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# Institutional uncertainty and the maturity of international loans

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**Abstract**

This paper shows that non-economic uncertainty in foreign countries contributes to a bias toward short-term maturity in international lending. Frequent government changes and weak institutions explain why some countries find it difficult to obtain long-term financing. Debt maturity is also explained by the level of economic and financial development of a country, the composition of loan portfolios in terms of the type of borrowers, and debt restructuring programs, among other variables. The results are obtained using data on international lending by three groups of U.S. banks: large, medium-sized, and small. Small banks shorten the maturity of their international loans in response to uncertainty to a greater extent compared to large banks.
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## 1. Introduction

The maturity structure of international loans has been the focus of a number of recent papers and policy discussions. For example, explanations for the financial crises in the 1990s have often centered on the effect of large volumes of short-term debt accumulated by emerging economies (Radelet and Sachs, 1998; Chang and Velasco, 2001). With the surge in interest,

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several papers have also opened a discussion on the factors that contribute to short maturities in international lending. One important theme in the literature is that foreign lenders face uncertainty about the preferences and policies of policymakers in terms of debt repayment. In the theoretical part of Rodrik and Velasco (1999), uncertainty is modeled as the likelihood that a "populist" (as opposed to an "orthodox") government comes to power. As "populist" governments are more likely to default on international loans, lenders prefer to lend short-term and decide whether or not to roll over their loans depending on the election outcome.[1] Rodrik and Velasco (1999) then go on to examine empirically the determinants of the maturity of international loans. Interestingly, however, their empirical model does not include variables that measure the political and institutional risks emphasized in the theoretical model. This paper explores the effect of such variables using data on international lending by U.S. banks.

During the 1982–1996 period studied here, 62 percent of the international loans of U.S. banks had maturity of one year or less and 15 percent had maturity of more than five years. There was much variation across different countries. In some countries, more than half of the loans had maturity of more than one year and in some countries close to 90 percent of the loans had maturity of one year or less. The empirical tests show that non-economic uncertainty contributed significantly to explain those variations.

The paper makes contributions to several strands in the literature. First, the paper contributes to the literature on political risk in international lending. In Citron and Nickelsburg (1987) and Ozler and Tabellini (1991) governments face a trade-off between current consumption and servicing international debt. Servicing debt ensures future access to international capital markets. In countries with high political uncertainty, current governments discount more heavily future gains from access to capital markets and, therefore, are more likely to default. Based on such framework, the literature has shown that political uncertainty (usually measured as frequent changes in government) is associated with greater default probabilities and with greater cost of borrowed funds (see De Haan et al., 1997, for a recent survey). This paper offers evidence that political uncertainty also affects debt maturity.

Second, the paper contributes to the literature on debt maturity. Most of that literature is on corporate debt (see Ravid, 1996, for a comprehensive survey) and not much has been done on the maturity of international credit. Rodrik and Velasco (1999) were probably the first to offer such evidence. They explain debt maturity by several country characteristics, which are also used in the analysis here. Recently, Buch (2003) and Buch and Lusinyan (2003) have adopted the empirical framework of Rodrik and Velasco (1999) to study the maturity of international credit by German banks and lending by BIS (Bank for International Settlements) reporting institutions. Broner et al. (2004) study the maturity and term premium of international bond issues by seven emerging economies, showing an increase in the cost of long-term credit relative to short-term credit during crisis periods. The empirical tests here extend those analyses by incorporating measures of non-economic uncertainty. In that sense, the paper is close to Miller (1997), who shows that political uncertainty leads to a tilt toward short-term maturity on

[1] The recent concerns over election results in Brazil provide an excellent example. The *New York Times* (October 2, 2002, p. 10) reports: "Much of the market nervousness can be attributed to growing worries about the presidential election to be held in October, a race now led by Luiz Inacio da Silva of the left-wing Workers' Party…Analysts here and on Wall Street fear that if Mr. da Silva is elected, he will renegotiate or even default on Brazil's foreign debt, a stance that his party has endorsed for most of its 20-year history." In response to that uncertainty, while Brazil was still able to roll over its short-term bonds, the maturity of "a chunk of them" is now "running for only one month." (*The Economist*, October 19th, 2002, p. 68).

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