Capital Market Innovations and Financial Flows to Developing Countries

Krishnan G. Saini

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Number 3
Capital Market Innovations and Financial Flows to Developing Countries

Krishnan G. Saini

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This paper is one in a special series of World Bank Staff Working Papers on international capital and economic development. Prepared as background papers for *World Development Report 1985*, the series provides more detailed treatment and documentation of the issues dealt with in the Report. The papers cover a range of topics including a historical perspective on international capital and economic development; the effects of policies in industrial and developing countries on international capital flows, external debt, and economic development; and the role of official assistance, commercial bank lending, securities markets, and private direct investment in developing countries. Several studies of individual developing countries are also included in the series.

The background papers draw on a large number of published and unpublished studies of individual researchers, on World Bank policy analysis and research, and on reports of other organizations working on these issues. The papers are the work of individuals and the views and interpretations expressed in them do not necessarily coincide with the views and interpretations of the Report itself.

I hope these detailed studies will supplement *World Development Report 1985* in furthering understanding of the relationship between international capital and economic development. A complete list of the papers appears on the overleaf.

Francis X. Colaço
Staff Director
*World Development Report 1985*
Aliber, Robert. Financial Intermediation and the External Debt Crisis


Blanchard, Olivier, and Lawrence H. Summers. Perspectives on High Real Interest Rates Throughout the World


Dornbusch, Rudiger. The Effects of OECD Macroeconomic Policies on Non-oil Developing Countries: A Review

Fishlow, Albert. Capital Markets During the 19th Century and the Interwar Period: Lessons from the Past

Hooper, Peter. The International Repercussions of the U.S. Budget Deficit


Ishiyama, Yoshihide, and Keiko Atsumi. Capital Outflows from Japan to Developing Countries

Iqbal, Farrukh. Korea's Debt Accumulation, Use, and Management Strategies

Johnson, John H. The Role of International Finance in Argentine Development, 1965-84

Lessard, Donald. International Financing for Developing Countries: The Unfulfilled Promise

Llewellyn, David. International Financial Intermediation and the Role of Banks in Balance of Payments Financing

Martone, Celso L. Macroeconomic Policies, Debt Accumulation, and Adjustment in Brazil, 1965-84

Muller, Patrice, and Robert Price. Public Sector Indebtedness and Long-Term Interest Rates

O'Brien, Richard, and John Calverley. Private Banks and Developing Countries


Rybczynski, T. M. Internationalization of Financial Arrangements and the Developing Countries: The Evolving Relationship

Sachs, Jeffrey, and Warwick McKibbin. Macroeconomic Policies in OECD Countries and External Adjustment in Developing Countries

Saini, Krishan G. Capital Market Innovations and Financial Flows to Developing Countries

Sherbiny, Naiem A. Arab Financial Institutions and Developing Countries

Swoboda, Alexander, and Hans Genberg. The Stages in the Balance of Payments Hypothesis Revisited

Weigel, Dale, and Robert R. Miller. Foreign Direct Investment in Economic Development

Wyplosz, Charles. International Aspects of the Policy Mix in Six OECD Countries

Zietz, Joachim, and Alberto Valdés. The Costs of Protectionism to Developing Countries: An Analysis for Selected Agricultural Products
Abstract

This paper reviews recent patterns in international financial flows to both developed and developing countries. It notes that, while borrowings by developed countries have increasingly been characterized by innovations in instruments and practices, financial flows to developing countries have largely been in the form of syndicated credits. Following a brief description of some of the more prominent innovations in international capital markets, the paper concludes that there is now a marked preference by lenders for short-term, tradable paper. It then examines the reasons for the absence of innovations in the lending process for developing countries and discusses ways for introducing innovations to the international financial intermediation process for developing countries. The conclusion is that the "securitization" of the lending process is likely to be the norm in the future as it holds benefits for both borrowers and lenders, while the syndicated credit will be largely confined to "involuntary" lending. Finally, the paper recommends that international institutions, in particular the World Bank, take the initiative in helping introduce international capital market innovations to the borrowing process for developing countries.

Acknowledgements

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International capital markets have undergone a quiet revolution over the past two years. New instruments and practices have emerged to eclipse the traditional Eurocurrency syndicated credit and the Eurobond. However, the new instruments and practices have been largely confined to borrowings by industrial countries. This paper asks why capital market innovations have not spread to the financial flows to developing countries. It also examines ways by which the new methods utilized by developed countries can be adapted to improve capital flows to developing countries.

The discussion proceeds as follows. Section I introduces some pertinent facts concerning the growth of Eurocurrency syndicated credit and Eurobond markets. Section II describes the more recent innovations in capital market instruments and practices and how they work. Section III attempts to explain why these newer, as well as some old, instruments and practices in capital markets have not been widely used in intermediating capital flows to developing countries. The discussion closes in Section V by pointing out that if voluntary capital flows to developing countries are to be enhanced, nonbank sources of funds—for example, insurance companies, trust funds, pension funds, savings and loan associations, and manufacturing and other corporations—must be tapped. That can be done only if an effort is made in the financial intermediation process to satisfy the developing countries' need for longer term funds and the lenders' desire for shorter term assets.

