

# The need for flexibility in international banking

*The Deputy Governor discussed:*<sup>(1)</sup>

- **World economic prospects** *'An optimist could make a case . . . that prices will decelerate faster than is generally expected' and that 'sustainable non-inflationary growth might be nearer than we think. On the other hand, a pessimist could point to serious downside risks'.*
- **Prudential standards** *' . . . in the first flush of exuberance in the euromarkets after the 1973 oil shock . . . there was often inadequate assessment of individual country risk . . . Now, however, there is a danger that we might see the converse. At a time when banks have been made rather more sharply aware of the risks involved in their exposure to particular countries in difficulties, there could be a problem if they began more generally to withdraw from, or at least to run down their involvement in, individual countries or groups of countries, without a fully balanced assessment of those countries' positions . . . Excessive prudence can be as dangerous in some circumstances as excessive exuberance in others.'*
- **Financial sanctions on Argentina** *' . . . the Bank of England was asked to administer the restrictions as agent for the Treasury—a role with which it was familiar from the days of exchange control. However, there are significant differences. This was not to be fully-fledged exchange control against Argentina, but a limited operation designed to freeze Argentine assets in this country and to limit the ability of Argentina to obtain new credit from international markets . . . The maximum pressure would be achieved if Argentina continued to meet its obligations and it was denied new sources of funding.'* *'Suggestions that the restrictions have been applied in a lukewarm manner are . . . both false and misconceived.'*

## The world economic background

Our lunch today comes within a fortnight of the summit meeting at Versailles and follows a series of discussions in both the OECD and IMF on prospects for the world economy over the next couple of years. We are now just emerging from a period of adjustment to the immediate effects of the second oil shock. In contrast to the period following the first oil shock, most countries have this time pursued non-accommodating monetary and fiscal policies.

These policies have produced some striking successes in the battle against inflation. In the United States, Japan and Germany, inflation is at present running at 5% or less; and in the United Kingdom it is now in single figures. But the many long-standing rigidities which characterise most of our industrial societies have meant that this was only achieved at considerable cost.

Behind the fall in inflation, virtually all commodity prices—most notably, perhaps, oil and gold—have been weak. Asset prices, too—whether for stocks, bonds or private houses—have tended to soften in most countries. In those cases where prices have proved less immediately sensitive to demand, volume has tended to suffer—most

importantly in the labour market, where there has been pressure on employment and thence on activity.

In addition to the achievements on inflation there have been important structural adjustments, especially in the field of energy saving. Success in this area has no doubt been one important reason for the recent weakness of the oil market. There have also been other achievements. In the particular case of the United Kingdom there have been some impressive statistics on productivity—the improvement in output per man in manufacturing last year, of 10%, was some three times the average even of the easier days before the first oil shock. There seems a fair chance that this jump will not be reversed—indeed the prospects for continued productivity increases have probably also improved.

But these successes have been hard won. Unemployment has in most countries reached post-war record levels. Interest rates have been generally high and volatile, and have contributed to the sharp movements we have seen in exchange rates.

Moreover, as both inflation and inflationary expectations have begun to die down, interest rates in real terms have almost everywhere reached levels not previously

<sup>(1)</sup> In a speech at the Financial Times Annual Lunch for representatives of foreign banks in London on 26 May.

seen since the war. Industry in most countries has experienced considerable financial strain; many raw material producers have seen sharp deteriorations in their terms of trade, with the consequent need to rein back their domestic economies and often their living standards; and as interest rates have risen, the burden of debt service has been substantially increased, in some cases severely taxing the capacity of borrowers to repay.

All of this must, I think, mean substantial uncertainty in assessing how things might go in future. We are in some important respects outside previous experience and in such circumstances we should perhaps not place a great deal of trust in the predictions of our conventional models. The broad picture which they almost all are now suggesting is for some revival in activity in the second half of this year—with GNP in the major countries as a group rising at an annual rate of perhaps between two and three per cent—and, barring any untoward disruption, for this to continue through 1983.

With such rates of growth it seems unlikely that there will be any significant impact on unemployment in the near future; indeed unemployment could continue to rise. On the other hand, inflation rates may ease further, although in some countries remaining uncomfortably high. Some of the deceleration in costs may be absorbed as companies seek to rebuild profit margins, which is in itself a highly desirable aim and is probably a necessary precondition for a revival of investment.

On external account, many of the very large imbalances which emerged in the aftermath of the oil shock have disappeared. Germany and the United States are hovering in rough balance; the Japanese have recorded a modest—perhaps surprisingly modest—surplus; and, most dramatically, the OPEC surplus has shrunk rapidly from around \$110 billion in 1980 to something perhaps barely positive in the first half of this year. On the face of it, this more moderate pattern of current account imbalances should point to greater stability in the foreign exchange markets.

