International debt problems — a progress report

*The **Deputy Governor** discusses[(1)] international debt difficulties and measures to deal with them. He focuses his remarks on three themes:*

- *How banks may best by individual effort ensure that they survive and prosper in the difficult environment they face.*
- *How they may best ensure that this environment is as benign as possible by self-interested collaboration with each other, with the central banks and with the international institutions.*
- *What they may expect from the development of the world economy and the policies of governments.*

Capitalisation and profits

Let me begin with what banks can and should do to strengthen themselves. Take first the question of capital adequacy, on which much attention has been focused as appreciation has grown of the risks of international lending. It is clear that international business is only one part of a bank's overall balance sheet and cannot be looked at on its own in this respect. Capital is a general resource available to a bank to meet any loan losses, whether they arise in domestic business or in international. There is general appreciation, I think, that there has been an erosion of capital adequacy in the banking systems in many countries in the past; and that this trend cannot be allowed to continue—especially at a time when the quality of many banks' assets has fallen as a result of the deterioration in economic conditions. Many banks are now making successful efforts—in part, at the instigation of their supervisors—to halt or reverse this decline. The recovery in banks' share prices in the principal stock exchanges in recent months and the increased number of capital issues which have been made recently may owe something to these efforts.

The issue of capital adequacy must, of course, be related to profitability: healthy profits are important not only to build up capital, but also to form the first defence against loan losses. It has been argued that banks have been making too much money out of reschedulings and debt problems: instead of exacting fees and higher spreads from borrowers, the argument goes, they should be paying for their mistakes. But it is not, I think, generally the case that the return now being earned by banks on rescheduled loans is excessive. There are in fact some cases where the margin on the new or rescheduled lending is scarcely higher than that already being paid at the start of last year. In others, the margin is certainly significantly higher than it was previously. But a higher margin may be appropriate in order to reflect the greater risks attaching to a bank's assets in current circumstances—risks not foreseen when the loans which have been rescheduled were originally negotiated. With rescheduled or new loans the banks still bear the risks; and they should earn a return sufficient to remunerate the capital resources needed to support that lending and build up an adequate cushion of reserves.

An issue is often made of the extent to which banks ought to give depositors the added protection which would accrue from retained earnings rather than use their profits to make dividend payments. But this is to take too limited a view of how banks' resources may be restored to adequacy. Historic performance of both dividends and profits affect the success of a capital issue; and each bank's management must strike a balance in dividend policy between their need to build up resources from profits and the adequacy of their distributions to shareholders. The primary concern—both of the bank itself and of its supervisors—is that the total resources available to it should be maintained at a level which preserves its reputation for prudent management. How a bank elects to meet this objective is a less important question.

Some remarks made on these questions by Mr Peter Cooke last November were interpreted by some observers in much too narrow a way. The actions of the major British banks have, in our view, been reasonable in taking account of these broader considerations. If I may be forgiven in this international gathering for making a national point, perhaps I can quote some striking and illustrative figures for the four major British clearing banks in respect of 1982. Their total dividend payments amounted to £235 million compared with retained profit added to reserves of £880 million and a total charge for provisions of almost £1,000 million.

The appropriate mix of profits, provisions and distributions can enhance a bank's ability to raise more capital from the market. We have seen this over the past year—even in the difficult circumstances pertaining—in the case both of British banks and, quite strikingly, a number of the major American banks.

(1) In a speech at the Financial Times annual lunch for representatives of foreign banks in London on 11 May.

Collaboration

While there is much that an individual bank can do by itself to improve its position, there are in present circumstances strict limits to the efficacy of solely self-regarding acts. This is particularly true of efforts to reduce lending exposure. It may be readily admitted that for many banks engaged in international lending the distribution of their assets, built in yesterday's sunshine, is not what they would choose with the barometer standing where it does today. But in these questions hindsight is not merely useless: it is dangerous. We are where we are; and attempts by these banks to move somewhere else before the general situation permits will bring trouble for all of us.

For some other bankers here, and notably those who had restrained their international lending in the past, the present situation provides an excellent example of the central moral precept of the great German philosopher Immanuel Kant. 'Do only' he said (I translate rather freely), 'what would be right if everyone did the same'.