I. Some Background Facts

In 1983, all types of borrowers raised an aggregate sum of $74 billion in the Eurocurrency syndicated credit markets. As Table 1 shows, industrial countries accounted for slightly more than half (or, $39 billion)
and developing countries $33 billion; centrally planned economies and international organizations borrowed an additional $1 billion each. 1/ Prior to 1973, however, the syndicated credit market was very small, and thus developing countries raised little capital in syndicated credit markets; they met their current account financing requirements through direct investment inflows, export credits, and loans from multilateral and bilateral agencies. In 1970, for example, developing countries received financial flows totaling $20 billion, of which $11 billion was nonconcessional. As Table 2 shows, $4 billion of the nonconcessional flows was in the form of official or officially supported credits and $3.7 billion in direct investment, whereas only $3 billion was in bank loans and $0.3 billion in bonds. 2/

<table>
<thead>
<tr>
<th>Borrower</th>
<th>1981</th>
<th>1982</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial countries</td>
<td>86.0</td>
<td>42.6</td>
<td>38.7</td>
</tr>
<tr>
<td>Developing countries</td>
<td>45.3</td>
<td>41.5</td>
<td>32.9</td>
</tr>
<tr>
<td>Latin American</td>
<td>30.2</td>
<td>26.7</td>
<td>15.4</td>
</tr>
<tr>
<td>Asian</td>
<td>10.3</td>
<td>8.4</td>
<td>8.8</td>
</tr>
<tr>
<td>Middle Eastern and African</td>
<td>4.8</td>
<td>6.4</td>
<td>8.7</td>
</tr>
<tr>
<td>Centrally planned countries</td>
<td>1.8</td>
<td>0.8</td>
<td>1.2</td>
</tr>
<tr>
<td>International organizations</td>
<td>0.3</td>
<td>0.2</td>
<td>1.3</td>
</tr>
</tbody>
</table>

Note: These are credits with a maturity of one year or more, publicly announced in the period. Numbers may not add up because of rounding.

Table 2  Total Net Resource Receipts of Developing Countries from All Sources in 1970

<table>
<thead>
<tr>
<th>Source</th>
<th>$ Billion</th>
<th>Percentage of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Official development assistance</td>
<td>8.2</td>
<td>41.0</td>
</tr>
<tr>
<td>Grants by private voluntary agencies</td>
<td>0.9</td>
<td>4.5</td>
</tr>
<tr>
<td>Nonconcessional flows</td>
<td>11.0</td>
<td>55.0</td>
</tr>
<tr>
<td>Official or officially supported</td>
<td>4.0</td>
<td>20.0</td>
</tr>
<tr>
<td>Private</td>
<td>7.0</td>
<td>35.0</td>
</tr>
<tr>
<td>Direct investment</td>
<td>3.7</td>
<td>18.5</td>
</tr>
<tr>
<td>Bank sector</td>
<td>3.0</td>
<td>15.0</td>
</tr>
<tr>
<td>Bond lending</td>
<td>0.3</td>
<td>1.5</td>
</tr>
<tr>
<td>Total receipts</td>
<td>20.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Note: Numbers may not add up because of rounding.


In the international bond markets, US$76 billion was raised in 1983 (see Table 3). Borrowers in industrial countries accounted for US$60 billion of this amount and multilateral organizations for US$13 billion. In the same year, developing countries raised only US$2.5 billion, or 3.3 percent of all international bond issues. 3/

The distribution of the sources of funds for developing countries in 1983 does not represent an isolated example. That is to say, although the Eurobond market has grown tremendously over the past ten years, most of the borrowers have been in industrial countries. 4/ With but one exception, the volume in Eurobond issues for developing countries has not exceeded $5 billion in any year. Moreover, if oil-exporting countries are excluded, Eurobond issues by developing countries are reduced even further.
### Table 3 International Bond Issues (billions of dollars)

<table>
<thead>
<tr>
<th>Borrower</th>
<th>1981</th>
<th>1982</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial countries</td>
<td>40.9</td>
<td>63.1</td>
<td>60.3</td>
</tr>
<tr>
<td>Developing countries</td>
<td>4.9</td>
<td>5.0</td>
<td>2.5</td>
</tr>
<tr>
<td>Latin American</td>
<td>3.7</td>
<td>2.5</td>
<td>0.1</td>
</tr>
<tr>
<td>Asian</td>
<td>1.1</td>
<td>2.1</td>
<td>2.3</td>
</tr>
<tr>
<td>Middle Eastern and African</td>
<td>0.2</td>
<td>0.4</td>
<td>0.2</td>
</tr>
<tr>
<td>Centrally planned countries</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>International organizations</td>
<td>7.2</td>
<td>9.9</td>
<td>13.4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>53.0</td>
<td>78.0</td>
<td>76.3</td>
</tr>
</tbody>
</table>

**Note:** These are new issues with a maturity of three years or more and are publicly offered or privately placed in the period.


