The tasks of the banks in a time of recession

Speech by the Governor[1]

- *In the difficult economic circumstances of recent years, banks have been moving closer to their customers, both corporate and national, and this process should be built on.*
- *If a company's problems are deep-rooted and permanent, 'the banker or company that is not realistic and firm about corrective action will be acting neither in the interest of shareholders nor of the wider domestic economy.'*
- *Banks cannot aspire to the same relationships with sovereign borrowers as with corporate customers. Official international institutions such as the International Monetary Fund must take the lead if economic adjustment programmes are needed to restore creditworthiness.*
- *Up to now, cases of bank rescheduling for heavily borrowed countries, although increasing, have not created anxiety about the ability of the banking system to handle them. 'A more widespread difficulty could, however, arise if a failure to agree on a rescheduling were to lead to a default or moratorium which caused banks to react defensively towards other indebted countries.'*
- *'Banks must of course consider carefully whether the difficulties faced by a company—or a country—are transient, or whether . . . they reflect fundamental maladjustment or mismanagement. But banks do not withdraw support from a range of companies merely because one of them is in difficulty; nor should they do so from a range of countries, just because one may be forced to reschedule.'*

. . . In September [I spoke] in San Francisco on world economic issues, and I do not wish to repeat tonight what I said then—on the need for greater stability in exchange rates, on energy problems and on the need for domestic economic adjustment.[2] These are all long-term problems. Tonight I want to speak of more immediate matters. And I shall speak of them primarily in a European context. I hope that you will think it in line with your own practical concerns and my own responsibilities if I pay special attention to the position of the banks in the current situation and to the problems that arise for bankers.

Looking out from Europe it is easy to think some economic difficulties bear with special force on our countries. Looking one way, we see the attention of the United States concentrated primarily on solving its own very real problems. Looking the other way, we see the countries of the Pacific Basin bursting with such energy and innovation that the world trading system is hard pressed to accommodate them. In this perspective, it is natural to see a community of interest in Europe. Evidently the problems differ from country to country within Europe; but some of them can be solved more easily if we recognise that, in essence, they are common to us all. The arrangements of the European Economic Community provide a framework within which to pursue a common approach.

It would be right for me to acknowledge that our difficulties have a political as well as an economic dimension. Some of the political difficulties arise from our geographical situation—neighbour as we are to the Eastern European area. Others arise directly from the performance of our economies. The economic problem that Europe faces is created by the disquieting combination of rising unemployment, together with inflation that has been slow to subside and is still running at too high a level. The carrying through of firm economic policies in such circumstances demands a degree of political consensus which is not always easy to achieve and hold. There are sometimes suggestions from observers outside Europe that the problems which we face are proving too great to be successfully handled, and that they are imposing intolerable strains on our political and social cohesion. But it is an exaggeration to describe our situation, as some do, as 'a crisis of capitalism'. It is salutary to remember in this connection that most countries of Eastern Europe have problems altogether more serious and fundamental than our own.

The economic challenge that you and we and other Western countries face is that of mastering stagflation. In all our countries, inflation has been stimulated by the rises in the price of oil over the past decade. We are sometimes prone to

(1) Delivered at the Annual Assembly of the Bundesverband deutscher Banken in Bonn on 14 December 1981.

(2) This speech was reproduced in the December 1981 *Bulletin*, page 540.

forget just how significant a shock that has been to a world economic system in which inflation had already taken root. We are trying to reduce the inflationary repercussions by following cautious fiscal and monetary policies; and progress is proving slower than we hoped a year or two back. As the IMF has recently pointed out, the time horizon of concern to economic policy-makers has lengthened considerably in recent years because of the greater magnitude and intractability of the problems to be faced. We in the United Kingdom take satisfaction at having reduced our rate of inflation significantly in the last two years. But it is, of course, still appreciably higher than yours. Both our countries have a high level of unemployment. Although yours is a good deal lower than ours, you are rightly concerned, as we are, by the level that it has now reached and at its continued growth.

Though inflation is proving obdurate, this cannot be a reason for giving up the attempt to reduce it; and I know that conviction on the need to persevere is nowhere more deeply felt than in Germany. A similar determination is at the heart of UK economic policy. We have made progress and this year have had little increase in manufacturing unit labour costs. We also believe that we have passed the worst of our recession and may now be beginning to see some first signs of a resumption of economic growth.

