

L.5.2

RFD 270

Board of Governors of the Federal Reserve System  
Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

July 3, 1956

The Rate of Interest on Government  
Foreign Lending

7 pages

Stephen H Axilrod

NOT FOR PUBLICATION

This Review is intended primarily for internal circulation and should in no case be cited or quoted. It consists of personal and informal contributions by the author, which in many cases represent tentative analyses of the subject considered.

July 3, 1956

The Rate of Interest on Government  
Foreign Lending

Stephen H. Axilrod

This paper discusses certain problems in setting the rate of interest on medium- or long-term loans by one government to another or to private borrowers in another country. A basic assumption is that the government has three purposes -- sometimes conflicting, sometimes complementary -- which must be considered in its lending policy: (1) acceleration of economic growth abroad; (2) encouragement of private lending to foreign borrowers; and (3) encouragement of domestic exports. The rate of interest will be discussed in light of its effect on the achievement of these purposes, with particular attention to the relationship between private and governmental lending. 1/

Much of the ensuing discussion is relevant to lending by the U.S. Government through the Export-Import Bank, which obtains its funds, as needed, by borrowing from the U.S. Treasury. The Bank makes both medium-term "exporter credits" -- maturing generally in more than one year and less than ten years, and mainly financing the export of capital goods for industry -- as well as longer term "project loans" for such purposes as irrigation, power, and transport development.

According to its statute, the Bank "...should supplement and encourage and not compete with private capital..." In practice, this involves the Bank in determining how its policies, in particular its interest rate policy, affect private lending. The next section contains a discussion of factors which the government might consider in analyzing the effect of its interest rate policy on private lending, as well as the reverse effect of the policies of private lenders on the government.

Relation between government and private lending

The government may encourage private lending to foreigners by making certain that its interest rate 2/ is not so low as to provide

---

1/ The effect and desirability of other forms of governmental action, such as grants in aid, or other techniques, such as private direct investments abroad, in achieving some or all of these purposes will not be discussed, nor will the effect of other purposes, such as political and strategic factors, on governmental lending be discussed.

2/ The discussion of this paper will usually be in terms of a single rate. It is recognized that actually rates vary with the term of the loan, its purposes, and the credit standing of the borrower. Whenever a single rate is referred to, one might envision, theoretically, a structure of rates averaging to the single rate. As the rate moves up or down, the structure moves up or down, with arbitrage maintaining an appropriate relationship of rates within the structure.

an incentive for borrowers to seek government rather than private financing. However, since there may always be some interest rate at which lenders are willing to make funds available, the government must make a judgment about what interest rate it is "reasonable" for borrowers to pay. For example, although a particular country might secure private financing at 15 per cent, this probably would be considered "unreasonable" and the government may make funds available at a lower rate. Whatever interest rate the government charged would not discourage or compete with private lending in this instance since the foreign country presumably would not be willing to pay the private rate. To take another example, however, there may be instances in which private lenders are willing to make funds available at 6 per cent. A foreign country may be willing to borrow at this rate -- although it would prefer a lower rate -- so that a lower governmental interest rate would discourage private lending. The government must decide whether it is "reasonable" for the borrower to pay 6 per cent or whether the government should lend at a lower rate and in effect compete with the private market.

In the many instances in which borrowers could only secure private financing, if at all, at obviously "unreasonable" rates, the government need not worry about the effects of its interest rate policy on the growth of private lending. However, if the government is not to take actions that discourage private lending, it will have to decide, in view of prevailing conditions in private markets, that some particular interest rate charged by lenders is "reasonable" for borrowers to pay and that, if private lending is to be encouraged, it will not lend at a lower rate. Thus, there will be no interest incentive for those borrowers who are willing to pay that rate to seek government financing.

In general, the higher the government sets this rate, the larger will be the number of prospective borrowers that may shift from public borrowing to the private market. At the same time, however, a higher government rate will discourage borrowing by countries that are not willing to pay so high a rate, thus to some extent slowing down economic growth in these countries. Problems involved in resolving the partially conflicting goals of both encouraging private lending and stimulating economic growth will be discussed at a later point.

Factors affecting private interest rates. The government may be guided in its choice of what is a "reasonable" private rate by its judgment of the extent to which the private rate is influenced by noneconomic factors and of the extent to which the private rate should influence the allocation of investment resources abroad.

For a number of reasons there may not be any private lenders at any interest rate for which there would be borrowers (even if there is no government source of funds to attract borrowers away from the private market): (1) The interest rate that would be acceptable to borrowers on the basis of the purely economic risks of the project may be deemed insufficient by lenders because of other risks in a

particular country, such as an unstable political situation which may result in default on interest and principal, independently of the success or failure of the project itself. (2) Past experience, e.g., related to the defaults of the 'thirties, may cause lenders to attach an "unreasonable" discount to foreign dollar bonds. (3) Private lenders may be willing to supply funds, but only at an interest rate higher than would be indicated by what is often termed the "social return," in contrast to the private return, of the project. Roughly speaking, an adequate private return would mean that revenues were at least as large as costs (including enough profit to induce people to undertake the project). The structure of interest rates privately determined, by the interaction of borrowers and lenders in the market, might be considered as the market's evaluation of the prospects of achieving a satisfactory private return for various projects. There may be cases, however, when the market's evaluation is not satisfactory to the governments involved, because it would result in a higher interest rate than the rate at which the project, in the judgment of these governments, would have an optimum impact on the economy as a whole.