However, these figures should not leave the impression that developing countries have no experience in issuing bonds abroad. Indeed, many developing countries made frequent forays into the international and Eurobond markets in the 1960s alone. In 1960, for example, developing countries issued international and foreign bonds amounting to about $172 million out of a total of $1.1 billion; by 1970, the figure had risen to only $372 million out of a total of $5.2 billion (see Table 4). Among the developing countries that issued international and foreign bonds in the 1960s, Argentina, Malaysia, Mexico, and the Philippines were prominent. These and other developing countries failed to broaden their use of the international bond markets in the post-1973 period when a diversity of sources for current account financing
would have been a natural expectation. Instead, they came to rely almost exclusively on the syndicated credit market to finance their current account requirements. The reasons for this are explored in Section III.

Table 4  Foreign and International Bond Issues
(millions of dollars)

<table>
<thead>
<tr>
<th></th>
<th>1960</th>
<th>1970</th>
</tr>
</thead>
<tbody>
<tr>
<td>All issues:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>In the United States</td>
<td>720</td>
<td>1,293</td>
</tr>
<tr>
<td>Elsewhere</td>
<td>396</td>
<td>3,955</td>
</tr>
<tr>
<td>IBRD, IDB, and ADB issues:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>In the United States</td>
<td>125</td>
<td>300</td>
</tr>
<tr>
<td>Elsewhere</td>
<td>28</td>
<td>182</td>
</tr>
<tr>
<td>Developing countries' issues:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>In the United States</td>
<td>160</td>
<td>198</td>
</tr>
<tr>
<td>Elsewhere</td>
<td>12</td>
<td>174</td>
</tr>
</tbody>
</table>

Note: These figures refer to public and known private issues with a maturity of more than one year.

II. Innovations in Capital Market Instruments and Practices

Domestic and international capital markets are continuously evolving to serve the needs of borrowers and lenders. Whenever the available instruments and practices have become unsuitable for the intermediation process, those operating in the capital market have usually risen to the challenge by designing new instruments or adopting new practices.

These elements may become unsatisfactory for a variety of reasons. Arrangements that require borrowers to follow inflexible repayments schedules even when they are faced with fundamental changes in their domestic and international economy, for example, cannot be said to be adequately serving the needs of borrowers. Similarly, arrangements that allow the assets of lenders to dwindle as soon as changes occur outside their control will be considered obsolete.

The borrower's desire for flexibility in debt servicing and the lender's desire for greater liquidity in assets are not mutually exclusive objectives. That is to say, innovations in capital market instruments and practices can satisfy at least one side's needs without adversely affecting the other side. In general, these innovations will improve the lot of both borrowers and lenders—in the sense that the intermediation process will become smoother and more efficient—and thus will generate more borrowing and lending activity than would otherwise take place.

Innovations of this kind can be classified into two groups: those designed to provide flexible repayments schedules for borrowers and those designed to satisfy lenders' needs for greater liquidity in their assets. Both are necessary if the intermediation process is to be efficient and effective and capital markets themselves are to expand.
Innovations that help borrowers

Economic affairs, both domestic and international, have recently become more uncertain as a result of fluctuating exchange rates, extremely variable interest rates, and an inflationary environment. The United States, for one, has responded to this situation with a number of innovations, perhaps the most notable being that introduced in the home mortgage market. A similar change has taken place in the financing of international projects. These innovations have attempted to adapt borrowers' debt service payments to the changing economic environment and thus are directly relevant to lending arrangements for developing countries. Four of these innovations in particular could be adapted for use by the developing countries.

1. Under the Flexible Maturity Loan, debt service payments are held constant in absolute terms or, possibly, in relation to export receipts. Thus, when interest rates rise, the amortization component of debt service declines. The maturity of the loan is duly increased to reflect this. If interest rates rose sufficiently, however, negative amortization would occur, so that lenders would be providing new money to borrowers.

Flexible maturity loans offer advantages to both borrowers and lenders. Borrowers can fully anticipate their debt servicing payments and make their plans accordingly. Although a country can never be sure of what its export receipts will be—since commodity prices and the strength of demand abroad are outside its control—it can nevertheless improve the management of its reserve assets and thereby be prepared to deal with unforeseen contingencies. In fact, the mechanism of flexible maturity may be particularly suitable in cases where export receipts are volatile and thus not easily predictable. Moreover, a country can be assured of the continued net
inflow of resources from abroad and thus be permitted to manage its economic policy program over a longer time horizon.

At the same time, lenders can match their loan commitments with the maturity or rollover period of their loans and thereby minimize interest rate risk. In addition, they will not have to be concerned about debt rescheduling or about the declining quality of their assets. Banks, however, will not be certain of the timing of principal repayments. The World Bank has begun to make this type of loan, but it is not yet in widespread use.

2. Under the **Graduated Payment Loan**, debt service payments are initially low and gradually build up. This mechanism may be particularly suitable in project finance loans, where the earning power of a project improves—as does its potential debt servicing capacity—as the project matures and achieves the various economies generated by operating at full capacity.