The problems of inflation and unemployment are related to many aspects of our social arrangements. One might indeed say that they raise questions about the modern Welfare State. Maintenance of the real value of welfare provision, and still more its improvement, must depend on the underlying strength of the economy; and the economic substructure is showing the strains of increased demands from this source. There is a tendency for people to take for granted the benefits and security, but not to create the wealth necessary to sustain them. It is essential to rectify such economic malfunctioning.

A part of that malfunctioning, perhaps more evident in Europe than elsewhere, relates to the capacities, skills and attitudes of the work-force, where change is perhaps most difficult to accomplish. It is possible that European countries compare unfavourably with other industrial countries in this respect, and that we face the danger that adaption to the rapid pace of technological change will be frustrated from this source.

The world-wide speed of technological advance may seem daunting. But we in Europe must be able to match the enterprise, inventiveness and skill of our competitors. I have just said that the arrangements of the European Community provide a framework in which our problems can be tackled. How dismal it would be if that framework, instead of helping us to be vigorous members of the world economy, were to be used to turn us inward in a futile attempt to protect us from change. There are some who would see a protectionist Europe as possible, if not probable; perhaps one of our most fundamental tasks is to prove them wrong.

In my speech in San Francisco three months ago, I spoke of the framework of stability provided in the first twenty-five post-war years by the Bretton Woods system. I spoke of the disadvantages of volatile exchange rates and the need to restore a greater degree of exchange rate stability. It is natural to see the European Monetary System (EMS) as playing a role in creating such a framework of stability. It is, perhaps, almost inevitable that there should be strains on the EMS as long as there remain major divergences in policy and performance. Yet it is a fair observation that the EMS has successfully weathered these strains since its inception in 1979.

The instability of interest rates in the United States has contributed to the instability of world exchange rates. We in the United Kingdom have been affected in much the same way as other European countries. We have had to pay closer regard to our exchange rate. Though a member of the Economic Community, we have stood as spectators —benevolent spectators—of the exchange rate mechanism of the EMS. But our philosophy and practice have, I think, become appreciably closer to your own philosophy and practice.

All our countries have sought to control the rate of expansion of money, and, with this in view, to control government deficits. But recession has resulted in greater recourse to bank lending. Banking systems in Europe have thus been called upon to intermediate more, even in those countries where securities markets have not played a significant role in financing industry. This development of the scale of banking activities has been taking place during a period of institutional change in the financial system: for example, in my own country the banks are actively seeking to extend their share of certain markets. This expanded intermediary role naturally creates new problems for the banks; and it is important for the sake of our economies in general that the banks carry out their responsibilities in the present situation with prudence and understanding.

Banking in a recession

In developing my observations on the present role of the banks, it is of course their position in my own country that will be in the forefront of my mind. While I feel confident that there are many parallels with your situation, I must leave it to you to apply the morals to your own circumstances. There are certainly parallels between the greater role of the banks in financing domestic industry and their greater role in financing international deficits. Later in what I have to say I shall go on to comment on some of these parallels.

In particular, despite obvious differences, there is, I suspect, a measure of similarity in the problems now faced by German and British banks in their dealings with industry. It needs to be recognised that, if the opportunities thus presented are wisely seized, the banks can make a contribution to the structural adjustments which are needed in both economies.

As one result of their increased financing role, banks are now more often involved in questions of the survival or otherwise of corporate customers than has been the case for a long time. In my own country, the dependence of the corporate sector on the banking system increased over the whole of the past decade as the high nominal interest rates associated in particular with inflation in this period have made companies unwilling to borrow on a fixed-rate basis through the bond market. More recently, dependence on the banks has been intensified by the depth and duration of the present recession. With lower output and capacity utilisation, internally generated funds have been reduced. Pressures have been increased by the doubling of oil prices in the course of 1979, with very little subsequent easing. It is probably these factors that have most frequently led to requests for exceptional facilities or support from bankers, and I understand this to have been the case in Germany as well as in my own country; though no doubt there are some differences in the situations.

