Should developments in the euro-markets be a source of concern to regulatory authorities?

A talk given by J. A. Kirbyshire, Chief Adviser, Bank of England, to The Financial Times Euro-Markets Conference, London, 23 February 1977.

I have been asked to address myself to the question: 'Should developments in the euro-markets be a source of concern to regulatory authorities?'. If I were to answer 'No' to that question, I suppose that the theme for next year's conference might then become: 'Should the authorities be a source of concern to the euro-markets?' And you might even find that a more entertaining subject. But as I am not actively seeking notoriety, I hope that you will forgive me if I treat the question put to me in the rhetorical sense, which I am sure was intended.

Of course the Bank of England, as the regulatory authority in the City of London, have to be constantly and very closely concerned with developments over the whole field of international banking activity. Our concern follows directly from our operational responsibilities within the institutional framework of both national and international monetary management.

At this conference a year ago, C. W. McMahon, an executive director of the Bank, explained in some detail our concern with – and our attitude towards – the euro-markets in relation to our responsibilities for supervising the stability of the financial structure and for domestic and external monetary management. I do not want to go over the same ground of prudential supervision and monetary control again today; let me instead refer you to the written version published in the March 1976 issue of the Bank of England *Quarterly Bulletin* – off-prints of which are available.

What I would like to do is to discuss an aspect of the euro-markets which is relevant to both of these concerns – that is, the role of the euro-markets in financing the huge recent and prospective international payments imbalances that appeared with the emergence of large OPEC surpluses after 1973.

I shall deal with three main questions. First, has there been too much or too little financing in total – taking official and private financing together – in relation to the particular circumstances of the past three years? Second, within this total, has the share of bank financing been too large or too small? Then finally, I shall look to the future and ask 'Can, will, and should the banks continue to provide balance of payments financing on the recent scale?', suggesting some areas in which I believe changes of policy may be required.

Too much or too little financing overall?

The geographical distribution of surpluses and deficits during the past three years is familiar, but none the less worth repeating.

The combined current account surplus of OPEC was $142 billion. None of this found a counterpart in current account deficits in the three largest economies in the world. In fact, the United States, Western Germany and Japan shared a surplus of $26 billion (although the United States seems to have run a small deficit in 1976). In addition, the Benelux countries and Switzerland ran a surplus of $12 billion.

Among the deficit groups, France, the United Kingdom, Italy and Canada had a deficit of $50 billion between them; other OECD countries also notched up an aggregate deficit of $50 billion; and the non-oil developing countries scored a deficit of $78 billion.

In other words, an OPEC surplus of $142 billion plus oil importers' surpluses in six countries of $38 billion – $180 billion in all – was, as it happens, matched by the deficits of the other importers I have mentioned, which added up to $178 billion.

These figures, impressive though they are, do not tell us very much about whether the payments imbalances, and the financing that allowed them to go largely uncorrected, were reasonable or excessive in the circumstances that prevailed. For that purpose, one has to try to disentangle three distinct strands in the overall pattern of imbalance – while recognising that in practice there is a good deal of overlap and interconnexion between them.

One element is structural and reflects long-term commercial investment flows as well as a concessional transfer of resources to assist the very long-run development process in developing countries. A second element, and certainly the dominant one since 1973, is the oil imbalance which, on the surplus side, is now concentrated on the few low-absorbing oil-producing countries, and which is 'unadjustable' except in the medium to long run, even assuming that appropriate energy conservation policies are adopted by the rest of the world. But even if one makes generous allowance for these two elements, country by country and country group by country group, large imbalances remain – especially among the major OECD countries, but also between those countries on the one hand and the smaller OECD and non-oil developing countries on the other. This residual element of imbalance represents the familiar short to medium-term 'adjustment problem'.

To recognise that there is indeed a large – and continuing – adjustment element in the recent situation is not necessarily to admit that financing has been excessive or that more adjustment should have taken place. That question calls for very difficult judgments, and it is fortunately not my primary concern today. I would only say, against the present background of high world unemployment and rates of inflation, that unless the adjustment can be initiated by the countries which are externally stronger, it is likely to be very costly in terms of world economic activity. On the other hand, if too much of the adjustment is borne by these countries, there is an obvious danger of a recrudescence of inflation. If policies destructive of world trade and widespread financial disruption are to be avoided, we may have to err on the side of more financing and slower adjustment than might otherwise seem desirable.

My answer to the question whether or not the amount of financing overall has been excessive is thus equivocal; how one answers it must depend on one's view about not only the nature of the adjustment policies that would be necessary to achieve smaller imbalances, but also about the political feasibility of such policies.