These considerations are particularly relevant to the interbank market and its role in international lending. Concern is frequently expressed that short-term interbank funding has been inappropriately used and that interbank linkages have increased the vulnerability of the banking system to shocks.

With regard to the former, it now seems clear that some banks have not always taken full account of the risks to which they were—through the interbank market—exposing themselves. The market has therefore been a particularly easy source of funds for some banks who were engaged in final lending with an excessive geographical concentration of exposure. The same volume of funds could have proved considerably more difficult for them to raise from non-bank sources, and to that extent the criticism of 'easy money' may be valid.

In the longer term, we may want to work towards a position in which borrowers are less dependent on shorter maturities and in particular interbank deposits; but this cannot be achieved quickly. Interbank lines have become an important part of some borrowers' financing structure, which is why it is often vital that such exposure be maintained—at least until alternative funding sources have been provided. For the time being, maintenance of interbank lines is a crucial part of the burden sharing which has contributed to the stabilisation of the situation in the last six months. In the longer term, it should prove beneficial that recent difficulties have focused attention on the importance of the proper assessment of risks in the interbank market and more widely.

Turning to the potential vulnerability of the banking system arising out of interbank linkages, the likelihood that default by a single bank on its interbank debt would lead in itself to the insolvency of another bank is surely small. Banks set limits on their lending to individual banks in the market to prevent such a possibility; and it would only be a very imprudent bank which had an exposure to another institution in the market large enough to absorb more than a small part of its capital in the event of default.

Nevertheless, we have seen in the past that reactions are not always measured, or even completely rational, and one must reckon with the possibility that, in the absence of care and responsibility, the effects of a loss of confidence could spread from one bank to another. Many banks might then be affected at once. Though this could happen in the absence of an interbank market, the effects of such 'contagion' would be worsened by dependence on interbank deposits, if banks should misguidedly all react to developments in the same way. This is one of the reasons for the substantial efforts that have been made, and are continuing to be made, to maintain the market's integrity.

We in the United Kingdom saw at first hand, in the secondary banking crisis of 1973–74, the effects of contagion at work in the UK banking system through the close connecting links within sterling wholesale markets. I need no persuading that strenuous collaborative efforts between central and commercial banks have been justified in avoiding any such development in the international interbank market.

The world environment

So much for what banks must do for themselves and for what they can do in collaboration with the central banks. I turn thirdly to the world economy and developments largely beyond the control of the banking system. Important though it is that adequate international financing is secured and maintained, the solution to our difficulties can in the end be found only in developments in the real economy: that is by adequate sustainable and non-inflationary growth in the industrialised world, and by appropriate adjustment by the debtors.

Looking back at what I said to you on this subject last year, when most forecasts—wrongly as it turned out—were predicting some imminent revival of activity, I find that much of it might still appear to apply today. The latest assessments again point to a revival—albeit fairly modest—beginning this year and continuing through next. Within this, the main strength this year seems likely to come from the United States; prospects in Europe look less encouraging. In 1984, the pattern may be more balanced. On average, GNP may be growing at 2%–3% per annum. Outside the major countries, however, weak export prospects allied with severe financing pressures seem likely to force continuing retrenchment in the non-oil less developed countries and also now in OPEC. Overall, these countries' imports may fall in 1983.

In assessing the likelihood that this year's expectations will be fulfilled, it is useful to consider why last year's expectations were disappointed. Analysis in the Bank of England suggests that the main reason was an unexpectedly severe cutback in companies' spending on fixed assets and stocks, and a widespread shake-out of labour, together aimed at maintaining companies' financial positions in the

face of high real interest rates, severe liquidity pressures and a general erosion of confidence. Falling employment had the further result that, despite increases in real earnings per head of the employed labour force, total real personal disposable incomes in the main industrial countries hardly rose at all over the year.

The very harshness of these cutbacks may paradoxically now give some reason for cautious optimism. If financial adjustment in the private sectors of the industrialised countries is now nearing completion, then there is some reason to hope that world economic recovery, led by private sector expenditure on consumer goods, fixed investment and stocks, may continue rather than falter as it did last year.

Further encouragement can be drawn from developments in the oil market. The lower oil price will help to reduce inflation and should help to support a revival in activity. Inflation in the major economies has already come down substantially—it is at present below 3 per cent at an annual rate on a three-month measure, compared with a little over 6 per cent in the last quarter of 1982. In the three largest economies (United States, Germany and Japan) inflation has been close to zero on this basis—and though interest rates have so far not fully reflected the reduction in inflation, we can hope that the benefits will be seen in due course.

