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INTERMEDIATION:
A LONG AND TROPICAL VIEW

EDMAR LISBOA BACHA
AND
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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS
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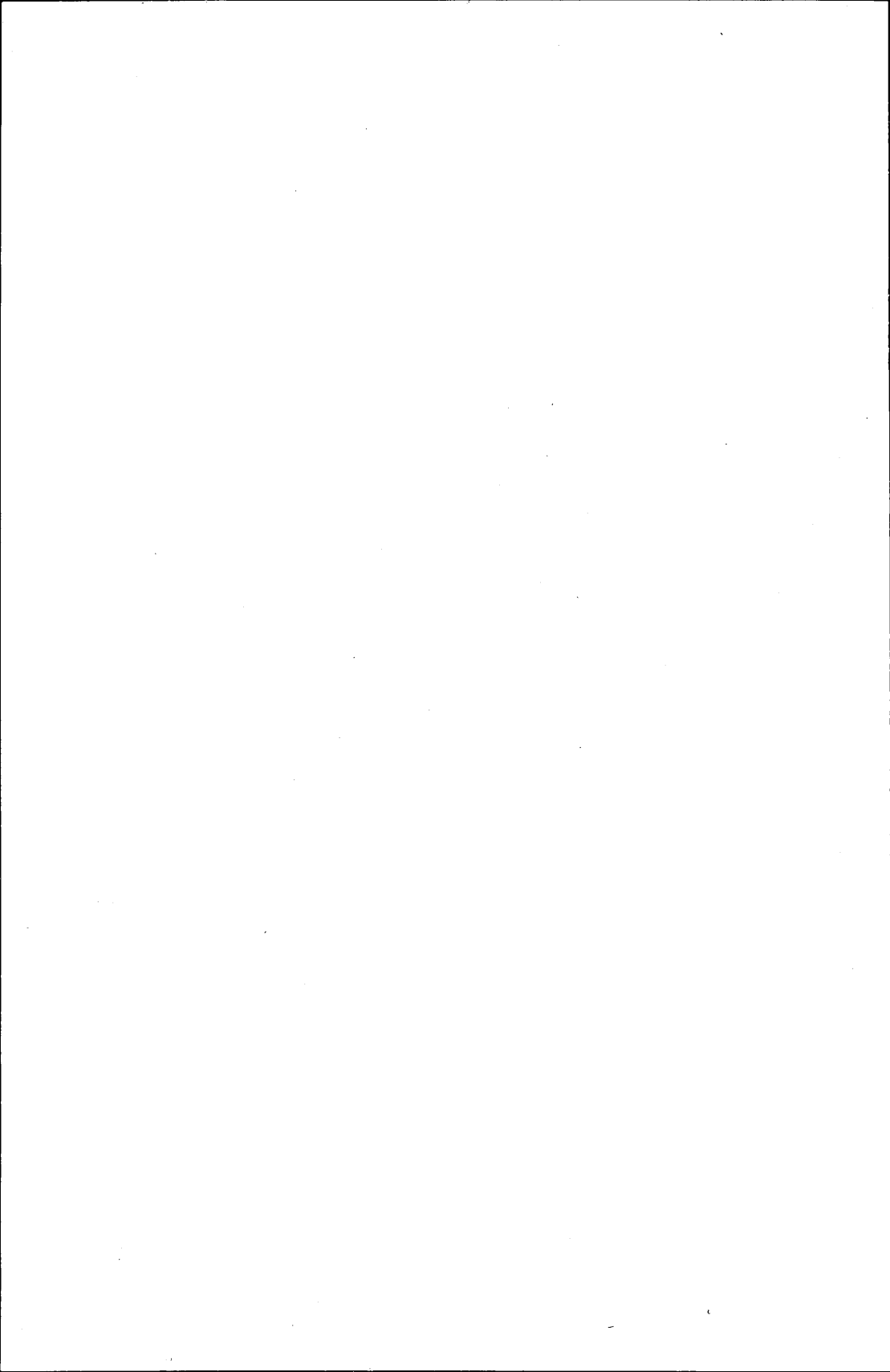
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CONTENTS

