International banking in turbulent times: some lessons from recent experience

*The **Governor** reviews[1] events of the last six months on the international banking scene and notes:*

- *The most important and heartening aspect of the response to the recent debt problems has been the way borrowers, the IMF, governments, central banks and commercial banks have quickly and informally concerted arrangements for mobilising assistance.*

- *In responding to critical situations, changes have occurred in international banking practices: some will prove temporary responses; others offer lessons of lasting value.*

Tonight is the last time that I shall rise as Governor to address the distinguished gathering of bankers that each year assembles here in the Guildhall for the Overseas Bankers Club banquet. It is hard to resist a moment's backward glance to the first time I spoke on this occasion, early in 1975, and, in doing so, impossible to escape a feeling somewhat akin to *déjà vu.* As we negotiate the way forward through the difficult and painful transitional phase while economies adjust to lower inflation, the prospect sometimes looks daunting. But so it did nearly ten years ago when we faced in short order the first oil shock, the secondary banking crisis at home and the collapse of Herstatt.

Those events of a decade ago are at once remote and yet evoke resonances today. In 1975 I put before you three main problems. First, the consequences of the quintupling of oil prices. Today it is the consequences of a lower oil price that we seek to evaluate. Second, the problem of recycling OPEC surpluses. Today the surpluses are no more, with OPEC countries having become net takers from the international banking system since late 1981, but the balance of payments deficits and inherited indebtedness of the developing countries remain a key preoccupation. Third, I mentioned then the weakening in the economies of the industrial countries. Today our central and most pressing preoccupation remains the weakness of our economies and how to restore growth without rekindling inflation.

Origins of our present situation

It is among these problems of the past decade that we can find the origins of our present financial situation. On the international side the difficulties came suddenly to a head last August, but financial strains had been growing for some time. Some countries had been finding their burden of debt increasingly hard to service in the harsh environment of world recession and high interest rates. New credit commitments then began to slow.

Following the first oil shock, there was general approval of the helpful role the banks played in the recycling of oil exporters' surplus funds to the importers of oil. The only qualification was that it was desirable for a larger proportion of financing to come from conditional financing through official sources, with its stress on policies to redress imbalances. In the event, the bulk of the financing was provided by the banks. This cushioned the shock, and borrowers were given the chance to respond more gradually to the sudden and dramatic change in their circumstances. Looking back after the second oil shock of 1979–80 and its consequences, we may now be able to conclude that the respective contributions of financing and of adjustment —especially given the stock of debt which had built up in the meantime—were not after all so appropriate. But it is right to remember that many of the assumptions shared by borrowers and lenders have been invalidated by the recent performance of the world economy in a way that few could or did fully anticipate. No one expected real interest rates to remain so high for so long. Most underestimated both the length and the depth of the recession.

In any event, to speculate how things might have been managed otherwise is less useful than examining our response to the present situation. As I am addressing an audience of practical bankers, I want tonight to focus particularly on the consequences for international banking of the events of the past six months. But we must of course bear in mind the close interplay of events in the financial world with those in the real economy and vice versa.

Concerted response to debt problems

I regard the most important and heartening aspect of the response to the debt problems of recent months to have been the way in which borrowers, the International Monetary Fund, governments, central banks and commercial banks have quickly and informally concerted arrangements for mobilising assistance. It is true that the

(1) In a speech to the Overseas Bankers Club on 8 February.

response has been pragmatic and ad hoc—it had to be; but it is noteworthy that the interdependence between these participants was so quickly recognised. Our achievement so far in containing the situation has hinged vitally on the willingness of each to perform its particular role. I want to say a few words about each in turn.

I start with the borrowers. The essential is that they should be willing to undertake the economic adjustment necessary to restore their creditworthiness. In most cases this means working out an economic programme with the IMF. This is an indispensable first step, and the earlier it is taken the better. The World Bank and other international lending agencies may also have a part to play.

Resources of international organisations

The role of the IMF is crucial. I take this opportunity of paying a high tribute both to the managing director, Jacques de Larosière, and to the staff of the Fund on the way they have responded to the challenge of recent difficulties—both in the onerous task of devising programmes with the borrowing countries, and in pressing to ensure that the Fund has, and will continue to have, sufficient resources to meet the financial requirements of members in difficulties.