Adjustment by debtor countries

While debt problems are likely to be eased by world recovery, lower oil prices and any easing of interest rates if that occurs, it is essential that debtor countries pursue properly structured adjustment programmes. This will ensure both that the confidence of lenders is not further weakened and also that borrowers will be better able to service their debts in the future. Adjustment will take time. Even countries following firm IMF programmes will require some further financing. It is also important to ensure that the adjustments which are made are not simply temporary measures which fail to tackle the major structural problems underlying these countries' shortages of foreign exchange—for without this the breathing space which has been afforded will not have been used to good effect. For the major debtors it is vital that their domestic economies are placed on a sounder footing, by continuing to direct investment to productive uses and by correcting the distortions which have contributed to their difficulties.

What effects may we see in the international capital markets? The lower oil price will obviously worsen the aggregate OPEC current account position and doubtless increase the extent to which some OPEC countries run down their deposits in the euromarkets. But fears, which one sometimes hears expressed, that this will lead to a shortage of liquidity seem misplaced. Individual banks may find that the need to attract funds presents them with some transitional difficulties, as they may need to adjust their pattern of funding; and, to the extent that OPEC deposits were obtained relatively cheaply because of OPEC asset preferences, the changes in location of surplus sectors may slightly increase the cost of funds to the banking system as a whole. But these effects are likely to be marginal. OPEC countries have for over two years now been net takers from the euromarkets and the OPEC share of euromarket deposits has been declining. It is now below 15 per cent while the share of other areas, notably the United States, is rising.

The outlook for trade is an important factor in the sustainability and success of these adjustment programmes. For this reason alone we must avoid resorting to protectionist measures. Protectionism would hold back the healthy export growth that is essential for many of the developing countries to continue to manage their debt servicing, and for the viability of their economic programmes— including those agreed with the IMF. Such export growth should be achievable if world trade revives and markets start to expand again at something like their historic rates, but if we start adopting protectionist measures to restrict these markets, financial burdens for a number of countries may become insupportable.

Conclusions

It is time to draw my various themes together. There is no doubt that we are in difficult waters and are bound to remain so for some time to come. Sound economic recovery, on which all else depends, is not yet firmly assured, though the signs are better than they were even three months ago. Serious adjustment programmes by debtor countries, equally important for a satisfactory outcome, will often prove socially and politically difficult to achieve. Here too there are many question-marks but a start has been made. In the middle are the financial institutions —the commercial banks, the central banks, and the official international bodies—who all face risks both in doing too much and in doing too little.

Some observers are uneasy about the close—but unsystematic and one might almost say untidy—degree of collaboration between the banks themselves, the central banks and the international bodies that has developed since last summer. Those who feel this way divide into two camps: those who believe that the authorities should stand back and leave the markets to sort matters out; and those who believe on the contrary that it is necessary for the authorities to develop articulated and generalised rescue schemes which would, under certain conditions restructure some of the debt and remove it from the banking system.

I have already given my reasons for believing that the authorities cannot responsibly expose the international financial system to the kinds of risk that might be involved in a generalised 'hands off' policy. But I am equally unattracted by the idea of a fully 'hands on' policy whereby the authorities would move into the centre of the network of international bank lending and build a new debt structure.

This is not because I would deny that the present and prospective patterns and totals of sovereign lending raise

major policy issues. I would certainly hope and expect that important changes—for example in the relative proportions of official and private lending—will occur in the years ahead. And it is certainly right that in all the individual programmes and collaborations in which we engage, we should have our eyes open to the longer run implications of our actions; and be mindful of the way we wish to see the international economy and its financing evolve. But 'evolve' must surely be the word. Evolution can carry a system or organisation quite as far as revolution—not quite as fast perhaps, but with much less risk of moves in the wrong direction.

Perhaps the most important thing we have learned from the upheavals of recent years is the importance of the learning process itself. Time and again in the past ten years we have seen potentially brittle situations rendered flexible by the application of patience, effort and thought: thought which is no less hard and deep for being addressed to the immediate situation rather than to the creation of a new system.