A graduated payment loan can also provide negative amortization; that is, it can generate new money from the lenders. More important, this arrangement links borrowers and lenders more closely in that debt-service payments are contingent upon the completion of the project being financed. Thus, benefits and obligations exist for both the borrowers and lenders. Borrowers are relieved that other sources will not be tied up to service a particular loan. As for lenders, they must carefully evaluate the commercial viability of projects financed and accept the responsibility—in terms of lower amortization—when, for whatever reasons, the project does not come on stream as planned. As a result, the projects financed are likely to receive closer scrutiny and the quality of assets is likely to improve. A variant in project financing would allow a certain percentage of the loan to go into arrears, with the proviso that subsequent debt-service payments are increased to clear the arrears. It may be possible to combine the flexible maturity
loan with the graduated payment mechanism, but perhaps some mechanism would be needed to handle any radical change in underlying factors such as a sharp drop in commodity prices, crop failure or other natural disaster, the onset of a worldwide recession, a sharp rise in interest rates, and the like.

3. The **Shared Equity Loan** invites lenders to accept below-market rates on loans in return for a share in the equity of the revenue-generating project. This arrangement, too, should be attractive to both borrowers and lenders in that they can share the risk that the financed project will not be successful. Since the revenues depend upon prices charged for the output of the project, however, some provision will probably be needed to account for cases in which the borrower insists upon subsidizing the prices of the product or service sold. This implies that, with equity interest, lenders will have some say in the management of the project, including the calculation of net income, which must take into account input prices. Moreover, lenders' equity interest will have to be protected against nationalization. Finally, since lenders assume added risk with equity sharing, they will presumably be compensated for doing so.

4. The **Price-Level-Adjusted Loan** attempts to maintain the "real" value of the outstanding principal relative to some preselected price index that has to be negotiated between the borrower and the lender. The borrower would obviously like to use the price index of its exports, whereas the lender would prefer to use the home consumer price index as the basis for calculating the real value of the principal. The interest payments will have to be fixed at a spread over the real rate, which will be subject to negotiation. Again, both borrowers and lenders benefit. If the borrower's export price index is used to adjust the real value of the principal, the country is protected against the variability of export receipts. Thus, the need for reserves is reduced
and the economic program of the country can be better managed. Borrowers have no protection, however, against the size of interest payments, which are usually greater than the principal over the life of the loan. Under normal circumstances, though, the real interest is likely to be around 2-3 percent and, therefore, the burden should be more easily predictable. Although the lender is exposed to changes in the movement of the real interest rate under this arrangement, its loans are more likely to be serviced on schedule in that debt-service payments are tied to borrower's export earnings.

Innovations that Help Lenders

The international debt crisis in 1982 brought home to lenders the fact that the market can push their assets in a country into illiquidity. Since lending to developing countries has been primarily in the form of bank loans, these institutions have borne the brunt of the international debt crisis. They have seen the quality of their assets being questioned both by national regulatory authorities and by equity markets. In other words, supply-side considerations are beginning to make it difficult for banks to lend as much to developing countries as they did in the 1970s.

One problem is that regulatory authorities appear to consider diversification of international loan portfolios to be good protection against risk ("banks are best protected against adverse developments through diversification within their foreign loan portfolios." 9/). Furthermore, they have viewed concentrations of exposure as undesirable. 10/ Regulatory authorities have also encouraged or required banks to set aside more funds as a reserve against loan loss in the light of nonperforming loans. 11/ This practice has also helped to reduce the earnings of banks. At the same time, authorities have asked banks to strengthen their capital bases. Still another problem is that these regulatory actions and the emphasis on the international
debt crisis in the news has led investors to perceive bank stocks as embodying higher risk than before, with the result that bank stocks have suffered in equity markets. Encouraged by regulators, banks have proceeded to establish stronger internal management controls, including loan limits for individual borrowers.

Overall, banks have taken a more conservative stance toward international lending, partly out of necessity—because of constraints on their capital base and on the concentration of exposure—and partly by choice. Although it may be difficult, if not impossible, to establish a cause-and-effect relationship between the slowdown in bank lending over the past few years on the one hand and the various supply-side constraints on the other, there is little doubt that bank lending to developing countries has suffered a sharp slowdown. Thus, "banks' exposure [as reported to the BIS] grew an average 35 percent a year from 1979 to 1981, well above banks' capital base growth. But the slowdown in the 18 months to the end of 1983 was very sharp: only 5 percent growth at an annual rate." In order to strengthen their balance sheets, banks have been increasing their capital bases, raising loan-loss reserves, and selling off to other institutions, whenever possible and even at substantial discount, portions of their loans to developing countries. In addition, banks are showing a preference—as evidenced by oversubscription, finer spreads, and lower fees—for short-term tradable paper as desirable assets on their books. More specifically, according to a survey of the domestic and international capital markets, international banks are showing increasing preference for revolving underwriting facilities (RUFs) and transferable loan instruments (TLIs) over the traditional syndicated credit. These instruments are not always assets—in the traditional sense of the term—on the books of underwriting or
participating institutions. Banks are going for quality assets by default (that is, by easing off their lending activity in developing countries) and quality borrowers are taking advantage of the situation by choosing cheaper options. Most banks, however, would still choose medium-term over quality borrowers, if they could, because medium-term credits generate higher revenue and allow assets to build up since there is no need to continually replace runoffs.