This last is a key constituent part. I share President Duisenberg's hope that, at the meeting of the Interim Committee in Washington, agreement will be reached on the eighth quota review, providing a substantial increase in the resources of the Fund. As he pointed out, agreement has already been reached among the major industrialised countries that the resources available under the General Arrangements to Borrow (GAB) should virtually be tripled; and, more importantly perhaps, that funds obtained through the GAB may in future be lent not only to the lending participants, but also to non-participant countries if this is needed for the stability of the international monetary system.

In turning to the role of governments, you will perhaps permit me to remind you—and this is sometimes forgotten by commercial bankers naturally concerned that burdens should be equitably shared—that the resources of the IMF and other international financial institutions derive from public funds. The new resources likely to be available as a result of an increase in Fund quotas and the GAB will constitute a substantial new commitment of funds by governments.

Next, central banks have also been able to help. It is a feature of the liquidity crises that beset countries that they break very suddenly. A loss of confidence for whatever reason can stem the expected inflow of funds to a borrower and a haemorrhage of existing finance can seriously exacerbate the problem. There is almost inevitably a gap of weeks or months before confidence can be restored, normally through agreement on a carefully structured Fund programme, and funds begin to flow again. There may often therefore be a need for bridging finance, which can be supplied either by banks themselves, or by official bodies, or partly by one and partly by the other.

Over the past few months there have been occasions when it has seemed appropriate for the Bank for International Settlements to organise temporary support, generally with the backing of a number of central banks. This seems to me to have had a positive effect on confidence. There are, however, important limitations on the scope of BIS action which need to be understood and respected if it is to play such a role. The resources of the BIS are to a large extent the national reserves of central banks. This means that the BIS must maintain a high degree of liquidity. Its lending can thus only be of a short-term bridging nature, and there must be unambiguous terra firma at the other end of the bridge. Hence the importance of the availability of adequate and unencumbered collateral, or the clear promise of Fund or other resources from which the bridging loan can be repaid.

The contribution of bank supervisors

Central banks and other bank supervisory agencies also have a critical contribution to make in the exercise of their supervisory functions. International co-operation in this field has been greatly developed over the past decade, and important progress has been made in ensuring that banks throughout the world are adequately supervised and that supervisors apply so far as practicable a consistent and co-ordinated set of principles. As in all fields of international co-operation, there is always room for improvement. There is no inherent reason why it should be easier to obtain identity of views among supervisors of national banking systems which have evolved differently than among negotiators on questions of commercial, military or political co-operation. Nevertheless, under the auspices of the Basle Supervisors Committee and other supervisory groups worldwide, patient and largely unpublicised work continues to improve both the coverage and content of supervision. I believe that the fruits of that co-operation are making their contribution in the present difficult conjuncture. It remains of the utmost importance that the commercial banks of the world should be soundly based and soundly run if the fabric of the system is to be sustained in the years ahead.

An important concern of supervisors is to ensure that banks make proper provision in the form of sums set aside for the possible future inability of borrowers to repay debt when due. One aspect of this is the adequacy of provisioning in banks' accounts for rescheduled sovereign debt. This has naturally been a matter for discussion between central banks. It soon became clear that no across-the-board rules could be applied: accounting practices and conventions vary too much from country to country, as do the circumstances of individual banks. It has, however, been recognised that where a country has adopted a programme of economic adjustment under IMF auspices, it is not inconsistent for banks to grant new lending to it while at the same time making provision in their accounts against part of their outstanding claims on that country, to recognise that the quality of those assets has deteriorated. In the right circumstances additional lending can be a justifiable and prudent way of seeking to improve their quality in the longer term.

Responsibilities of the banking community

On bank lending as a whole, there would, I think, be general assent to two propositions suggested by President Duisenberg. First, that, given the state of the world economy, the rate of increase of international bank lending reached by 1981 had become unsustainable. And second, that, given borrowers' reliance on capital inflows, too precipitate a reduction in the international lending of banks would generate an insupportable burden of adjustment. Figures for international lending in 1982 endorse the first proposition. The commercial banking system's constructive response in the last six months in the problem country cases bears witness to the acceptance of the second.

This response has not come without effort. In the first place there was the sheer problem of communication given the numbers of banks involved. The establishment of advisory or liaison groups of banks to deal with each separate case has obviously been a great organisational help. The commitment of time and management and other resources in the wider interest by the relatively small group of banks most heavily engaged has been commendable. I welcome too the decision to create the Institute of International Finance. This should be helpful as a focus for the gathering, analysis and dissemination of information which should benefit borrowing countries and lenders alike.