Increased dependence on the banks for finance in these circumstances must clearly involve more challenging judgments for the banks themselves. It will not usually be difficult for them to establish that the financial strains of a corporate customer were caused by one, or a combination, of the factors that I have just mentioned. What is much more difficult for them is to determine whether and how far recession or high nominal interest rates may have brought to a critical point a process of erosion that had been going on for some time, as a result, perhaps, of management weakness or failure to keep abreast of developing markets.

In responding to a corporate customer seeking exceptional financial support, the banker has to decide whether the difficulties are largely transient, in the sense that they will ease when an upturn in demand comes or interest rates fall and some balance sheet restructuring has been achieved; or whether the problems are more fundamental and likely to persist, at any rate unless new finance is accompanied by radical action of some kind. I am sure you will agree that where there is underlying management and structural weakness there is no ready-made strategy for corrective action. In some recent cases of major difficulty in the United Kingdom, restructuring has involved pruning of stocks and, often, of labour; changes in top management; closures of loss-making operations; even, on occasion, the disposal of some good businesses as a means of strengthening the financial position of the rest of a group. I am sure that this must have been your experience too in many cases.

There may well be an initial reluctance to contemplate radical action of this kind, but the banker or company that is not realistic and firm about corrective action will be acting neither in the interest of shareholders nor of the wider domestic economy. The criterion must be the prospect of restoring companies to sustained profitability. It is not, of course, any easier for a company's bankers to arrive at satisfactory answers than for its management—or indeed than for others with a stake in the outcome, such as Government. But, in my country at least, the current difficulties have substantially increased bankers' knowledge and understanding of their customers' business; and businessmen are now more conscious of the need to keep their bankers fully in the picture. This drawing together of banks and industry makes it less difficult for the banker, with the breadth of his experience of different industries to draw on, to make an assessment of what action is necessary to put a company in difficulties on the road to sustainable viability.

It is, of course, a hard fact that the only possible course may sometimes be receivership. We have seen in the United Kingdom a high rate of corporate failures in the last couple of years; banking support operations have not always prevented a receivership or liquidation, and it would be foolish to suggest that there were not companies whose difficulties were so great as to make continued reliance on greater borrowing an unrealistic course. The process of receivership may offer the best way of ensuring that the good parts of a business are kept in operation, albeit under different ownership. But the comforting feature of recent British experience is the extent to which companies have weathered the storm, through a combination of self-help and constructive help from their bankers.

Against the background of your own experience, it will come as no surprise to you that I regard it to be important that this closer relationship between banks and their corporate customers which has been established in the United Kingdom during a phase of exceptional difficulty should be built up and put to good use in the improved business environment which must surely come.

At the same time as their customers are making additional demands on the banks for loans, inflation is causing a gradual transformation of their own balance sheets. Capital ratios tend to be under pressure while profits are squeezed by greater competition, particularly in international banking, and also by increases in the cost of funds as depositors become more aware of inflation. Reduced profitability does not, however, in the present conjuncture march hand in hand with reduced risk. The recession increases bad debts and the provisions to be made against them. Banks are therefore facing business difficulties of their own at a time when the calls upon them by business in general both for financial support and constructive guidance have perhaps never been greater.

I have been talking of the problem cases among bankers' customers, but it is important to recognise that they are the exceptional cases, not the general rule. Alongside them have been many constructive developments, and I will mention two of them in the United Kingdom. The first is the substantial progress that has been made by very many companies in improving their efficiency and in streamlining their operations under the spur of financial pressure. Second, this has been a phase of exceptional innovation in banking, not only at the retail end, but in the very substantial increase in the array of facilities available to help small and medium-sized firms. There is an inevitable tendency for such positive developments to be obscured by the public focus on a handful of problem cases. But let us be mindful of the large progress being quietly made elsewhere.

International banking problems

I have already suggested that the increased domestic role of bank lending has its parallel in the increased international role of bank loans. And it is to the international scene that I now turn. There is wide and proper recognition that without the commercial banks' part in the recycling of surplus funds to deficit countries following the two oil shocks, the world economy would have been plunged into even graver difficulties than it has in fact experienced. Between 1973 and 1980 the outstanding stock of loans from commercial banks to developing countries increased by approaching $170 billion— thereby enabling those countries to maintain much higher levels of imports and economic activity than could otherwise have been sustained.

