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THE WORLD ECONOMIC SITUATION AND ITS IMPACT ON BANKING

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

First Inter-American Bankers Convention

Key Biscayne, Florida

Saturday, July 31, 1976

SUMMARY

Latin American countries are benefiting from worldwide economic expansion. The upswing in the international business cycle, now well into its second year, seems solidly based and can be expected to continue at a moderate pace. Latin American countries are benefiting particularly from higher commodity prices. A good use of this welcome relief after a period of great pressure on their balances of payments would be to build up foreign exchange reserves and restrain the growth of foreign debt.

During the commodities boom of 1972-73, many countries further increased their resources by borrowing abroad. This intensified world inflation and caused countries to incur foreign debt that proved burdensome in the recession. Many Latin American countries have demonstrated a very satisfactory capacity to sustain such foreign debt. Their international credit standing has greatly improved compared to the 1960's and has helped them to weather the recession. A conservative policy stressing accumulation of reserves moderating the rise in debt would further strengthen their credit standing and help avoid a repetition of the events of 1972-73.

The banks have played an important role in financing many Latin American and other developing countries. They have recognized a credit capacity not previously honored adequately in the international markets. To continue this lending on a solid basis, improvement in data on debt outstanding would be desirable. This would usefully supplement broader data already being collected by the Federal Reserve.

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It is a real pleasure to have this opportunity to address a distinguished group of bankers from Latin American countries and from Florida on the subject of the world economic situation and its impact on banking.

World Situation and Outlook

The over-all economic situation, as you are well aware, is one of widespread gains in output and reduction of unemployment. Progress has also been made in reducing rates of inflation. But while the outlook for continued increases in economic activity is good, the outlook for price movements remains clouded. How long and how far the expansion can go will depend very decisively on how well inflation can be kept under control. But before I comment on what may be ahead, let me examine some of the events of the last few years. They furnish both an explanation of why we find ourselves in our present position, and a guideline for future policies if we want to avoid a repetition, perhaps on an even larger scale, of what has been the severest recession of the postwar era.

The roots of that recession go back, not only to the rise in oil prices, but to the preceding highly synchronized expansion in the world economy of 1972-73. It was a boom that, while it lasted, seemed to offer great gains particularly to Latin America and other developing countries. Prices of primary products rose sharply, aided by bad crops in some parts of the world. Investment in most developing countries was high, their rate of growth very satisfactory. During that time, the credit capacity of Latin American and other developing countries became increasingly recognized by large U.S. and other banks. Access to private international credit became possible to a range of countries and on a scale that had not been visualized earlier. The ensuing pro-cyclical borrowing by developing countries further intensified the boom they were experiencing. Fortunately, some part of the rapidly mounting foreign exchange receipts was employed to enlarge monetary reserves.

Then came the quadrupling of oil prices and soon thereafter the recession. The surplus which the oil-exporting countries generated for themselves, of the order of $65 billion in 1974, necessarily had to find its counterpart in deficits elsewhere in the world. The industrial and other developed countries went into a severe recession during 1974 which sharply reduced their imports. Raw material dropped sharply. In consequence, by 1975 the developed countries were able to avoid a substantial current account deficit in their balance of payments, although some among them had large deficits. The developing countries, and especially Latin America, on the other hand, maintained their imports by borrowing. As a result, a large part of the 1975 OPEC-induced deficit came to rest with the non-oil developing world.

The developing countries thus were able, for a while, to postpone adjustment to the new conditions created by the higher price of oil. Sooner or later such an adjustment would have to be made, however, in the form of higher exports or lower imports, signifying a reduced transfer of real resources to the non-oil developing world. The question is whether early or late adjustment is preferable.

In one sense postponement of the adjustment, through continued current account deficits and borrowing, has implied an evident advantage. It allows time for a reordering of priorities and a transition to the new situation. But, in another sense, it has implied a burden: the burden of a heavier debt which in part at least has reflected imports for consumption rather than for investment. Debt capacity has been used up with not very much to show for it.

Many countries began to move toward a policy of adjustment, however, as the limits to continued borrowing became increasingly visible. This process of adjustment, involving a more moderate rise in imports and of indebtedness and hence a smaller current account deficit, is now in progress in many parts of the developing world. It is being aided importantly by the mounting exports that recovery in the developed countries is calling forth. The nature and evolution of this upswing in the developed world will therefore be of great importance for Latin America and other developing areas.

The initial stage of that upswing has taken the form, very predominantly, of an inventory movement. During the decline, inventories were reduced drastically. The mere ending of this phase brought a substantial increase in demand for primary products as well as processed goods. In this sense, the inventory-oriented nature of recovery thus far has been a substantial advantage for primary producers.