The share of euro-market bank financing – too big or too small?

Perhaps here again I might remind you of some statistics.

Of the aggregate OPEC surplus since 1973 ($142 billion), no less than $50 billion (35%) was channelled into bank deposits world wide.[1] By comparison, less than $10 billion (7%) of the OPEC current surplus was put through official recycling channels, i.e. the IMF oil facility or loans to the IBRD and other development institutions. In addition, about $25 billion (18%) of their surplus was used for the making of bilateral inter-government loans.

On the deficit side, most of the cumulative current account deficit of smaller OECD countries seems to have been financed by bank borrowing, compared with only $2 billion (5%) borrowed (net) from the IMF and IBRD. In the case of the non-oil developing countries, the comparable figures were $45 billion net (58%) borrowed through the banking system, and only $11 billion net (14%) borrowed from the Washington institutions.

Nearly all the borrowing from the IMF by these two groups of countries was outside the higher, more conditional, credit tranches.

These figures indicate that bank financing has borne a very large – and perhaps excessive – share of total financing; this conclusion is sharpened, I suggest, if one considers two other main, qualitative, factors.

The first relates to the quality of bank lending, because the banking system has been used as a source of finance for all three of the elements – the structural, the oil-induced and the residual – that I identified a few moments ago; and while bank lending has a proper role to play in relation to each of these needs, it is not appropriate on its own for any one of them.

For instance, bank credit has been drawn upon to fund structural long-term development projects with a pay-back period far in excess of the five to seven-year maximum maturity which has recently been the norm for euro-market loans; and as a result, some developing countries in particular are likely to face a growing need for refinance on this account, which will add considerably to their gross credit demands. I do not mean, of course, to suggest that bank lending has no role to play in this area, but rather that it should play a supporting role to long-term credit institutions.

The euro-markets, and the banking system more generally, have also been used as a primary vehicle for recycling oil monies. Despite the remarkable flexibility with which they have adapted to this role, neither the banks nor the regulators can afford to ignore the very considerable maturity transformation and country credit risks which this has involved; there may also be a potential problem in a few cases of heavy dependence on individual depositors.

Finally, the banks have provided a very large share of the financing for the adjustment element of imbalance. Both here and in the recycling area, a principal attraction to the borrowers of recourse to bank credit has been the absence of any form of adjustment conditionality. It might be argued that the variations in spreads represent a kind of conditionality; however, I do not regard this as more than a very marginal contribution to adjustment.

The second – and to my mind conclusive – factor which suggests that too much reliance has been placed on bank financing is the mounting concern about country credit risk, which many banks have themselves begun to express. In the wake of the oil price increase there was some tendency to prophesy immediate doom; when the worst did not happen, there was a corresponding tendency to believe that international financing problems had, by and large, been surmounted. But it was always likely that the country risk problem would become acute as a result of the cumulative, rather than initial, effects of imbalance. In relation to some individual oil-importing countries, the banks are now approaching the limits of the credit risk that they can prudently bear.

[1] i.e. into deposits with banks in the eight European BIS reporting countries plus Canada, Japan and the United States, including US bank branches in off-shore centres.

For the time being, serious difficulties are likely to remain limited to a few individual borrowers. But if one looks beyond the next couple of years, there is little prospect of an early reduction in the overall international payments imbalance; thus, these difficulties – left to themselves – may well become increasingly widespread and may not necessarily be confined to developing countries. Furthermore, the emergence of a series of individual problems, even if they are individually solved, is likely to affect the general willingness of the international banking system to take the risk of making new loans.

A number of factors have combined to produce this situation. The OPEC countries, for example, have shown an understandable inclination to look for a safe home for their investments, in the strongest economies, with a large proportion placed in the form of short-term bank deposits; in other words, they have largely succeeded in avoiding both the credit and the transformation risks. Borrowing countries have been prepared to pay a higher price for bank finance in order to escape the discipline associated with official medium-term adjustment finance; the emphasis in official lending has thus shifted towards special facilities with a relatively low degree of conditionality. Finally, one might argue – not altogether unfairly – that the banks themselves have not been completely unwilling victims. With loan demand in the major industrial countries depressed by the recession, they have certainly been active in seeking alternative ways of increasing their assets.

Against this background, I turn now to the crucial question for the future.

Can, will, and should euro-market financing continue on the recent scale?

I have already implied that, if one looks beyond the next year or so, the banking system cannot continue to carry the same share of the financing burden. As the debt of the main groups of deficit countries continues to build up – as it will inevitably continue to build up, even assuming more emphasis on adjustment – the number of countries in which banks are willing to increase their exposure is likely to shrink. Nor is it appropriate that the banking system should continue to provide so large a part of the necessary balance of payments financing, given that bank credit on its own is not always especially well suited to the nature of the different financing needs.