When the rate asked by private borrowers reflects such factors as those mentioned above, the lending government may consider the private rate "unreasonable" and may give borrowers access to government funds at a lower rate. Regarding the first point mentioned, the government may believe that it is better able to evaluate and face noneconomic risks of default: e.g., it may be able to minimize these risks through influence exerted by its direct participation. As to the second point, the government may judge that the reactions of private lenders are based on prejudice or on past experience that may be no longer relevant in view of a changed economic and political situation; in this case, too, the government might believe that its own view of the situation is sounder than the judgment of the market. It might be mentioned that statutory or traditional restrictions on institutional private lenders might also create conditions that could be considered to justify government lending -- e.g., if their restrictions render the available volume of potentially loanable private funds too small to make for a competitively determined private rate of interest.

With respect to the third point, there are some projects usually undertaken by governments, such as irrigation works, which may not be both self-liquidating (by raising water taxes to farmers high enough to cover annual costs) and at the same time most beneficial to the domestic economy (by inducing farmers to use all the additional water). Private lenders may be willing to provide funds at an interest rate that would increase annual costs so much that either the charges would have to be raised above the optimum level, or that part of the government's general tax funds would have to be earmarked for debt service on the project. Making tax funds available for this purpose diverts funds from other projects or purposes which, by the government's judgment, may be equally necessary. Under these circumstances the

prospective lending government might feel justified in making a loan at a lower interest rate than would be charged by private lenders. However, it is largely a matter of judgment on the part of both the lending government and the borrower as to what projects fall into this category -- and there is no reason to assume that these judgments will necessarily coincide.

Effect of variations in the government rate on private lending.

The extent to which governmental interest rate policy may encourage or discourage private foreign lending depends on how favorable other market factors are. In general, it would appear that factors such as doubts about the attitudes of foreign countries toward foreign investors and institutional restrictions are more important influences on private lending than the government's interest rate. When these factors are unfavorable, variations in the government rate would have a negligible effect on the encouragement of foreign private lending. When they are favorable, however, the government rate may be an important influence on the growth of private lending.

These other factors at present appear to be generally unfavorable, though slowly improving, with respect to United States private long-term lending to foreigners. During the most of the postwar period Canada and Israel, both of which are special cases, were the only important foreign long-term borrowers from private lenders in this country. Recently though, there has been some increased interest in foreign dollar bonds of other countries; and Australia, Belgium, Norway, and South Africa have successfully floated new issues in the United States. However, a large part of these issues was taken up by foreigners. Also, the Belgian and Norwegian issues (in late 1954 and early 1955) and the South African issue (in late 1955) were floated in conjunction with International Bank loans -- so-to-speak under the shelter of the International Bank's reputation for sound lending -- and were themselves only intermediate maturities, up to ten years. Since the end of the war there have been no significant new issues by Latin American countries, which were large borrowers in the prewar period. This change may in part be related to the fact that these countries have been able to obtain dollar financing from the Export-Import Bank and the International Bank, but it also reflects a lack of receptivity on the part of private lenders, who remember the large-scale default of the 'thirties.

Market factors appear to be generally favorable, however, in regard to U.S. private medium-term lending abroad. This is evidenced by the growing interest during the past two years of United States banks and their subsidiaries in such loans, either entirely on their own account or in participation with the Export-Import Bank and the International Bank. Net disbursements on medium-term loans by U.S. banks (loans reported as maturing in more than one year) were \$225 million in 1955 and \$100 million in 1954. The only previous year where there

were net disbursements of comparable size was 1950. Another aspect of the increasing interest in medium-term financing was the formation in 1955, by a group of five large banks, of a subsidiary for the purpose of making medium-term credits available for United States exports.

The inadequacy of medium-term financing facilities has been an important gap in United States capital markets, and the need for such facilities has become more urgent with increased competitiveness in world trade. Exporter credits of the Export-Import Bank were designed to help fill this gap. These credits are granted on the request of the exporter, but the repayment obligation is on the foreigner, just as in longer-term project loans. In this field governmental and private facilities appear to be developing together, and it is likely that governmental interest rate policy can influence the pace at which private facilities expand.

Since the impact of different governmental interest rate policies on private lending varies with the extent to which other factors are favorable or unfavorable, this impact would at present seem to be different in the long-term and the medium-term sectors. In the case of long-term private lending abroad, the encouragement given to private lending would be zero at low interest rates and, because general market factors are unfavorable, would rise, if at all, in only small increments as the governmental rate of interest rises. On the other hand, in the case of private medium-term lending abroad, the encouragement would be actually negative -- i.e. take prospective customers away from established private lenders -- at low government interest rates but, since market factors are favorable, may rise by fairly large increments as the governmental rate of interest rises. As the rate rises, borrowers have increasingly less incentive to prefer government financing, and when there is the possibility of securing private funds because market conditions are relatively favorable, expansion of private lending may be expected.