The recovery of developed countries has, in its early phase, proceeded somewhat faster than was expected half a year ago or so. The countries of the OECD (Organization for Economic Cooperation and Development), which includes nearly all of the developed countries, experienced a rate of growth estimated at 6-1/2 per cent in the first two quarters of 1976. While most of the major countries showed very satisfactory rates of growth, the recovery of some of the smaller OECD countries thus far has been somewhat weaker.

Meanwhile, however, the inventory swing seems to have come to an end in the major countries. Inventories by and large have reached levels with which business, pursuing a conservative policy, seems to feel comfortable. Inventories will have to increase as production expands. But if the present spirit of caution -- which is observable certainly in the United States and which is much preferable to the speculative spirit of 1972-73 -- continues to prevail, inventories are not likely to move ahead of production. Further expansion of economic activity therefore depends on other forces taking over to provide momentum.

The most likely source of such a new impulse is an increase in investment. The same caution that businessmen are exhibiting in building their inventories seems to be present also, however, in their investment decisions. There are numerous indications, especially in the American economy, that business investment may soon rise substantially -- high liquidity, good profits, moderate interest rates, and the prospect of a continued growth in activity. But for the time being, excess capacity remains substantial and hence business seems to be prepared to go slow in expanding capacity.

Excess capacity is not large, however, in relation to the probable future needs of the American economy, and perhaps the same applies elsewhere. Excess capacity is high only with respect to the relatively low level at which the U.S. economy is still operating. Mounting investment activity in the United States, and probably in other industrial countries, therefore, seems likely at some future point.

In fact, there is some doubt whether, even with high rates of investment, the capacity of the United States can be expanded sufficiently and rapidly enough to avoid bottlenecks in the course of the expansion. Business capital spending has been very modest in the last couple of years. The labor force meanwhile has continued to expand. We could easily find ourselves in a situation in which the capacity of the U.S. economy might prove inadequate. Beyond that, we have increased the demand for investable resources by imposing upon the economy rules for protection of the environment, protection of health and safety of employees, and other socially desirable programs. A higher rate of investment than was normal in the past will therefore be required at least in the United States in order to maintain historic rates of growth. Under these conditions, the possibility of a capital shortage cannot be precluded as the U.S. economy moves back toward full employment. The ability of the United States to be a large net exporter of capital likewise appears less certain under these conditions.

All these considerations suggest that if we want a sustainable expansion leading back to full employment -- free of bottlenecks and speculative excesses -- a moderate rate of progress, such as we have experienced in the first half of 1976, will be desirable. That would give us the best hope of avoiding a resurgence of the inflation which made the end of the previous expansion inevitable.

Such an expansion would be consistent with a gradual move of the developed countries as a group toward a greater current account deficit. This would contrast with the normal current account surplus of these countries, but so long as the oil-exporting countries remain in surplus the corresponding deficit must be accepted somewhere in the oil-importing world. The United States has already moved significantly in the direction of a deficit, as our recovery rapidly has drawn in imports while exports advanced more slowly. Some industrial countries that have been running excessive deficits certainly will have to improve their positions. But the countries whose current account balances were relatively strong during the recession can afford some downward adjustments. Together with a reduction in the OPEC surplus -- which now seems to be leveling off at about $35 or $40 billion -- these balance-of-payments adjustments will give the developing countries room for improving their own international accounts.

If in the course of these developments inflation diminishes, or at least does not seriously accelerate, and if a moderately paced expansion also slows upward pressures on interest rates, one may hope that the wide swings in exchange rates of recent years may abate. But we should remember that many influences work upon exchange rates, and that in the long run exchange rate stability is not likely to be achieved without price stability.

Financing the Payment Deficits of Latin American Countries

One of the few gratifying aspects of the past recession has been the ability, so far, of many countries in Latin America and other developing areas to finance the import of goods and services and so cover the deficits in the current account of their balances of payments. This was made possible, in addition to a modest drawing on reserves relative to import volume, by the combined action of a variety of creditors: international agencies, individual governments, national and international bond markets, suppliers, and, very importantly, commercial banks. The rediscovery, on an important scale, of Latin American credit capacity began prior to the recession as I have already noted. This ability to borrow was well maintained throughout the recession.

The countries of Latin America were aided in this operation, in many instances, by the maintenance of their exchange reserves at or near previously reached high levels. They also proceeded sparingly in utilizing their upper credit tranche drawing rights on the International Monetary Fund. Some large debtors engaged in a careful scheduling of their obligations to avoid cash flow problems at nearby dates. Most developing countries were able to maintain their debt service ratios on longer term debt more or less unchanged from their levels in the early 1970's. All these circumstances suggest that borrowers and lenders were careful to avoid straining the borrowers' credit capacity.

Evidence of continued lender confidence can be found in the fact that during the first half of 1976 the volume of Latin American Eurocurrency syndications was only 12 per cent below the average of the first and second halves of 1975.