So that there should be no misunderstanding, I want to make it clear that I am not predicting – or still less advocating – a sudden or dramatic freezing over of the stream of international bank finance in the short term. The damaging

consequences of any abrupt change in the general pattern of financing of that kind, for the banks themselves, for the borrowing countries, and for the international financial system as a whole, are obvious and are recognised by all those involved. And there have been several recent instances which confirm that, where serious difficulties begin to emerge, the banks, as well as the official creditors, have been prepared – as they must be prepared – to accept their share of responsibility for finding an orderly means of overcoming such difficulties. Important though this is, it will not, however, necessarily avoid a gradual contraction in the net flow of international bank finance.

Nor do I mean to imply that private lending has no part to play in balance of payments financing, in its most general sense, in the longer term. On the contrary, it is essential that the banks should continue in a large and active role – although there may be a case for a greater involvement of the traditional capital markets in the provision of long-term international finance; whether equity financing can play much of a part in this – as I would think desirable prima facie – is primarily a political question. My point is that, if the banks are to be able to continue in their proper role beyond the next few years, and if the danger of a sudden freezing over of private international financing is to be avoided at some point in the future, then we must begin now to envisage a gradual shift of emphasis towards official financing, which in turn will underpin a continuing major role for the banks.

The banks and the regulatory authorities have a difficult course to steer in the years ahead. If prudence now comes to mean excessive caution, it could result in too abrupt a contraction in the net flow of international financing; this in turn might precipitate the disorderly situation which it was intended to avoid. If, on the other hand, prudence is interpreted in a way that leads to insufficient caution, this could endanger confidence in the stability of the whole financial structure. The problem is all the more difficult because what is 'prudent' cannot, in the final analysis, be determined for each bank by its own decision, nor even for each national banking system by the decisions of its own regulatory authority; it will be determined ex post by the collective, independent, decision of the hundreds of banks engaged in international financing, which are made interdependent by the realities of the situation – and not just through the fact of cross-default clauses in their loan agreements.

I am, therefore, pleased to see evidence of a growing, informal co-ordination between the banks and the international institutions in Washington and elsewhere. This has, perhaps, gone somewhat further in the development field where so-called 'co-financing' between commercial banks and the IBRD and, I believe, the regional development banks, is no longer just an idea. In the adjustment field, too, there have been a few recent instances where private banks have only been prepared to extend further financing in parallel with IMF credit and its associated conditionality. Like co-financing, such parallel financing needs to be actively encouraged in appropriate cases. It can provide the banks with a degree of assurance that borrowing countries will pursue appropriate adjustment policies (the only ultimate security for the lending) without any direct policy involvement on the part of the banks themselves; and although it implies greater use of official financing facilities, it might also enable the banks prudently to lend more than they might otherwise feel able to. From the IMF standpoint, arrangements of this sort can gear up the amount of finance effectively attached to the normal credit tranches, and thereby help to overcome natural reluctance to accept Fund conditions, without any necessary relaxation in the Fund's policy standards. If I may say so, I regard the United Kingdom's recent euro-market borrowing, which has supplemented the resources available to us from the IMF credit tranches, as very much along the general line which I am advocating.

Closer working relationships between the banks and the IMF and IBRD – which will probably require changes in working practice on both sides – can help in this situation to bring about the necessary gradual shift of emphasis between the roles of private and official financing. Better co-ordination – between the banks themselves and between them and the various authorities – can be promoted through more regular private contacts, as well as through the wider dissemination of detailed factual information on the evolving country credit risk. The current BIS statistical exercise, designed to establish a maturity analysis of bank lending to non-OECD countries at the end of last year, is an example of the kind of thing which could be of real help.

To argue for a shift of emphasis away from bank financing implies that, if such a change is to be achieved without serious disturbance, adequate official financing arrangements must be available when necessary. Such arrangements cannot in practice be set up in a hurry only after an immediate need appears. I believe, therefore, that it is necessary to put in hand quite quickly a review of official international financing facilities covering all three of the types of financing need identified earlier. To discuss the content of such a review would require at least one more talk of this length, and you will not expect that from me now; but one important element of it would, in my own view, have to be the subject of whether and how the OPEC surplus countries can be more involved in the operation and management of official financing arrangements. Above all, however, I hope that this review will look beyond the immediate prospect which, as I have indicated, should be manageable without undue difficulty; rather, it must look to the implications of a continued large payments imbalance at least over the medium term.