In the securities market, preference has shifted from the traditional fixed-rate bond issues to floating rate notes (FRNs). As the following sections show, these new instruments in international capital markets can be of assistance to both borrowers and lenders.

**Transferable Loan Instrument (TLI).** This is the latest instrument to be devised to entice international banks, especially the so-called regionals, back into the lending arena. TLI standardizes the system of transferring lending commitments from the primary to the secondary market. In effect, it creates a secondary market for Euroloans. The international lending banks have the option of converting their loan commitments into one or more TLIs, which would have varying denominations, subject to some minimum size. A TLI carries a single repayment date that corresponds to one of the scheduled loan repayment dates. TLI sales are agreed upon between parties—that is, between banks making the initial loan commitment and banks that subsequently want "a piece of the action"—on a standard form that complements the traditional loan agreement (which is evidence of commitment under the credit arrangement). This TLI sale agreement entitles the TLI holder to receive interest and other benefits of the original loan agreement.
Under TLI, international banks have more flexibility in managing their assets, although the borrower retains the choice of interest period, amortization, and drawdown period. Because TLIs can be issued in varying maturities and denominations, they are potentially attractive to second- and third-tier banks. Although the syndicate leaders are the ones committed to provide the funds, the fact that they can sell their commitment to other banks gives them the flexibility that the current Eurocurrency syndicated credit arrangements do not provide, except sub rosa. Buyers of TLIs are accommodated in their desire for relatively short-term, small-denomination, tradable instruments.

Borrowers will find that the TLI innovation offers not only a broader choice of possible syndicates, but also a substantial reduction in borrowing costs. Furthermore, TLI can be used to enhance lending to developing countries. Thus, countries with unblemished debt-servicing records—such as Korea, India, Singapore, and Thailand—can take advantage of this instrument to widen their borrowing choices and reduce their borrowing costs.

Countries that have recently had to reschedule their debts may have to be eased into this instrument. For example, Mexico, which has shown a remarkable sensitivity to the needs of lenders, is likely to be the first country to use TLIs. In any case, given the tradability of TLIs, a country will have to make certain that its existing debt obligations are not sharply discounted. This will be a problem for both borrowers and lenders. But, if international bank lending is to remain operating on a voluntary basis, ways must be found to take advantage of the availability of the TLI instrument.

Revolving Underwriting Facility (RUF). This facility may be considered to be a bridge between the traditional syndicated credit and bonds, especially when its underlying feature is the issue of Euronotes, or CDs, to
back the drawdown of funds. Thus, RUFs reconcile the borrower's preference for long-term funds with the lender's desire for short-term, tradable assets.

This is how RUFs work: An underwriting syndicate signs an agreement with a borrower to lend, for example, US$1 billion for ten years. The borrower, say, a nonbank, borrows funds from the syndicate by selling three- or six-month Euronotes. The underwriting syndicate is committed to providing funds for the duration of the facility. If the syndicate is unable to market the paper, it takes the paper on its own books.

The borrower has access to funds for the desired long term and the cost is lower than it would be if the borrower were to seek these funds in the traditional syndicated credit market or in the FRN market. The borrower issues, at its own option, three- or six-month notes to drawdown funds. Since these notes are placed with the purchaser at a discount, the total cost to the borrower consists of this discount, the spread on the paper, and the underwriting fee, which amounts, as noted above, to less than the cost of an equivalent borrowing in the syndicated credit and FRN markets.

For the lenders, whether underwriters or ultimate providers of funds, RUFs are short-term, tradable, and therefore relatively liquid, assets (although they do represent contingent assets or liabilities for the underwriters). As a result, they can be marketed more easily than if lenders were to participate in a syndicated credit arrangement. Moreover, for any given lender (other than the underwriting syndicate), the commitment is, at the most, only for the term of the Euronote, or Euro-CD, that it has purchased. Therefore, the lender does not feel locked into a relatively long-term, illiquid asset, as it would with a traditional syndicated credit.

By and large, Floating Rate Notes (FRNs) have replaced the fixed-rate bonds, and for industrial country borrowers they have become a rival to the
traditional syndicated credit. 19/ Reasons for this situation are not hard to find.

FRNs are attractive to borrowers because they can be arranged more quickly than the traditional syndicated credit (FRNs require less documentation). By using FRNs, a borrower is also able to tap the nonbank sources of funds. Finally, funds raised through FRNs cost less than those raised by means of syndicated credit.

For the lender, FRNs represent a relatively liquid asset, thereby giving its balance sheet some flexibilty. Nonbank lenders range from investment trusts to pension funds, insurance companies, and corporate treasuries. Among the financial institutions, the demand for FRNs comes from banks, savings and loan associations, and money market investors.

III. Why Developing Countries Have Failed to Tap Nonbank Sources of Financing

Developing countries have not yet gone to the world's bond markets to finance their current account requirements for three main reasons. The first has to do with the general experience and preferences of developing countries themselves, the second with the preferences of lenders in the post-1973 period, and the third with conditions in international and foreign bond markets that may have made it difficult for developing countries to enter these capital markets.