1	INTRODUCTION	1
2	INTERMEDIATION IN THREE PERIODS	2
	The Pax Britannica	2
	The Pax Americana	5
	Pax Arabica?	7
3	STYLIZED FACTS AND TRENDS IN THE 1970s	9
	Global Patterns	10
	LDC Financing Arrangements	12
	Debt Accumulation and Servicing	14
	Private Banking	17
	Other Lenders	21
4	SYSTEMIC ISSUES FOR THE 1980s	23
	Shifting Orthodoxies and Heterodoxies	23
	Financial Markets in the 1970s: Sound or Flawed? Heroes or Villains?	25
	The 1980s: Hangover, Penance, and Purges?	28
5	CONCLUSIONS	33
	REFERENCES	35



International Financial Intermediation: A Long and Tropical View

1 Introduction

Private international financial intermediation has witnessed successive cycles for the last one hundred and sixty years. In this century, it blossomed before the First World War and through the 1920s. In the 1930s and 1940s, private capital markets went into an eclipse, to reappear timidly in the 1950s, expand in the 1960s, and boom in the 1970s. Theorizing about financial markets has been extremely sensitive to those cycles. Few are the examples of powerful propositions emerging from general financial theories that are independent of historically specific institutional arrangements.

This essay analyzes the interplay between the financial history of international capitalism and the theorizing about financial markets, which has been carried out mainly in Northern countries. The essay is organized as follows. In a brief review of three epochs of financial intermediation and theories, various orthodoxies are identified and their evolution traced in the light of circumstances. Special emphasis is given to the impact of the different epochs on Latin American and other peripheral countries. A long section then describes major stylized facts and trends in international intermediation during the 1970s, sketching global patterns of current-account deficits and surpluses, the financial arrangements of less developed countries (LDCs), and the expansion of LDC debt. Major actors on the lending side and LDC savings and investment trends are also reviewed. The essay then turns to a discussion of systemic issues raised by the international arrangements of the 1970s and those which appear to be evolving during the 1980s. Central issues include the degree of imperfection and instability of international financial markets, and how imperfections in those markets are perceived by various groups in the North and South. Some reform proposals and future scenarios are also analyzed. A short section presents some conclusions.

Frequent references will be made to orthodoxy. This term is not easy to

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define; it may be helpful to separate "academic" from "practical" orthodoxy. Academic orthodoxy is the product of the foremost academic centers of the time; it tends to be flexible and agnostic. Its leading thinkers often are its own major critics, frequently curious about heterodox notions. Practical orthodoxy is more assertive. It is found in the editorials of the business press, among private or public executives with master's degrees, and among some of the more politically or financially ambitious academics. The latter sometimes play a double role: in their Northern universities, disciplined by their colleagues, they are cautious scientists; during their summer tours of the periphery, their *libido imperante* unleashed, they become fountainheads of practical orthodoxy.

It is practical orthodoxy that puts the system to work and typically sets the Northern tone in North-South debates. As such it will be the main focus of our analysis.

2 Intermediation in Three Periods

The Pax Britannica

The ideas underlying the pre-1929 international financial order enjoyed a degree of intellectual hegemony that has never been rivaled. The gold-exchange standard was regarded as the natural regulator of the balance of payments. Current-account deficits and increases in international reserves were financed by using bonds with long maturities and fixed interest rates as well as by direct investments. Under the long Pax Britannica, some countries (Germany, the United States) graduated from the role of capital importer to that of capital exporter. At least until the 1920s, London ruled the waves and regulated the whole system,¹ whose occasional defaults and crises were regarded as passing aberrations or a necessary purging of "excesses."

National financial systems showed greater heterogeneity. In the United States, populist pressures blocked the creation of a central bank until early in this century. France and Germany developed financial systems more centralized and state-dominated than that of the United Kingdom (see Gerschenkron, 1962, Chap. 1). Apparently, British hegemony in international relations of all types explains the greater homogeneity of the rules of the international financial game than of those applicable nationally.

