5 Visit the World Bank's website, www.worldbank.org, to discover its current projects.

Sources: J. Einhorn, "The World Bank's Mission Creep," *Foreign Affairs*, Vol. 80, No. 5, pp. 22–35; M. M. Phillips, "World Bank Rethinks Strategy for Poor: Political Change is Necessary, Not Economic Growth Alone, a Study Suggests," *The Wall Street Journal*, Sept. 13, 2000, p. A2; and www.worldbank.org.