Underlying the present position, however, there are substantial disparities in competitiveness. Over the last year, relative labour costs in the United States have deteriorated by something like 20%; in Japan, relative costs have been roughly unchanged; while in Germany there has been an improvement of about 5%—and all this started from a position in which Japan and Germany were already strongly competitive. On this basis, substantial pressure for shifts in exchange rates may be felt in due course, especially if US interest rates fall and activity there revives.

While what I have described may be a best guess at immediate prospects, there are, as I have suggested, great uncertainties in the picture. Matters could turn out to be significantly better or worse. An optimist could make a case for believing that prices will decelerate faster than is generally expected. He could argue that even now the extent to which underlying rates of inflation have been brought down is underestimated in many countries by the public

and the markets. As a general realisation of the improvement in the position grows, we might see interest rates fall faster than is now expected; and to the extent that savings have been boosted by a desire to maintain real money balances, consumption could grow faster than forecast. Sustainable non-inflationary growth might be nearer than we think.

On the other hand, a pessimist could point to serious downside risks. He could argue that until the tension between fiscal and monetary policy in the United States is resolved, doubts must remain about any early or significant reduction in interest rates there and about the strength of any general upturn in the US economy. More generally he could be concerned as to how economies may react to a long period of high real interest rates. And there is a separate but related question of how far debtors—be they countries or industrial companies—will be able to adjust to the higher real cost of servicing their borrowing. We must all hope that the optimist will prove right. But as central and commercial bankers it behoves us to consider very carefully the implications of the pessimist's scenario. No time is so usefully wasted as that spent in guarding against disasters that do not in the event occur.

### Risks in international lending

One potential worry that is clearly of particular concern to those of us here today is the prospects for large borrowers and the attitudes which their creditors should take to them. We in the Bank have always emphasised the need to maintain the highest prudential standards in banking. Such standards remain vital to the efficient running of a financial system. While shareholders will doubtless have their own interest in protecting their equity and its earnings, there is a wider public interest in securing the fullest possible protection for depositors consistent with an adequate return on their savings.

Of course, exhortations to be prudent have always been the stock-in-trade of regulators. But the nature of the exhortation, even perhaps the concept of prudent behaviour, is a particularly subtle one at the present juncture. There is little doubt that, in the first flush of exuberance in the euromarkets after the 1973 oil shock, as the potential for large-scale cross-border lending became widely appreciated, there was some feeling that sovereign lending was risk-free. I think that many bankers would admit if they were candid that in the early stages there was often inadequate assessment of individual country risk. Some blame must of course attach to periods of over-lax policy in some of the major economies; and borrowing countries certainly cannot be absolved of responsibility for their own policies. But it can also be argued that in a number of cases indiscriminate enthusiasm on the part of loan salesmen may have served to encourage borrowers to take on commitments they were ill-equipped to shoulder when the going became more difficult.

Now, however, there is a danger that we might see the converse. At a time when banks have been made rather

more sharply aware of the risks involved in their exposure to particular countries in difficulties, there could be a problem if they began more generally to withdraw from, or at least to run down their involvement in, individual countries or groups of countries, without a fully balanced assessment of those countries' positions. We have seen similar behaviour in respect of involvement in lending to companies, both domestically and internationally. Excessive prudence can be as dangerous in some circumstances as excessive exuberance in others.

Perhaps it would be useful at this point to recall the line which we at the Bank have taken on the whole subject of country lending—and I think it has been a broadly consistent line ever since the problem leapt into prominence in 1974.

First, we have always wanted to see the maximum possible contribution from the official international institutions—and especially the IMF. This has been because we believe that funds from these institutions with their associated conditionality are likely to carry the best prospects of facilitating appropriate adjustment. At the same time it has always been clear that the magnitude of the financing task has been such that official funds could not play more than a minor role. The major part has had to come from the banking system. That being so, we have concentrated on trying to ensure that international bank lending was prudently and appropriately carried out. We have encouraged the provision and distribution of as much information as possible. We have, with other central banks, worked to develop a collaborative approach to supervision of international lending. And we have encouraged banks not to react abruptly or short-sightedly to changes either in a borrowing country itself or in other countries with superficial similarities.

You will recall that the Governor addressed this question in a speech he gave in Bonn in December.<sup>(1)</sup> He noted that, as with domestic bankers in their dealings with companies, international bankers face a dilemma when a country begins to experience debt difficulties. Prudent banking practice may suggest that exposure should be reduced, by the refusal of requests for new credit and the termination of existing lines or deposits as they mature; on the other hand, action of this sort, if precipitate or taken simultaneously by a number of the country's creditors, may well hasten and exacerbate the very difficulties from which the banks are trying to escape. Action by a single bank taken in its own narrow interests can easily prove detrimental not only to its own longer-term interest, but also to the interests of the wider banking community. In such circumstances there can be no guiding rule, but each case must be judged on its individual merits.

A more widespread difficulty might arise if problems deriving from a particular rescheduling caused banks to react defensively towards other indebted countries,

precipitating difficulties for them. Banks must consider carefully whether the difficulties faced by a country are transient or whether they reflect fundamental maladjustment or mismanagement. A solution may, in some cases, lie in a widening of spreads with a consequent increase in the return on capital, so as to encourage further lending. But any banks which do withdraw support at an inappropriate moment, even if in one particular instance they manage to protect their immediate interest at the cost of precipitating difficulties for others, could find that damage done to their standing in the market might not serve them well in the longer term.