African and Asian colonies had little choice in their financial systems but

¹ Some writers have claimed that Paris was the strongest financial center in the world before 1914. Kindleberger (1978, pp. 191-192) concludes that the whole question emphasizes the rivalry between France and the United Kingdom, as well as the sensitive political nature of international finance. For a demonstration that direct investments represented an important share of all foreign capital in the third world even before 1914, see Svedberg (1978).

to follow prevailing orthodoxy. By contrast, Furtado (1970, Chap. 9) has shown that several independent Latin American countries had difficulty adhering faithfully to the gold-exchange standard. Mexico followed a silver standard for many years while silver depreciated vis-à-vis gold. Argentina and Brazil often resorted to an "inconvertible paper standard," frequently accompanied by fiscal deficits and inflation. (The United States went through a similar period after its Civil War.)

These Latin American experiments with flexible exchange rates were viewed with fascinated disgust by orthodox scholars and bankers. The recurrent need for foreign finance, as well as domestic political pressures to keep debt service from taking too large a share of the budget, would sporadically dictate a return to the gold-exchange standard and greater controls over domestic credit expansion. Foreign missions played important roles in these attempted returns to orthodoxy. Examples include the Montagu Mission to Brazil in 1924 and those of Professor Edwin Kemmerer to several Andean countries. (For a fascinating analysis of the Montagu Mission, see Frisch, 1979.) At least in the case of the Brazilian return to the gold-exchange standard in the 1920s, the economic results are regarded as negative. During the 1920s, the League of Nations also participated in missions associated with stabilization plans in countries such as Austria and Hungary (Kindleberger, 1978, p. 194).

The conditionality attached to international lending before 1929 was not linked only to the natural desire of bankers to be punctually paid at least the interest due on loans. Political considerations also played a role in regulating access to capital markets. French and German lending was heavily influenced by political factors, as illustrated by France's loans to Czarist Russia and Germany's loans to the Middle East (Kindleberger, 1980, pp. 6-9). In the late 1920s, Brazilian access to the New York market was blocked by Herbert Hoover, then Secretary of Commerce, in retaliation for the Brazilian coffee price-support scheme, while its access to the London market was discreetly vetoed by the Foreign Office in retaliation for the Brazilian withdrawal from the League of Nations (de Paiva Abreu, 1980).

The conditionality imposed before 1929 on the weakest peripheral countries included foreign control over their tariff revenues and other aspects of their fiscal and monetary machinery, as was the case with some Caribbean and Central American nations. (The same sort of conditionality was imposed on Zaire during the 1970s.) Such extreme conditionality typically followed political and economic turmoil but did not always wait for default (see, for example, Thomas, 1971, Chap. 46).

The Great Depression of the 1930s destroyed the gold-exchange standard and international capital markets as they existed before 1929. The prestige of high finance collapsed. In the United States, financiers were the target

of New Deal attacks, and legislation seeking to reduce financial crime and negligence reduced the flexibility of national and international financial intermediaries. Markets previously regarded as basically self-regulating were perceived after 1929 to be intrinsically prone to instability and chock-full of informational and other imperfections. Stock markets, eminent theorists argued, were little better than casinos, whose peculiar "beauty contests" should be taxed (Keynes, 1936, Chap. 12). Both the British and the German governments adopted exchange controls, encouraging their trade and financial partners to follow suit. Several industrial countries declared moratoria on domestic debts, suspended payments on international obligations, and reformed their financial systems.

Peripheral countries with some political autonomy, such as Argentina, Brazil, and Colombia, reacted to the Great Depression with a fairly rapid abandonment of gold-standard orthodoxy, wisely avoiding classical remedies. Thus, a mission headed by Sir Otto Niemeyer of the Bank of England advised Brazil to return to a fixed exchange rate and to maintain convertibility, in June 1931, a mere two months before Britain left the gold standard (de Paiva Abreu, 1974, p. 15). Instead, these large or reactive Latin American countries allowed substantial depreciations of their exchange rates, imposed exchange controls, and maintained a reasonable degree of domestic liquidity. Normal debt servicing was suspended in most cases, just as U.S. farmers suspended payments on their mortgages. The fundamental causes of Latin American default were well put by a young economist in 1943: "If the depression of the 1930's had been mild, and if the steady expansion of world trade and capital exports had continued thereafter, defaults probably would have been infrequent and could have been settled without much difficulty. . . . Without . . . attempting to deny that insufficient care was exercised, and that Latin American countries were encouraged to borrow excessively one may question whether these factors were decisive" (Wallich, 1943, p. 321).² Partly because of the closing of international markets, Latin American countries showed greater interest than before in mobilizing domestic resources via the tax system and in the creation of new government-controlled credit institutions. The formula of letting goods be homespun whenever conveniently possible and letting finance be primarily national was remarkably successful in those countries during the 1930s.³