As well as the organisational challenge, there has been a need to change attitudes of mind. What has been required is a shared recognition that the participation of commercial banks in international lending involves responsibilities which the banking community as a whole cannot avoid. The leading central banks quickly realised that rescue packages could succeed only if implemented as a whole and if the burden was seen to be widely spread. Given the importance of London as a major financial centre, it has fallen naturally to the Bank of England to play a prominent role in the process of co-ordination and encouragement. This we have willingly done.

I will illustrate the nature of the problems, and our own involvement, by reference to the inter-bank market. The foreign branches of banks from some countries in difficulty had taken very substantial short-term deposits from other banks and largely lent them back at longer term to their home countries. These short-term deposits were so large that any significant withdrawal of them would have jeopardised the whole package of support facilities. Moreover, if some banks succeeded in reducing their exposure, others would be strongly tempted to follow suit.

In order to help the banks obtain a better appreciation of the situation as a whole we felt it right to let the market know that we regarded maintenance of exposure to these branches as very desirable given the needs of the moment. Parallel action was taken by our American counterparts in New York. The final decision on how to respond to the situation has been one for the bankers themselves, our part having been to ensure that they were aware of the broader considerations. Their response has been positive.

Adjustments by borrowers require time

In assessing where we are at the moment, we are right, I think, to take comfort from what has been achieved over the past six months, but it has been emergency management aimed at fighting fires. The necessary adjustments by the borrowers require a longer time perspective; and it is right to recognise that, for them, it will be a difficult road. There are, however, various developments in the world economy that could help them.

One most helpful factor would clearly be a lower level of world interest rates. Here as always the prospects remain uncertain, depending as we all know on many factors, most notably in the United States. But it would be wrong not to hope that we will in fact achieve a lower level of rates, given the progress being made generally in reducing inflation.

Another positive factor could be lower oil prices. While a fall in oil prices could aggravate certain countries' existing debt problems, a reasonable reduction to a lower but stable level would plainly be beneficial to most developing countries. More generally, it should be beneficial to the world outlook for inflation and growth.

A revival of demand for their products in world markets, fed by a resumption of growth in industrial countries, would be equally important for developing countries. World economic recovery has been long delayed. But it is not unreasonable to hope that with continuing success in reducing inflationary expectations in the United States and other industrial countries, the general line of policy will help to restore growth.

Such developments could greatly ease the borrowing countries' present severe problems of adjustment; and assist the return to a more normal structure of financing. Their deficits need to be reduced to levels that can be financed on a sustainable basis, rather than, as at present, requiring emergency actions.

Some lessons for the future

Though we are still very close to the developments of the last six months, I think it is useful, and not altogether premature, to seek to distil some of the lessons we should learn for the future. For what we think the lessons are will affect the future that we must build.

In the course of responding to critical situations, the roles played by the various actors in the drama have led them to develop new and unfamiliar relationships, both within their own groups and between groups. Some of these developments have been vitally necessary in the circumstances we have had to face, but may prove only temporary. Other developments should survive the ending of emergency conditions or be further built on—just as the development and extension of international supervisory co-operation has long outlasted the initial effects of the Herstatt affair which provided the original stimulus. I would certainly place in this latter category the new mechanisms for co-operation and exchange of information within the banking community itself.

But in thinking of the role of banks in future, there are clearly questions as to the scale of the role they can be expected to play. Looking to the further future, a better balance will, I suggest, need to be struck between the volumes of flows supplied by the commercial banking system, and those coming from other private sources and through official channels which will have to play a relatively larger role.

In looking ahead to more normal conditions, it is also, I think, plain that neither banks nor central banks should come to consider it part of the ordinary working of the market for the authorities to play as direct a role as has recently been necessary in the search for solutions to current debt difficulties. Nor, I think, should it be the natural order of things that the programmes of the IMF have to be made strictly conditional on firm commitments by banks to provide specific amounts of new money.

Nevertheless, the closer contact which has recently come about between the banks and the IMF has a lasting value. From the point of view of the Fund, it must be right and natural that, in devising programmes for countries in balance of payments deficit, it should have some sense of the amount of private finance likely to be available. And from the point of view of the banks, their lending plainly needs to pay more regard to how far such countries are committed to economic programmes likely to restore reasonable economic performance.

We have a duty and a self-interest to ensure that the valuable lessons about co-operation and co-ordinated response that have emerged from our present bout of travail are well learned and retained for the future.