Attitude of Borrowers

Developing countries have made little attempt to tap nonbank sources of funds such as Eurobonds. Sometimes it is alleged that the defaults of the 1980s had made developing countries unwelcome in international and foreign bond markets. This proposition does not bear close scrutiny. 20/
first place, defaults were concentrated among Latin American countries. Other countries, for example those in Asia, continued to serve their international bond obligations. Second, and perhaps more important, even the countries that had defaulted in the 1930s found some markets for their bonds in the 1980s.

All evidence suggests that developing countries have not tapped bond and related markets for funds primarily because they found cheaper, and relatively painless, sources of funds among multilateral and bilateral agencies in the 1950s and 1960s and among commercial banks in the post-1973 period. In retrospect, the decision of developing countries to ignore the bond markets as a source of long-term funds may have been costly. Since requirements of creditworthiness in bond markets are more stringent than those prevailing in the syndicated credit markets, developing countries would have found it salutary to maintain the confidence of foreign investors in bonds.

As it was, developing countries found it convenient to borrow from commercial banks since loans in may cases were for general purposes rather than for specific uses 21/ and required no rigid performance tests for drawing down funds. Thus, there was little need to calculate any rate of return or otherwise justify loans. Indeed, by the late 1970s, commercial bank credits were so readily available that many countries preferred these funds to loans already committed from such international developing agencies as the World Bank. The reasons were simple: these developing countries did not want to commit domestic funds needed to pursue projects supported by the World Bank, nor, perhaps, were amenable to the close scrutiny that the Bank and other institutions would give to the use of their funds, especially when less discriminating lenders were competing in the same market.

Finally, some developing countries have raised questions about the "justness" of some of the loans that were contracted under previous
governments. 22/ To bond investors, questioning the debt obligation is nothing short of heresy: They expect bonds to be serviced on schedule and do not ask whether it was appropriate to issue them in the first place. Countries concerned with the validity of their international debt obligations not only take themselves out of the international capital markets, but they also make it difficult for others to diversify their sources of capital inflows.

**Attitude of Lenders**

International capital markets contain basically three classes of lenders: commercial banks, financial and nonfinancial institutions (that is, pension funds, trust funds, savings and loan associations, insurance companies, manufacturing and other corporations, and the like), and individuals. Since individuals are a relatively minor factor in international capital markets, we can set aside this category of lenders by simply noting that for this group, a long and unblemished history of creditworthiness is the principal motivating factor in decisions to buy and hold bonds issued by institutions or governments abroad.

In the post-1973 period, a new type of lender emerged in the form of international banks flush with funds from deposits related to petroleum earnings, especially from OPEC. These banks became very aggressive, ever ready to provide funds to willing and reasonably creditworthy borrowers, generally in the belief that sovereign risk in such lending was nonexistent. 23/ Thus, investment banks had only a small role to play in the international financial intermediation process because they traditionally obtain their funds from insurance companies, pension funds, and the like (that is investment banks place the issues they underwrite with these institutions).
Moreover, governments in lending countries made it difficult, if not impossible, for investment banks to place bonds with investors. This occurred because most of these governments (at the national, state, or local level) have rather restrictive requirements concerning the composition of assets of pension funds, trust funds, and so on. In effect, these rules placed investment banks at a competitive disadvantage relative to international banks in their attempts to provide funds to developing countries.

IV. Ways of Increasing Financial Flows to Developing Countries

Developing countries are expected to continue to have large external financing requirements that are unlikely to be met from traditional sources, namely, multilateral and bilateral development agencies and commercial banks. Indeed, even these institutions are under a variety of pressures to curtail the expansion of lending to developing countries. Thus, it has become imperative not only to facilitate the continuation of financial flows from these sources, but also to tap other sources of funds.

Recent innovations in international capital markets have the potential to stretch the resources of current suppliers of funds to developing countries. These innovations may also give developing countries access to international bond markets. The funds can come from a number of sources.

As noted earlier, Commercial Banks have reduced the time for which they wish to commit funds. They have also indicated a marked preference for assets that they can trade in the secondary market. To achieve increased liquidity and tradability in their assets, banks have been willing to accept substantially lower spreads than they do on traditional syndicated credits.
An idea of the reduction in borrowing costs can be gained from the first TLIs created in July. Ireland has been the first borrower to try out this innovation. It has received funds for ten years at a spread of 3/8 percent over LIBOR. In comparison, another ten-year Irish loan signed in January carried a split margin of 3/8 percent over LIBOR for the first three years and 1/2 percent for the remaining seven.

As for the lenders, they have received a tradable instrument with a short-term maturity (the mechanics are described in the preceding section). Although syndicate leaders commit funds for ten years, they can pass on these commitments in market-suited packages to other banks that do not want to commit themselves for ten years.