² Governor Wallich, in a 1981 letter to one of the authors, qualifies other points in his 1943 article, such as his approval of the repurchase of defaulted bonds by several Latin American countries. He concludes: "Today, in any event, I am all in favor of people and countries paying their debts as punctually and fully as they can."

³ The formula was suggested by Keynes (1933) in a peripheral country during the first Finlay Lecture delivered at University College, Dublin, Republic of Ireland, on April 19, 1933.

The Pax Americana

The international financial order that emerged from Bretton Woods in 1944 and lasted until 1973 initially reflected the disenchantment of the 1930s with laissez-faire in financial transactions and was influenced by Fabian/New Deal notions then dominant in the United Kingdom and the United States. The then U.S. Secretary of the Treasury, Henry Morgenthau, regarded Bretton Woods as the achievement of his lifetime ambition to "drive . . . the usurious moneylenders from the temple of international finance" (Gardner, 1980, p. xix).⁴

The International Monetary Fund (IMF) was born accepting changes in exchange rates only to correct "fundamental disequilibrium" and allowing controls over capital movements. The creation of the International Bank for Reconstruction and Development (World Bank) reflected pessimism regarding the viability of private financial intermediation in the postwar world. In the United States, the official Export-Import Bank, created in the 1930s originally to finance trade with the U.S.S.R., was to play an important role in financing U.S. exports of capital goods and was a critical institution in U.S.-Latin American economic relations. In the 1950s and even more in the 1960s, the original Fabian/New Deal flavor of the Bretton Woods institutions was diluted, but they continued to reflect a theoretical and practical eclecticism absent from the pre-1929 international financial order.

Early in the postwar period, a new practical orthodoxy appeared regarding capital movements. It became common to hear advice aimed at peripheral countries regarding the importance of maintaining a favorable climate for direct foreign investments from the North. Before 1929, especially before the First World War, portfolio investments had dominated those of a direct nature, and a good investment climate involved mainly the punctual servicing of debt. In the 1950s and 1960s, however, direct foreign investment, suppliers' credits, and official development assistance of various sorts made up the bulk of capital inflows into the periphery. All these forms of finance implied a complex and fairly intimate relationship between lenders and borrowers.

At least during the late 1940s and 1950s, both national and international financial intermediation received low priority. The ultra-Keynesian notion that "money does not matter" could easily be extended to "financial intermediation does not matter." It was not until the late 1950s that Europe abandoned rigorous exchange controls; the United Kingdom maintained them

⁴ Today such a statement would probably be branded "emotional third-world rhetoric" by the U.S. Secretary of the Treasury. Indeed, the first influential president of the World Bank and his advisers are reported to have been skeptical of much of the idealism of Bretton Woods and of "Morgenthau and all those clucks" (Sampson, 1981, p. 72).

until 1979. Balance-of-payments analysis focused on the current account, with private capital flows regarded mostly as exogenous variables.

Academic orthodoxy had surprisingly little to say about the benefits and costs of the postwar structure of capital flows between North and South. There was a tendency to add up all forms of capital flows into one aggregate necessary to finance the "foreign-exchange gap." A common attitude was that the greater this aggregate flow, the better all around. This academic complacency was first punctured by peripheral (and Australian, Canadian, and European) criticism of some of the consequences of direct foreign investment and of multinational corporations. Some aspects of official development assistance also came under closer scrutiny, leading to more sophisticated evaluations of the grant element involved in such flows.

