# International debt—thinking about the longer term

*The **Governor** looks at measures which might relieve problems in the longer term.*[1] *He argues that:*

- *capital flows which do not add to the developing countries' burden of debt, particularly inward direct investment, could usefully make a greater contribution to financing needs;*
- *banks can continue to help by responding to successful adjustment measures taken by debtor countries by reducing spreads;*
- *banks could also help by lengthening maturity and grace periods to spread out debtors' servicing burdens—and by restructuring two or three years' debt at a time; and*
- *banks need to recognise in their balance sheets the deterioration that has occurred in the quality of certain assets.*

There has been a marked improvement in the performance of the world economy during the past year, especially in North America and Japan: indeed, activity has overall picked up faster than many had forecast. And there is general agreement that the gradual recovery in the industrialised countries will continue and become more broadly based.

Against this background, the day-to-day management of debt problems has become somewhat less difficult. This is a tribute to those bankers, particularly in the various Advisory Groups, who have worked so tirelessly over the last eighteen months to bring us to the present, rather more hopeful, position. We now, I suggest, have an opportunity and a responsibility to think more deeply about the longer term. There are no simple measures which will immediately transform the situation, but I would like to discuss a few proposals which might be of some benefit.

I will begin with the way in which borrowers meet their financing needs. The size of the external debt that they have already accumulated—and indeed are continuing to accumulate—as a result of their dependence on banking finance remains a problem, despite their various efforts at adjustment. In these circumstances, it seems to me that borrowers might usefully make more vigorous attempts to attract capital flows of a type which do not add to their stock of debt.

## Debtor countries might aim to diversify their sources of finance

Direct investment is perhaps the most important of such flows, even though its contribution to the financing of the deficits of the developing countries over the past decade has been only a quarter that of bank lending. Many developing countries have been unenthusiastic about inward direct investment, perhaps principally because—unlike bank borrowing—it involves a degree of direct control over domestic resources by foreign interests. But borrowing from banks is also not without its constraints, as in order to raise new loans borrowers need to follow policies which maintain or restore their creditworthiness.

By comparison with bank lending, direct investment has the special advantage that it is not simply a financial flow but can also encourage the dissemination of managerial and technical skills. In addition, unlike bank lending, there are no remaining financial obligations if a project should fail: there is a foreign exchange cost to the host country only when the investment is productive and profits are remitted abroad—and in these circumstances the project itself may well be generating or saving foreign exchange. Furthermore, if the project succeeds, the investor is likely to wish to maintain his investment, and not to repatriate it.

Perhaps the most helpful and successful investments yield mutual benefits in the form of real as much as financial flows, reflecting the enhanced output generated by the investment. Nevertheless, the ability to remit profits—which can be constrained by a general shortage of foreign exchange—remains important; and the ease of attracting capital in this form to finance new enterprises may therefore still be heavily dependent on the prospects for the host country's external financial position.

Foreign exchange shortages could discourage investors in the near term, and economic prospects will always be an important determinant of willingness to invest; but the removal of existing restrictions on foreign participation could help direct investment to make a greater contribution. It would, however, be unrealistic to expect direct investment to expand rapidly: its importance lies more in the growing contribution it could make to financing flows over the longer term.

(1) In a speech to the Overseas Bankers Club on 6 February.

## How the banks can help

I turn now to the potential contribution of creditors. In some of the latest packages to assist debtors there has been a narrowing of spreads; and while it would be premature to regard this as a full return of market forces, it is nevertheless a welcome indication that bankers are sensibly trying to reflect the progress that borrowers have made.

The possibility of more substantial interest relief as a means of reducing countries' debt servicing burdens has also been suggested. Unlike the narrowing of spreads, this would create many technical and prudential problems which would be awkward to resolve; and, more important, might represent a move away from normality rather than a return to it. In any case, I do not see where the necessary resources are to be found.

A more fruitful approach to alleviating the burdens may involve adjustment of the repayment period of the borrowed funds. Many countries which have borrowed heavily already have sizable debt servicing obligations in the years immediately ahead. It is clearly desirable that the terms of reschedulings and new money packages should take adequate account of the existing pattern of future repayment commitments: these may otherwise become so large as to interrupt the return to normality.