I do not underestimate the difficulties there are in making the appropriate differentiation between borrowers. Obviously there will be occasions when some common external factor, economic or political, influences a range of countries. Nevertheless, more often than not, there will be differences in the impact such factors have or in the reaction to them; and it is of great importance that such differences be properly assessed and appropriately responded to, in the longer-term interests of the banks, the borrowers and the wider world community.

The question is sometimes raised whether central banks are adequately prepared to deal with failures if, despite all efforts to guard against them, they arise. Recently the Group of Thirty risk study group has noted commercial bank concerns in this area. Traditionally, at times of uncertainty, confidence has been restored by resolute action by the relevant central bank. If problems were to arise from international lending, co-ordination between a number of authorities would be required, simply by virtue of the international nature of markets: responsibility would need to be shared amongst them. This need is fully acknowledged by the central banks of the major industrial countries. Indeed, as long ago as September 1974 the Governors of the Group of Ten central banks stated publicly in the wake of the Herstatt affair that they were satisfied that means were available for the provision of temporary liquidity to the euromarkets and would be used if and when necessary.

That statement still stands. As was also said in 1974, however, it would not be practicable or advisable to lay down in advance detailed rules and procedures for the provision of such liquidity. In particular, if such provision were to be in any sense automatic or if the factors or criteria which determined it were precisely specified, there would be a danger that the disciplines of the market would be overridden—if the arrangements looked too restrictive—or undermined, if they looked too lax.

### Financial sanctions on Argentina

After these rather general remarks, I would now like to turn to one particular question on which I am sure you will expect me to say something.

(1) See the *March Bulletin*, page 96.

The decision by the Government to impose financial sanctions on Argentina was, of course, taken at short notice and introduced with immediate effect on 3 April by means of Treasury Directions issued under the 1964 Emergency Laws [(Re-enactments and Repeals)] Act. As you know, the Bank of England was asked to administer the restrictions as agent for the Treasury—a role with which it was familiar from the days of exchange control. However, there are significant differences. This was not to be fully-fledged exchange control against Argentina, but a limited operation designed to freeze Argentine assets in this country and to limit the ability of Argentina to obtain new credit from international markets. In this way, the financial pressures on Argentina arising from its heavy burden of international indebtedness would be sharply increased. The maximum pressure would be achieved if Argentina continued to meet its obligations and it was denied new sources of funding.

The restrictions were codified in a notice from the Bank. At the same time as this was issued, the Governor wrote to all recognised banks and licensed deposit-takers in the United Kingdom, reminding them of the requirements of the freeze, and making clear that he expected them to respect the intentions and spirit of the formal restrictions and of the guidance that the Bank was giving. All banks and licensed deposit-takers incorporated in the United Kingdom were also asked to ensure that their branches and subsidiaries overseas should exercise, so far as possible, similar restraint. The Governor's letter was formally brought to the attention of the Stock Exchange, Lloyd's, the insurance companies and the building societies.

The powers that are available to the authorities are designed for the purpose of enabling financial assets in this country to be frozen and the lending of new monies from this country to Argentina to be prevented. We have avoided any claim to extra-territorial jurisdiction, but we believe that the restrictions are wholly effective in achieving their objectives. They have been accompanied by a severe contraction on general prudential grounds in the amount of credit available to Argentina. Suggestions that the

restrictions have been applied in a lukewarm manner are therefore both false and misconceived.

From a different side of the fence, it has been suggested that the application of the restrictions will damage the future of London as an international financial centre. There are clearly risks that we have to run in dealing with the present situation. Nevertheless it is our belief that the way in which we are administering the controls, and the wide international support and understanding that our position enjoys, should ensure that the position of London as a financial centre will not be adversely affected by the present temporary exigencies. The many factors that have attracted banking business to London over the years continue to be present here, and will continue to draw business, and ensure that London remains successful, even in these particularly troubled times. The authorities are grateful for the co-operation and understanding that has been displayed by the London banking community.

### **Need for orderly adjustments**

To return to international lending more generally, I would not wish to end on a gloomy note. There are, it is true, reasons to look critically at the present structure of lending and at the balance to be struck in extending new loans. There has been concern about profitability, the maintenance of adequate capital and the need to secure a reduction in risks. But we have seen some encouraging examples of what can be achieved when the markets, through a reassessment of spreads, signal their concern to particular borrowers and when the borrower then responds. I have the achievement of the Brazilian authorities notably in mind. For adjustments of this kind to be able to work smoothly and without disruption, it will be important that international bankers continue in the traditional manner always to undertake a fully considered assessment of risk and to act in accordance with it, always having in mind the need to keep a cool head and resist the rumours and fashions of the moment, whether they are put about by bulls or bears.