As noted earlier, the IMF and the World Bank began in the 1950s to depart from the bold vision of at least some of their founding fathers. The World Bank would go no further than to finance specific projects, avoiding program lending. It also refused to lend to state oil enterprises, arguing that there were plenty of private oil corporations willing to invest. The IMF staff increasingly favored rigid exchange rates, with sporadic but massive adjustments, buttressed by rigorous credit policies, in a pattern similar to the pre-1929 rules of the game. In its dealings with peripheral countries given to heterodoxy, such as several Latin American countries, the IMF missions revived the spirit of Montagu and Niemeyer, advocating stiff stabilization plans. It could be argued that, at least during the 1950s, the leverage of the IMF missions was no smaller than the leverage of Montagu and Niemeyer, as international credit sources in the 1950s were few and tended to follow the leadership of the IMF (and the U.S. Treasury). The consequences of the practical orthodoxy of the IMF were frequently similar to those of the Montagu Mission.

As late as the 1960s, those advocating greater resource transfers from North to South would call for more official development assistance under various forms. Regional development banks were created, adding new official financial intermediaries. New aid relationships were sought. Hopes were also expressed for a new spirit in direct foreign investment.

In the meantime, the great postwar economic expansion which culminated in the early 1970s was creating new conditions that eroded the postwar practical orthodoxy. Almost accidentally, an international capital market emerged in the mid-1960s, in the form of Eurocurrency credits.

The Eurodollar market, based on dollar deposits in banks outside the United States, arose from the desire of demanders and suppliers of those deposits to avoid actual or potential U.S. banking regulations. The Soviets were among the first depositors of dollars in European banks; they feared that accounts opened in the United States might be attached by U.S. citi-

zens who had claims against the U.S.S.R. During tight credit conditions in 1968 and 1969, U.S. commercial banks bid for dollars in the Eurodollar market by offering yields above those permitted in the United States. Banks based in London and other European financial centers found that accepting dollar deposits and extending dollar loans was profitable. Those deposits were not subject to official reserve requirements, although tacit approval of such operations by central banks was necessary. The practice of accepting deposits in currencies other than that used locally spread to sterling, Deutsche marks, Swiss francs, and others. Banks outside Europe also joined the market, which now encompasses agents in Singapore, the Caribbean, and elsewhere.

Growing macroeconomic disharmonies among the industrialized countries in the late 1960s, the U.S. involvement in Vietnam, and increased capital mobility put enormous pressure on fixed parities. These circumstances led to the abandonment by the United States of gold convertibility in August 1971 and to the generalized floating of key currencies in early 1973. This *Annus Mirabilis* culminated in the sharp rise in oil prices, putting an end to the postwar era of cheap energy.

Pax Arabica?

The period from 1973 to 1981 has been highly unusual in the history of international finance. A new type of capital exporter has emerged that has no historical counterpart. Consider the following contrast between OPEC capital exporters (primarily those in the Persian Gulf) and those of earlier eras:

1. The military power of major OPEC countries is trivial, certainly insufficient to enforce financial contracts against recalcitrant debtors. Mendelsohn (1980, p. 55) argues that every lender ultimately needs bailiffs at his back. OPEC does not have bailiffs of its own.

2. OPEC countries lack capital-goods industries, or indeed an extensive industrial base, to supply most commodities ultimately desired by foreign-exchange-constrained capital importers. OPEC's technological base is weak. It is difficult to imagine an OPEC equivalent to British exports of railway equipment or to U.S. direct foreign investment. Oil is not one, because it is a nonrenewable asset for OPEC but a current input for importers.

3. OPEC capital exporters had only limited financial institutions of their own during 1973-1981. Although this situation is rapidly changing, they still rely heavily on financial intermediaries of industrialized countries.

4. OPEC national currencies are used only marginally as reserve or vehicle currencies. The influence of OPEC over international monetary arrangements is growing but still modest.

5. The major component of OPEC wealth is a nonrenewable resource. If

investments in financial or real assets yield low rates of return, OPEC countries can adjust by decreasing their oil output, that is, by "investing" in oil underground. Thus, part of OPEC's "home investment" could *decrease* the world's aggregate supply of goods in the short and medium term.