At the same time, we should not overlook certain negative factors. In 1974, lenders began to shorten significantly the maturities offered and to increase the spread over the basic cost of money. Since then, spreads have not contracted and maturities have lengthened only slightly. Foreign exchange reserves of non-oil LDCs as a group, while well maintained in absolute terms since the 1972-73 boom, have, of course, dropped substantially as a fraction of annual imports. The grace periods for amortization operative in many of the earlier loan agreements are beginning to expire. Interest rates on bank loans typically fluctuate with the London inter-bank rate and may not remain at the low level achieved in the first quarter of 1976.

The credit standing of sound borrowers would probably gain if more complete data could be made available by national authorities. The World Bank puts together data covering the medium- and long-term public and publicly guaranteed debt of developing countries. Based on World Bank tabulations for recent years and a rough estimate for 1975, it appears that the longer term public and guaranteed debt of Latin American countries rose from about $20 billion at the end of 1972 to nearly $35 billion at the end of 1974, and to over $40 billion by the end of 1975. Not included in this total is private debt not publicly guaranteed and all short-term debt. Presumably much of short-term debt is used to finance exports and imports and in that sense contains a self-liquidating element. Much unguaranteed private debt may be to subsidiaries of large foreign corporations. Thus this part of the total debt, not included in the IBRD figures, may not present particular credit problems. At a very rough estimate it may be assumed to be of the order of one-quarter to one-half of the long-term public and publicly guaranteed debt for which data are available. But this debt nevertheless weighs in the balance of payments and additional information would be helpful.

The question is sometimes asked how all this debt is going to be repaid. It should be noted that a going and growing concern, whether it is a firm or a country, does not necessarily have to reduce its debt as it grows. What it needs to do to maintain its credit is to keep its debt and its debt service in proper proportion to its rising debt service capacity. In the case of a country, debt service capacity is fundamentally based on exports and gross national product.

It would be demanding indeed to expect a country that, by virtue of its stage of development, is structurally predestined to be a net importer of capital, to engage in net debt repayment overnight. What such a country needs to do is to restrain its borrowing sufficiently to maintain its sound credit standing. That will enable it to continue borrowing even in difficult times. It will also enable the country to borrow in times of stronger competition for funds such as might arise if the expansion should put an end to the present widespread lull in the demand for bank credit in the industrial countries.

It has also been averred that today's financing by Latin American countries is likely to repeat the pattern of such financing in the 1920's and 1930's. During that earlier period, of course, a flood of financing was followed by a flood of defaults. But the differences between THEN and NOW are striking. The loans of the 1920's consisted for the most part of bond issues, with no continuing relationship between borrower and banker. When difficulties arose, it was nearly impossible to round up the bond holders to negotiate with them. Today, private credit is given largely by banks which continue to hold these loans and to monitor the performance of the debtor.

In the 1930's the depression cut both exports and prices. Lending to developing countries stopped altogether. Industrial countries imposed trade restrictions, devalued their currencies, controlled foreign exchange. International trade shrank dramatically. Now, trade on the whole has been well maintained and again is expanding at an annual rate of 10 per cent or so. Industrial countries have learned to maintain economic activity by domestic expansionary action instead of by beggar-thy-neighbor policies. Trade and payments restrictions have been largely avoided. There has been very little competitive depreciation.

Finally, during the 1930's an effort was made to maintain fixed exchange rates, and controls of trade and payments were largely instruments to that end. Today, floating exchange rates make recourse to such devices unnecessary. For all these reasons, the maintenance of international lending and international debt service is buttressed more firmly than it was during the 1930's.

The Role of the Banks

In the total financing of developing countries, the banks have played a particularly effective role. American banks in particular have been active, and a substantial part of their activity has focused on Latin American countries. Recently, information on their activity has been greatly improved by publication of new data on lending by foreign branches. (Lending to Latin American countries from head offices and foreign branches of U.S. banks and from foreign banks in the U.S. is presented in Table 1.) With the help of the new data it becomes apparent that, as of March 1976, American banks had loaned $42.2 billion to non-oil developing countries, of which $29.3 billion was to non-oil Latin America. Comparable full data on the lending of banks of other countries are not available, because data on branches of non-U.S. banks located in offshore financial centers are for the most part not available. Those we have show bank lending to all non-oil LDCs at $80.9 billion, as of March 1976, and to all of Latin America at $48.2 billion. It would be highly desirable to complete these data, which are presented in Table 2 for Latin American countries.

Concern has sometimes been voiced about the heavy involvement of American and other foreign banks in financing of developing countries. I have stated earlier reasons for believing that in general the borrowing policies of developing countries have been justifiable, although one cannot preclude that individual countries may confront problems. Bankers have every reason to study very carefully the "sovereign risk" represented by their foreign lending. It is my impression that this work is being done carefully and responsibly. But, as I have noted, more information would be desirable to permit a more thorough assessment of borrowers' condition.