Another instrument that has found great favor with commercial banks is the Revolving Underwriting Facility (RUF). Banks like the RUF because it is also a short-term and tradable instrument. For this quality of asset, they are willing to forego some earnings. Although RUFs have been used almost exclusively in lending to industrial countries, there is evidence to indicate that developing countries can also take advantage of this instrument. As far as can be determined, Korea was the first developing country to do so. The RUF signed by Korea Exchange Bank has permitted the country to acquire five-year funds, against three- or six-month CDs, at a spread of 1/4 percent over LIBOR. In comparison, Korea Development Bank is raising funds for eight years at a split margin of 5/8 to 3/4 percent. Moreover, Korea Exchange Bank signed an eight-year loan in April that was priced at 3/4 percent over LIBOR. Several other developing countries have now begun to test the market reaction for this type of borrowing arrangement.

Multilateral Development agencies are under pressure from a number of sources to help developing countries graduate into international capital
markets. Apart from a few confinancing deals and sales of loan participations, these organizations have done little in this regard. Since the World Bank is the preeminent multilateral development organization, it is incumbent upon the Bank to help developing countries make the transition to international capital markets. Indeed, inasmuch as the Bank is highly regarded in international capital markets for its innovative approaches to borrowing, it is in a position to set the example and to lead the way in helping developing countries take advantage of the new instruments and practices in lending.

The World Bank can begin, for example, by adding the TLI element in its lending to developing countries. It can do so selectively in individual loans. When the Bank has a loan with the TLI feature, it can initially sell it to, perhaps, just banks; subsequently, it can help place these TLIs with nonbank lenders. What would the World Bank accomplish by this exercise?

First, the Bank would have far greater impact in lending to developing countries. It would indeed be the pioneer in identifying investable opportunities, developing them, and then offering them to the capital market. Second, the Bank would help establish a secondary market in developing country assets, which, needless to say, must be present if developing countries are to have any chance of breaking into the international bond markets proper. Third, the Work Bank would apply its resources in a wider context than it does now since a portion of the loans would be sold; in this way, the Bank could replenish its resources. Fourth, and more important, to the extent that it places TLIs with nonbank lenders, it would be tapping sources of funds that are not available to developing countries at present.

Nonbank Lenders consist of insurance companies, pension funds, trust funds, savings and loan institutions, manufacturing and other corporations,
and money market funds (that invest in money markets, not directly in countries). There is indeed a vast pool of funds—amounting to trillions of dollars—that remains practically shut to developing countries, partly because these countries are not yet considered sufficiently creditworthy by the nonbank lenders to be included in their portfolios; partly because rules and regulations of national, state, and local regulatory authorities prohibit these nonbank lenders from acquiring such assets as those issued by foreign entities, including developing countries; and, finally, because developing countries have not made a significant or serious attempt to issue the type of instruments that nonbanks lenders will feel comfortable with.

To take an example: Although pension funds are the single largest source of funds—amounting to US$653 billion at the end of 1980—for the United States capital markets, until recently they have not made any significant diversification into foreign securities, especially those of developing countries. This is the case even though (U.S.) pension funds now have greater leeway in investing them since the enactment of the Employee Retirement Income Security Act (ERISA) in 1974. The primary reason for this hesitancy has been unfamiliarity with foreign markets; other concerns include the nature of liquidity in foreign securities and, of course, exchange rate and capital transfer problems. With financial deregulation proceeding apace in several countries—most recently in Japan—there is increased scope for tapping these markets for the issues of developing countries.

Developing countries obviously have to be deemed creditworthy over the long term before nonbank lenders will be willing to purchase their paper. They may have to make a transition via TLIs to RUFs and FRNs. Creditworthiness depends on many factors, most notably the financial condition of the borrower, its attitude toward debt, and its history of the quality of
economic management. For the securities market, the process of creating acceptance is a long one, although this acceptance can be destroyed overnight. Thus, consistency and steadfastness of economic policies are important elements in establishing capital market creditworthiness. But a country need not jump into the securities market since it has the option of proceeding through stages via TLIs and RUFs. Moreover, since many developing countries are newly independent states, they have not had sufficient time (from the capital market viewpoint) to establish creditworthiness. These countries need to be assisted into the capital market by the World Bank, among others.

Other countries, such as India, Malaysia, and Thailand, have had a long history of servicing debt without interruption or problems as well as a prior history of issuing bonds in international markets. These countries, with their conservative economic management, are prime candidates for the introduction of new capital market instruments and practices outlined here.

Initially, it may be necessary to help capital markets become more receptive to the securities issues of developing countries. This may be accomplished, first, by increasing capital market awareness of the financial conditions of borrowers, their economic policies and management, and their attitude toward debt. If such information is made available by the World Bank or the International Monetary Fund, for example, it will have far greater credibility than if it were released by borrowers themselves. Second, the securities of developing countries may have to carry guarantees, probably from international organizations or the countries of lenders. Indeed, such agencies as the U.S. Overseas Private Investments Corporation, can play a constructive role in helping overcome investor wariness toward the securities of developing countries.
Finally, legal restrictions that are designed to protect savers in lending countries tend to discourage developing countries from issuing bonds. For example, regulations may prohibit insurance companies, trust funds, pension funds, and the like from holding more than a certain percentage of their assets in the form of foreign bonds and other securities. These restrictions mean that such institutions would probably load up their portfolios with the better-known names among bond issuers. Bond issuers in the developing countries are thus put at a disadvantage. It may be feasible to relax some rules a little where securities issues of developing countries are concerned.