These considerations imply a good deal of bilateral dependence between the old and new capital exporters, involving both economic and political aspects. These aspects have become highly visible since 1973, in contrast with previous years when the commercial, financial, and political links between major oil exporters and industrialized countries could be discreetly hidden under the general rubric of global interdependence. Yet the network of trade flows has also become more complex and multilateral, involving greater triangularity among old and new capital exporters and the third world.

The Eurocurrency market and international banking, already vigorous before 1973, have turned out to be (on the whole) flexible and efficacious instruments to accommodate the new capital exporters and the major semi-industrialized capital importers. A closer look at the Eurocurrency market and its links with the OPEC surplus is warranted.

Many transactions in the Eurocurrency market are between banks, and they produce only a limited amount of maturity transformation. International corporations also engage in considerable borrowing and lending in that market. Depending on circumstances, economic agents switch back and forth between the national financial markets of OECD countries and the Eurocurrency market. Using an old analogy, the Eurocurrency market, international banking, and OECD financial markets may be viewed generally as a giant bathtub within which much churning (gross financial intermediation) takes place, and where ripples in one segment are quickly transmitted to other segments.

Net inflows into and net outflows out of this bathtub can be defined in a number of ways, depending on one's analytical focus, including desired level of aggregation. In this essay, we will be interested mainly in the roles of financial markets as providers of net balance-of-payments financing to large groups of LDCs and as receivers of net inflows from OPEC.

It should be clear that the Eurocurrency market has a life and a financial role that are independent of OPEC surpluses, just as its coming into being was not caused by the U.S. balance-of-payments deficits of the 1960s. The gross stocks of assets and liabilities in this market are only marginally influenced in a given year by net balance-of-payment flows. Even if all countries were to be in balance-of-payments equilibrium from now on, one could expect the Eurocurrency market to continue to grow, because it would still serve as a financial intermediary among the various agents participating in international trade and finance. The irruption of a new kind of capital exporter no doubt influenced many specific features of the evolution of finan-

cial markets during the 1970s. But even without OPEC, international capital markets would have expanded significantly during the 1970s.

While the performance of international banks as financial intermediaries was remarkably good during 1973-81, present arrangements remain historically anomalous and vulnerable in several ways. Besides the contrasts already noted between new and old capital exporters, consider the following points:

1. The level of OPEC capital exports depends heavily on the real price of oil, at least during a longish short run, rather than on traditional long-term saving and investment propensities. During 1974 through 1977, OPEC surpluses were large, but they tended to decrease until 1978, when they practically disappeared, before rising sharply once again in 1979. Although the investment record was good for many LDCs in the 1970s (Sachs, 1981), it is unclear for some importers of both oil and capital whether the inflows are adding to productive capacity or simply maintaining consumption above levels sustainable in the long run, assuming the persistence of high real energy prices. Contrary to much historical experience in the periphery, worsening terms of trade accompany the capital inflow.

2. The 1973-80 recycling was aided by "money mirage" on the part of capital exporters. *Ex post* real yields on dollar-denominated financial assets were low, certainly lower than the yield on oil in the ground. This situation changed with a vengeance during 1980-81. Even if real interest rates on dollar-denominated financial assets decline from their freakish 1981 levels (on which more below), insistence by capital exporters on a "normal" positive real rate of return on their financial assets equaling the expected secular growth rate of real oil prices may impose impossible burdens on some capital importers.

3. Political relations between old and new capital exporters are far from harmonious. Tensions between Iran and the United States, leading to the freeze in 1979 of Iranian assets in U.S.-owned banks, had important negative repercussions in the Eurocurrency market. Although international banking emerged quite well from that crisis, catastrophic scenarios are much too easily imagined.

The historical anomalies presented by the emergence of OPEC as the major capital exporter deserve closer empirical scrutiny. The next section describes the structural features of international financial flows and stocks from 1973 to 1981, emphasizing those of special interest to the periphery.

3 Stylized Facts and Trends in the 1970s

In this section, global balance-of-payments patterns are reviewed first, with emphasis on LDC and Latin American current-account deficits. Recent LDC financing arrangements are discussed and compared with the postwar ex-