At the present time, the flow of syndicated Eurocurrency lending to developing countries in general and to Latin America in particular seems to continue at a high level. Improvement in the position of many borrowing countries, as manifested in more intensive efforts to adjust deficits, in better export performance thanks to recovery abroad, and in a stabilization of the gross foreign exchange reserves for Latin America as a whole help to explain the continued flow of lending. Nevertheless, there are good reasons why borrowers should not allow a continued favorable climate to tempt them away from the path toward better adjustment of their balances of payments. I would like to close my remarks by focusing on the reasons for recommending a more conservative posture.

In the light of hindsight, it evidently was not wise, on the part of borrowers, to use their improved credit standing flowing from the commodity boom of 1972-73 to increase very substantially their indebtedness at that time. It would not be wise to repeat this performance now that commodity prices once more are rising. Fundamental adjustments to the higher price of oil still remain to be made in many cases. Borrowing to cover the cost of imports that in large part serve consumption is not a good policy. There is a need to build up exchange reserves and bring them back to a better relationship with imports.

Countries that maintain a strong credit rating are always likely to find credit available when they need it. Weaker risks, in an environment of mounting activity in the industrial countries, may find the availability of credit diminished and the cost increased. The shift of developed countries toward smaller surpluses or larger deficits should be used by Latin American countries to improve their own trade balances. An important opportunity for financial consolidation is at hand. To allow it to pass unused would indeed be unfortunate.

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Table 1

BANK CLAIMS ON SELECTED[a/] LATIN AMERICAN COUNTRIES[b/]

Reported by Head Offices and Foreign Branches of U.S. Banks
and U.S. Branches of Foreign Banks [c/] [d/]

Latin America	Millions of dollars		
	September 1975	December 1975	March 1976
Brazil	8,184	9,449	10,430
Mexico	8,780	9,238	10,504
Argentina	2,209	2,132	2,220
Peru	1,418	1,512	1,640
Colombia	1,434	1,298	1,199
Chile	655	563	550
Other Latin America	2,207	2,654	2,744
TOTAL	24,887	27,477	29,287

a/ Oil exporters, Ecuador and Venezuela, and offshore financial centers have been excluded.

b/ Loans guaranteed by the Export-Import Bank or by American parents of foreign subsidiaries have not been excluded.

c/ Includes Edge Act corporations and U.S. agencies and branches of foreign banks. As of December 31, 1975, major U.S. agencies and branches of foreign banks held about $1.7 billion in claims on these countries.

d/ There is a small amount of double counting caused by the fact that some of the claims reported by U.S. head offices and foreign branches are claims on branches in Latin America which in turn relend the funds to borrowers in the countries where they are located, and in doing so report claims on the countries involved.

Source: Board of Governors of the Federal Reserve System. The data are consolidated from U.S. Treasury monthly foreign exchange reports and from Federal Reserve quarterly reports on the geographical distribution of the assets and liabilities of major foreign branches of U.S. banks.

Table 2

EXTERNAL POSITIONS[a/] OF BANKS IN MAJOR COUNTRIES[b/]

(Amounts in millions of U.S. dollars)

End March 1976

Liabilities/assets vis-a-vis		Liabilities	Assets
Latin America			
Argentina	JU	2,107	3,187
Belize		11	--
Bolivia		88	167
Brazil	JU	4,049	15,837
Chile	JU	454	786
Colombia	JU	629	1,448
Costa Rica		38	192
Ecuador	J	145	291
El Salvador		47	112
Guatemala		59	123
Guyana		57	26
Honduras		49	104
Mexico	JU	3,334	14,599
Nicaragua		125	268
Paraguay		103	20
Peru	JU	429	2,477
Surinam		139	8
Uruguay	U	576	248
Venezuela	JU	6,029	2,959
Residual	HCJU	4,694	5,363
TOTAL		23,162	48,215

a/ External positions in domestic and foreign currency.

b/ The major countries are Switzerland and the Group of Ten countries: Belgium, France, Germany, Italy, Netherlands, Sweden, United Kingdom, Canada, Japan and the United States. In addition to U.S. head office data, data are also reported for the foreign branches of U.S. banks in the Bahamas, Cayman Islands, Panama, Hong Kong and Singapore.

Note: For liabilities and assets of banks in Canada, Japan, Switzerland and the United States, a full country breakdown is not available. Positions of banks in these countries have been allocated as indicated in the table by the following: H = Switzerland, C = Canada, J = Japan and U = United States. The liabilities of banks in the United States exclude U.S. Treasury bills and certificates held in custody by the banks on behalf of nonresidents.

Source: Monetary and Economic Department, Bank for International Settlement.