V. Concluding Comments

Do international capital markets view borrowers from industrial countries as an inherently different class from those in developing countries when it comes to applying market innovations to the intermediation process? The answer is generally yes. Nevertheless, the experience of Denmark, a frequent European borrower, for example, and that of Korea show that the latter is slowly but steadily reaching market acceptability and, therefore, is close to creditworthiness of the type currently enjoyed by Denmark (see Table 5).

The trend in borrowing costs seen in table 5, clearly illustrates the central point of this discussion paper— that borrowers in developing countries who have maintained unblemished debt-servicing records now enjoy syndicated Euromarket creditworthiness almost of the quality of the prime European borrowers. Therefore, just as prime European borrowers have rapidly moved to take advantage of international capital market innovations, it behooves creditworthy developing countries to do the same. In the process they can not only reduce their borrowing
costs substantially, but they can also assure themselves of a broader set of sources for meeting their external financing requirements. However, it should be noted that they would do this whenever they can, but the market for their paper is at present small.

Table 5  Loan Experience of Denmark and Korea, 1981-84

<table>
<thead>
<tr>
<th>Borrower</th>
<th>Date loan signed</th>
<th>Amount (US$millions)</th>
<th>Maturity (years)</th>
<th>Rate + LIBOR (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kingdom of</td>
<td>2/81</td>
<td>$250</td>
<td>8</td>
<td>3/4-1/2</td>
</tr>
<tr>
<td>Denmark</td>
<td>4/82</td>
<td>$300</td>
<td>8</td>
<td>3/4-1/2</td>
</tr>
<tr>
<td></td>
<td>2/83</td>
<td>525</td>
<td>7</td>
<td>1/2-5/8</td>
</tr>
<tr>
<td>Korea Exchange</td>
<td>7/81</td>
<td>$700</td>
<td>8</td>
<td>5/8</td>
</tr>
<tr>
<td>Bank</td>
<td>5/82</td>
<td>$300</td>
<td>8</td>
<td>3/8-1/2</td>
</tr>
<tr>
<td></td>
<td>4/83</td>
<td>$250</td>
<td>8</td>
<td>5/8</td>
</tr>
<tr>
<td></td>
<td>4/84</td>
<td>$390</td>
<td>8</td>
<td>3/4</td>
</tr>
</tbody>
</table>


The international capital market is unlikely to be as familiar and, therefore, comfortable with the economic situation and prospects of other developing countries as it is with Korea. This is where international development organizations such as the World Bank can play a constructive role in informing potential investors about the quality of creditworthiness that developing countries possess.

It should also be noted that since there are two types of international lending—one type goes to finance projects and the other is used to meet general external financing requirements—some capital market
innovations may be more suitable for one than for the other. In any case, the process of adaptation implies that innovations are suitably designed to meet the needs and desires of developing countries and their lenders.

The task may be difficult, but it is not impossible. The important point is that the external financing requirements of developing countries need to be met from a wider variety of international sources than has been the case so far. The World Bank can, and should, lead the way in helping developing countries tap the nonbank reservoir of funds—as it has done for its own funding purposes.
Notes

1. These numbers are taken from Morgan Guaranty Trust Company, *World Financial Markets* (New York, September 1984), p.17. Three other sources can provide data on international lending: Euromoney Syndication Guide, Bank of England, and the OECD. However, because of differences in coverage, definitions, and so on, these four sources are unlikely to show an identical figure either for the aggregates or for an individual borrower.


4. This point is supported by the data regularly published in the four sources mentioned in note 1.


6. However, capital market innovations have not adequately dealt with the level of and fluctuations in the interest rate. In recent discussions on international debt reschedulings, proposals have been made to "cap" or subsidize interest rates, but they cannot be called capital market innovations per se.


11. Ibid.

12. This is evident, for example, from the numerous articles on bank stocks in publications such as the *American Banker* and *Financial Times*.


15. See, for example, Katherine Campbell, "Euromarkets: The Age of Hybrid," *The Banker* (September 1984); and Charles Grant, "The Liquefacation of the Euromarkets," *Euromoney* (October 1983).
16. The fact that regional banks have cut their international lending is evident from the recent data on foreign loans by U.S. banks. Thus, banks other than the largest twenty-four have sharply reduced their exposure, largely by reducing interbank placement with indigenous banks of developing countries. See Global Lending (February 14, 1984), and reports of U.S. regulatory agencies entitled "Country Exposure Lending Survey."

17. Details can be found in "New Euroloan Techniques," Agefi International Financing Review 527 (July 7, 1984).

18. See Grant, "The Liquefaction of the Euromarkets." Moreover, as Euromoney Syndication Guide, "Weekly Fact Sheet," no. 229 (June 15, 1984) shows, RUFs have mushroomed as a favored technique: In the first half of 1984, there were more RUF-related borrowings than in all of 1983. The technique was first used in 1981. Also, see the article by Nigel Bance, "Novelty wins the mandates," Euromoney (August 1984), p. 18.


22. This issue has emerged most recently in the local press in Argentina, for example, and previously in Nigeria, Nicaragua and elsewhere.


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