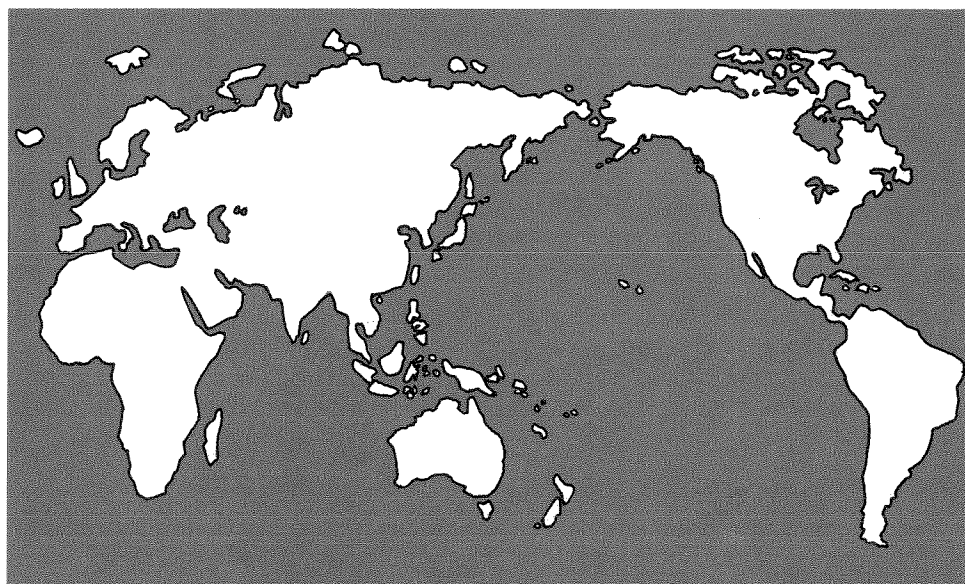


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Introduction and Summary

“When America sneezes, the rest of the world catches pneumonia”—so went the favorite cliché of the 1940’s and 1950’s. Now, with the fast-growing influence of foreign nations upon the American economy, the metaphor may have to be revised somewhat, along the lines recently suggested by Tilford Gaines—“When the rest of the world has the sniffles, the U.S. may get them too.” But although the international financial system has shown itself susceptible to a wide variety of economic ills, it has also demonstrated an ability to develop antibodies to fight off disease, in the form of new methods of analysis and new forms of cooperation and regulation. This issue

of the *Economic Review* analyzes the new diseases—and corresponding cures—that have arisen in the risk-infested world of the 1970’s, with special reference to their impact on the operations of multinational banks and multinational corporations.

In the first article, Hang-Sheng Cheng considers the impact of the heavy commercial-bank financing of payments deficits on the stability of both the U.S. banking system and the international financial community. Within several years’ time, the world has experienced an abrupt and large increase in world payment imbalances, a rapid accumulation of external debt by non-oil

developing nations, and a substantially enhanced commercial-bank role in financing those imbalances. Moreover, most analysts expect that this situation will continue for some time to come.

Cheng reviews the pessimistic discussion of the subject found in Congressional testimony and the press, and asks if the system is as inherently unstable as alleged. Judging from a recent International Monetary Fund study of balance-of-payments adjustments, he claims that the pessimistic argument is overdrawn. "Balance-of-payments developments and debt accumulation should be viewed in the context of a growing but inflation-prone world economy. When proper account is taken of output, trade and price changes, the world economy has been more successful in approaching financial stability than is generally realized."

Cheng finds little evidence to support the argument that balance-of-payments loans are inappropriate for banks. Instead he claims that the two-way capital flows between international banks and borrowing countries provide evidence of world-wide financial intermediation, which supports the world economy's efficiency of resource allocation. In particular, he notes the role played by banks as the consequence of a major shift of international payments—from the earlier build-up of payments surpluses by industrial nations to the present build-up of surpluses by OPEC nations and offsetting debt accumulation by less-developed countries (LDC's). Since the OPEC nations place a large portion of their surpluses with commercial banks, the latter play an important part in recycling such funds through the world economy.

Following on Cheng's argument, Nicholas Sargen notes that major international banks strongly discount the possibility of widespread defaults or rescheduling of developing-country loans. A more likely situation would be occasional repayment difficulties requiring refinancing or rescheduling. From the lending banks' standpoint, then, the crucial problem is to detect in advance which countries are likely to experience repayment difficulties and when these difficulties may arise.