It may also be worth considering the merits of restructuring two or three years' debts at the same time, particularly where those debts fall due in the period covered by an IMF programme. This could reduce the burden of negotiation for both creditors and debtors and facilitate forward planning. It might also on occasion be a useful recognition of efforts made by a borrower, and a sign of support for adjustment measures taken.

Against this course it might be argued that, if taken too far, it could weaken the incentive for debtors to carry through their adjustment efforts. This is certainly a danger; but in those cases where debtors still need new money to continue their adjustment, a rescheduling covering several years would give them no cause to relax. It is, I suppose, possible that some banks may not wish to lengthen the assets shown in their balance sheets. But the term of the assets created would do no more than recognise, in a sensible and orderly way, a reality already with us.

## A sounder base needed for international finance

I have been discussing some ways in which debtor countries might be assisted in their efforts to regain creditworthiness and financial health. It is, however, clear that whatever else is done these countries will continue to require net new funds on a substantial scale from the world's commercial banks. This fact in turn has implications for the health of the international banking system, with which, of course, I am, as a central banker, particularly concerned.

The somewhat easier situation in which we now find ourselves should not obscure the continuing need to secure a sounder base for international payments flows; and the good judgement of bankers around the world will be an important element in the resolution of this problem. The recent arrangements may now have bought us some time, but that time must be used productively. International banks need to sustain and strengthen their capital resources. They also need to reflect appropriately the deterioration which has occurred in the quality of many of their assets. This calls for complementary action by banks with regard both to the soundness of their capital base and to the adequacy of their provisions. Bankers need to examine their balance sheets very carefully with these considerations in mind.

I am glad to see what I believe to be a growing tendency among bankers to share the strongly-held conviction of supervisory authorities, that the trend toward an erosion of the capital base of international banks over many years should at the minimum be arrested and, as and when possible, reversed. The recent rebuilding of capital ratios in some countries should be viewed as the beginning of this process, and not as its completion.

As for provisions, a different dimension has been introduced by the events of the past eighteen months. It has been necessary to find a way of grafting onto the traditional judgement process for assessing the quality of domestic commercial loans a procedure for assessing sovereign lending and also the extra dimension of risk associated with cross-border commercial lending to countries experiencing external payments difficulties. These processes inevitably involve imprecise and subjective judgements; while this kind of business is not of course in itself new, its scale and significance are, in current circumstances, novel factors.

Procedures and responsibility for these matters in different countries vary. Given the diversity of legal, accounting, fiscal and supervisory regimes, this is not surprising. At the same time, it seems to me right to encourage a more consistent approach among international banks towards the handling of similar risks. Bankers may be assisted in this through the work of organisations like the Institute of International Finance, and supervisory authorities are increasingly discussing these issues among themselves.

In this country it is a central principle, and one which is fully consistent with our view of the supervisor's role, that the primary responsibility for recognising and acting on any deterioration in the quality of a bank's assets rests with the individual bank itself. The bank's auditors have a responsibility to review and report on the directors' judgement. The supervisory authority has a duty to review banks' policies and to form its own judgement on the adequacy of those policies in the light of its assessment of the general situation and the particular overall condition of each individual bank. This is a regular part of our supervisory procedures. If a bank's response is considered to be inadequate, the supervisory authority should act to promote some strengthening of it.

Regulatory traditions vary considerably from country to country; but I believe that, in their approach to provisioning, the authorities in all the major countries would agree with the views I have just expressed. Nevertheless, it continues to be of the utmost importance that these principles are applied within overall policies and business plans for international banks which recognise that the international banking community has to play a continuing and important part in meeting international financing needs. It is in the interest of us all to sustain and promote healthy world trade and payments flows.

Perhaps I can summarise by stressing that we must not relax our efforts to secure the return to financial and economic health by the major debtors; but progress so far seems to be sufficiently robust for it to be sensible to consider the most appropriate choices for the longer term. We must build on what has already been achieved, to speed the gradual restoration of normal market relationships and, at the same time, reduce our vulnerability to any further difficulties which may lie ahead.