Taking a broad view, our economies have shown a more helpful and rational response to the second oil shock than to the first. Energy conservation and diversification measures have been taken more seriously, wage responses to the renewed inflationary shock have been more moderate, governments have accepted that there is no easy answer through reflation and have been more conscious of the need for fundamental economic adjustments. In some respects, however, the problems may now be greater than last time. This recession may be shallower, but recovery threatens to be slower. Inflationary expectations are proving stubborn indeed, and the tight monetary policies generally adopted to counter them have contributed, along with many other factors, to produce unprecedentedly high real interest rates, adding substantially to the burden of the less developed countries on whom the brunt of the deficits has increasingly fallen.

In the great majority of cases, international lending has not run into difficulties. But it is only prudent to be alert to the possibility of problems. If I concentrate on these, it is because there are, it appears to me, some things that can usefully be said. The exercise of forethought is not a demonstration of pessimism, but rather its necessary antidote.

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. A narrowly perceived action by one single bank can easily prove detrimental not only to its own longer-term interest, but also to the interests of the wider banking community. As in the domestic situation, there is no simple guiding rule in such circumstances, but each case must be judged on its individual merits.

It is clear, I think, and experience has shown, that an early reaction by the borrower to a deteriorating situation is of considerable importance in containing debt difficulties. The reasons are obvious. Adjustments to economic policies can be more easily and less painfully effected; and external finance will be more readily obtained if it is apparent that the debtor country is taking steps to improve its external position. It is highly desirable that lenders should be kept fully informed of such action as part of a continuous dialogue between borrowers and lenders. Borrowers, I suggest, must provide adequate information on which credit decisions can be based, and banks are entitled to ask for such information. If banks begin to have hesitations about continuing to provide additional finance, it is better for such views to be discussed with the borrower as soon as possible.

But borrowing countries are naturally and rightly reluctant to allow banks to become closely associated with their economic policy; and bankers for their part are reluctant to allow themselves to be drawn into this area. It is therefore important to realise that banks do not have, and cannot realistically aspire to, the same relationships with sovereign borrowers as they can have with their corporate customers. In particular, they clearly cannot be in a position to impose on sovereign states the adjustment programmes that may be necessary to maintain or restore creditworthiness. If these are needed, official international institutions must take the lead. Because of its unique position in the international financial system, the advice of the IMF carries special weight. It is, moreover, in a position to provide technical assistance which the debtor country may be reluctant to seek from its creditors, whether they be private banks or other governments.

I would like to suggest, however, that there is an analogy between the way in which relationships are developing between bankers and corporate customers, and between the IMF and sovereign borrowers. In both cases, the ideal is a relationship so close that difficulties can be identified, and tackled, before they become intractable. There is still a long way to go in this process. Too often an approach to the IMF for a drawing is delayed until the economic situation of a country has deteriorated beyond hope of speedy reversal, and only the possibility of a difficult and protracted cure remains.

There are cases where, to provide a breathing-space during which the cure can take effect, it may be necessary to negotiate a rescheduling of debt. Since 1973 there have been twenty-one countries which have had to enter into negotiations to reschedule their debt. As might be expected, given the increased debt outstanding and the higher costs of servicing, the pace has quickened recently, with nine of these countries seeking reschedulings since the beginning of 1980. You will be well aware of the special difficulties of Poland, which raise questions of the broadest political character which the events of the past thirty-six hours have brought to the very centre of our attention.

Thus far, the magnitude of rescheduled bank loans has not been such as to give rise to anxiety about the ability of the banking system to handle them. A more widespread difficulty could, however, arise if a failure to agree on a rescheduling were to lead to a default or moratorium which caused banks to react defensively towards other indebted countries, precipitating difficulties for them. I think the parallel here with the response of banks in the domestic situation is close. Banks must of course consider carefully whether the difficulties faced by a company—or a country—are transient, or whether in either case they reflect fundamental maladjustment or mismanagement. But banks do not withdraw support from a range of companies merely because one of them is in difficulty; nor should they do so from a range of countries, just because one may be forced to reschedule. It is important that we should be able to be confident that banks will exercise careful judgment in this respect, and will not act with less than the responsibility that should accompany the power they possess.