More information and improved analytical techniques thus are necessary to detect potential default or rescheduling situations. Sargen finds

many existing procedures wanting in this regard, and discusses ways of improving country-risk appraisal through the use of several types of economic indicators. "Banks should focus on the inflation rate (and its determinants) and the debt-service ratio as the key economic variables affecting a country's borrowings and its ability to repay."

Sargen distinguishes between "liquidity" reschedulings, which are associated with the bunching of short-term commercial credits, and other reschedulings, which are identified with long-term debt relief on official credits. Monetary (and fiscal) factors appear to be closely involved in the "liquidity" cases. Inflation and overvalued exchange rates lead to export stagnation and over-importing—and thence to excessive reliance on foreign borrowing and frequently to foreign-exchange crises. He argues, however, that cases of chronic-debt relief—for example, Ghana and India in the mid-1960's—are less amenable to a monetary framework of analysis. He notes the difficulty of measuring the extent of overvaluation on the basis of inflation-rate differentials, because in these cases of chronic-debt relief, governments tend to resort to price controls, capital controls, exchange controls, and high tariff barriers.

Official regulators as well as commercial-bank analysts must cooperate in maintaining the health of the international financial community, according to Robert Johnston in a third article. He notes that banks have established a good record of international operations through diversification, improved information systems, and appropriate internal controls. "However, banks' collective risk assessment may still result in a banking system that is too risky from the viewpoint of society, and the function of banking supervision is to keep risk exposure within acceptable boundaries. Foreign risk, to the extent it affects the stability of the domestic banking system, makes supervision of international banking necessary."

Johnston argues that there are important distinctions between the types of risk involved—banking risk and sovereign risk. Banking risk is essentially the same at home and abroad. Despite greater potential difficulties in obtaining information on foreign borrowers, the credit factors

involved are fundamentally the same as in domestic lending. Sovereign risk is a different matter, for which there is no exact domestic counterpart. Actually, there are few cases where countries refuse to repay (or refuse permission for their citizens to repay) foreign loans, because borrowing countries don't want to foreclose the possibility of obtaining foreign credit again in the future. Rather, the real problem cases are those where countries get into balance-of-payments difficulties which force them to reschedule debt.

Johnston emphasizes that banks have been successful in reducing their loss exposure, judging by the relatively low losses they have experienced in their foreign operations. But to the extent that official international lending represents a form of insurance, banks may tend to take greater risks, and international supervision must act to counteract that tendency. "At the same time, this emphasis upon risk-taking should not interfere with the ability of U.S. banks to function as international lenders. Indeed, efforts to improve international-banking supervision must ultimately be judged by their contribution to the world as well as the U.S. banking system."

John H. Makin follows by analyzing the impact of a specific domestic action—the now-famous FASB-8—upon the operations of multinational corporations. Statement No. 8 of the Financial Accounting Standards Board was designed to standardize procedures for reporting foreign-currency positions of U.S. multinationals. FASB-8 prompted a storm of protest from many of these firms, which argued that it would cause violent swings in earnings unrelated to their basic economic condition, and hence would penalize their share prices and increase their costs of raising capital. But some analysts retorted that investors should be expected to "see through" reported earnings figures to distinguish between those fluctuations which reflect "fundamentals" and those which don't.

Makin's analysis represents a pioneer effort to measure statistically the impact of FASB-8 upon share prices of multinationals. He notes that FASB-8 standards were super-imposed upon a system of quasi-floating exchange rates which permitted various degrees of exchange-rate flexibility, selectively since August 1971 and more widely since March 1973. For multinationals, such flexibility meant increased variability of the dollar value of foreign-currency items on balance sheets and income statements, with possibly increased variability of net earnings. This fact should have been fully appreciated by investors well before FASB-8 went into effect in January 1976. It was thus necessary to look for possible effects of floating *per se* on costs of equity capital for multinationals, and then see if any additional effects could be attributed to FASB-8.

Makin concludes that the application of FASB-mandated accounting standards produced few unanticipated effects on earnings—and thus on share prices—of *typical* multinational firms such as the oils, drugs and chemicals. The performance of such groupings was generally indistinguishable from that of a control group of domestic firms—whether in the face of floating rates, anticipation of FASB-8, or actual application of that new standard. However, the performance of a group of companies whose earnings are especially sensitive to exchange-rate risk was adversely affected. "Our results suggest that earnings reports which resulted from application of FASB-8 did provide new information which helped investors distinguish *between* multinational groupings regarding the impact of exchange-rate adjustments upon (actual and expected) volatility of reported net dollar earnings. The new standards are significant, then, not so much because of their specific form but because they apply a single standard to all multinationals, and thereby enable the market to judge more accurately the relative importance of firms within the overall multinational grouping."