Effect of government rate on economic development and U.S. trade

The impact of interest rate policy on the demand for investment, and hence on economic development, has been debated at considerable length, and inconclusively, over the past decade or more. As a rough rule-of-thumb, interest rate variations seem to have a larger impact on the demand for such projects as power facilities, roads, and irrigation works, which yield their return over a long period and where fixed costs (including interest charges) are large relative to other costs. On the other hand, interest rate variations seem to have less impact on the demand for such goods as equipment for the development of industries, which yield a return over a relatively short period and where fixed costs are small relative to other costs.

Thus, in the case of what are often termed "social overhead" projects the amount of development may be significantly stimulated by low interest rates and may decrease significantly as the rate rises. In the case of industrial plant and equipment, however, the amount of development may decline only slightly or not at all if the interest rate rises within "reasonable" limits.

It might be said that long-term project loans to foreigners are primarily for the purpose of stimulating economic growth abroad and only incidentally have the aim of stimulating United States exports. Medium-term exporter credits, however, are at least as much for the purpose of stimulating domestic exports as for the acceleration of economic growth abroad. Thus, interest rate policy on medium-term credits must also take the effect on trade into account.

In international trade, the lower the interest rate charged by an exporter the more likely is he to obtain orders, other things being equal. If stimulation of exports were the only goal, this would imply the advisability of a governmental policy of low interest rates on medium-term credits. However, apart from the impact of interest rate policy on private lending, there is the further objection to such a policy that a very low rate would bring about uneconomical international credit competition. This is a matter which requires restraint on the part of all countries; and if a major country engages in unrestrained export credit policies, it may give others an excuse for taking similar action. Such a situation would be avoided if the rates offered by any individual government were no lower than the prevailing rates offered by the major competing countries.

### Policy implications

The preceding analysis has certain implications for governmental interest rate policy on foreign loans. No theoretical analysis can imply firm policy conclusions merely by the force of logic. At best, however, it may help in clarifying policy alternatives, and may indicate the facts and considerations affecting policy formulation.

1. The government might make a rule to the effect that its rate will be (a) no higher than  $x$  percentage points below some "unduly high" private rate and (b) no lower than the cost of borrowing to the government plus an allowance for administrative expenses and a reserve for contingencies. Within this range the government rate should be set where its marginal effectiveness for achieving (competing) policy goals is the greatest. Obviously this point cannot be determined exactly, but a broad judgment might be made on whether this may be toward the upper or the lower end of the range.

2. Under the assumption that acceleration of economic growth abroad and encouragement of private lending are competitive and about equally important goals, the government rate of interest for long-term financing should be near the lower end of the range. Since the encouragement given to private lending does not rise significantly as the government interest rate rises, while the possibilities of "social overhead" investment -- which is often financed by such loans -- may significantly increase as the government rate declines, the marginal effectiveness for achieving both goals may be greatest at a relatively low interest rate. This is true in particular with respect to those projects for which the social return to the borrowing country calls for a lower rate of interest than would be acceptable to the private market since in such cases no "reasonable" rate would bring about any private lending.

3. For medium-term financing, on the other hand, involving the export of capital goods for industry, the government rate might well be toward the upper end of the range -- at least under existing circumstances where the possibility of private lending might be favorably affected by relatively high rates while the demand for capital might not be very unfavorably affected. In loans of this type, however, stimulation of domestic exports may be an important aim of policy; insofar as this is the case, the interest rate might well have to be lower than it otherwise would be set.

4. As the government raises its rate, it usually throws some borrowers into the private market. The government is then in the position of lending only to the riskier borrowers, i.e., to those whom the private market will not take at the prevailing rate. However, so long as the government has a policy of stimulating economic development abroad or of encouraging domestic exports, this is not an anomalous situation, for this policy means that the government is willing to take risks that private lenders are not willing to assume.

5. More paradoxical, however, is the likelihood that the better foreign risks, who obtain loans from private lenders, may have to pay higher interest rates than the riskier borrowers, who are granted government loans. In some cases, the greater risk may be related simply to the lack of development, which in turn causes the country to be more urgently in need of external assistance for accelerating economic growth and makes it less able and willing to pay relatively high interest rates. In other cases, however, the greater risk may be due primarily to poor policies and management, and these cases pose the problem of how far inefficiency should be encouraged by preferred governmental interest rates.

6. Finally, it should be recognized that the relative importance of policy goals shifts with the changing domestic and world conditions so that, even if the facts did not change, the appropriate interest rate would vary with shifting goals. Actually, there is a constant shifting of both facts and policy goals, and policy must be based on a continuing re-evaluation of these changes.