The debt difficulties of sovereign borrowers inevitably pose particular problems. The interests and responsibilities of the parties directly involved—creditor banks, creditor governments, the IMF, the debtor country—overlap, converge or diverge in complex ways. Creditor governments must necessarily pay regard to the political consequences of a course of action which seems appropriate to banks or to the IMF. Creditor banks may be concerned to secure speedier adjustment than is considered realistic by debtor governments, or even by the IMF. Again, creditor governments and the IMF may not wish to see any financial assistance which they provide used to service banking debt. Given that the banks involved with particular debtor countries are often numbered in their hundreds, and that the various creditor governments may well have interests which are far from identical, it is remarkable that reschedulings have not been more troublesome.

Rescheduling must never be an easy option; but there may well be a case for eliminating unnecessary complications or misconceptions. It must always be wise, I suggest, for the parties concerned to recognise, and be sensitive to, the ways in which their objectives and methods will differ. A willingness to compromise is essential. It must be wise, too, to recognise the need for effective communication between the parties and to work towards it. Communications between governments and the IMF are one thing—the channels of communication are well defined. But communication between banks of different nationality, between banks and the IMF, and between banks and creditor or debtor governments is more difficult—even the channels of communication are unclear. There may be need for all concerned to give thought to ways in which present arrangements—or lack of them—can be improved.

Communication between the very large number of banks of different nationalities might seem to present the most awkward problems; the banks are more accustomed to competing with each other than they are to co-ordination. Yet in cases of debt difficulty, it is vital that banks should share information and consult closely before taking any action. Banks by now have a good deal of experience of rescheduling situations and have usually set up a task force or 'lead group' of banks to conduct negotiations both between creditor banks themselves and with debtor countries. This type of arrangement has proved its flexibility and effectiveness.

Bankers, I have suggested, are coming to terms with the complex, and somewhat unfamiliar, issues which they have to face when operating in recessionary conditions, and when, additionally, important structural changes are necessary both within economies and in the world at large. I have tried to show how, within both the domestic and international contexts, they are faced with difficult judgments affecting the balance of their short-term and longer-term interests. Needless to say, the way they exercise such judgments is a matter of central concern to their supervisory authorities. Having been a commercial banker myself before I became, *inter alia,* a supervisor, I am well aware of the narrowness of the path that bankers have to tread: if you stray to one side, you may be exposed to public criticism for unimaginative conservatism, and if to the other, to private criticism by supervisory authorities for imprudent banking practice. In the last analysis, however, it must be remembered that without a sound banking system, there is no way that domestic and international customers can be helped to adapt to present conditions.

In developing my thoughts tonight I have concentrated on some difficulties bankers face in a time of recession; and concentration on difficulties can all too easily lead to loss of proportion and a feeling that we cannot be master of our own destinies. I hope that what I have said has left no doubt about my conviction that the challenges faced by our bankers can be, and are being, met. What bankers can do, however, is only a part, albeit an important part, of what needs to be done on the wider European stage.

I began my remarks by discussing the condition of Europe as it appears to others—the verdict of some of those in the New World being not entirely favourable to, or optimistic for, the Old World which is Europe. As I have suggested, it may be difficult to defend ourselves against some of the charges made; and certainly the high expectations of continuous economic growth and high confidence that our economies could be easily regulated by delicate adjustment of fiscal and monetary instruments, which were common not so many years ago, have been disappointed. But we have no reason to falter or despair because of the challenges which we Europeans, as older democracies and maturer economies, are now the first to face. The achievements of European civilisation, of which we are justly proud and which the New Worlds rightly acknowledge, were wrought, we should not forget, in circumstances of political and religious strife and military confrontation. The unity of modern Europe, which the Community represents, is a relatively new creation, and it is hardly surprising that it should have accompanying birth pangs. But the instruments for political and economic co-operation, both within the European context and more widely, are more highly developed and more intensively used than they ever have been before. What would be surprising—and indeed a matter for reproach—would be that a united Europe should not be capable of rising to the challenges with which it is confronted.