

**FOR RELEASE ON DELIVERY
THURSDAY, JANUARY 24, 1980
1:45 P.M. EST**

THE FUTURE ROLE OF THE COMMERCIAL BANKS

Remarks by

Henry C. Wallich

Member, Board of Governors of the Federal Reserve System

at the conference on

New Approaches and Techniques for Managing Country Risk

New York City

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I am happy to have this opportunity to address the seminar on managing country risk. The topic once more has become a timely one. Two-and-a-half years ago, some of us participated in a symposium on "financing and risk in developing countries," the organization of which, like that of the present seminar, also was in the capable hands of Steve Goodman.

Some of the problems that we have to discuss today are quite reminiscent of those of mid-1977. Curiously, however, this is in good part not because the problems have persisted, but because, after at least in some degree having gone away, they have now come back with a vengeance. By that I mean, of course, that in 1977 we were still concerned with the problems created by the oil price rises of 1973-74. One pressing issue was the allocation of OPEC-induced current account deficits. Should the deficits end up in the LDCs where the capital inflow might be most needed, or in the industrial countries that could best finance them? In the period following, the surplus of the OPEC nations largely vanished, a massive deficit appeared in the United States and disappeared again, and the developing countries continued to grow, thanks in large part to continued heavy bank borrowing. Now the OPEC surplus is back bigger

than ever. One factor, however I believe, has changed significantly: the ability of the banking system to handle the ensuing deficits on the terms and conditions to which the market had become accustomed in the meantime.

During the last two years or so until very recently, the market has become very much a borrower's market. Minimal spreads, a severely compressed differential among spreads for different borrowers, longer maturities, and the large size of loans all document this condition. There are several reasons why this situation is likely to change. They lie both on the side of the borrowers and of the banks. On the side of the borrowing LDCs there is, first, the higher burden of oil imports. This comes on top of an already visible increase in burden of debt relative to the ability to carry it. At the new level of oil prices, the oil import bill will absorb, on average, one-third of the export receipts of oil-importing LDCs in contrast to an earlier one-sixth. This leaves less available for debt service as well as for payment of other imports. It changes, in other words, the meaning of a given debt service ratio.

There is, second, the previous rise in the burden of debt. This rise is by no means spectacular, but neither can it continue to be overlooked. Aggregate foreign debts of non-oil LDCs approximately tripled in the five years from 1973 to 1978 and rose perhaps an additional 25 percent in 1979. These rough numbers ignore unrecorded short-term debt, which adds to the burden, as well as the growth of foreign exchange reserves, which reduces it. But the proportionate increase in the debt would hardly be much altered if these variables, which probably rose on roughly the same scale during the period, were taken more fully into account. Since oil-importing developing countries experienced substantial inflation in their

foreign trade prices -- perhaps 70 percent in export unit values and 80 percent in import unit values -- the increase in debt burden in real terms is a good deal less. What is more, the real interest rate paid by the average borrower was probably negative. LIBOR (London Inter-Bank Offer Rate) for 90-day dollar obligations averaged 7.9 percent over the years 1973-78, as against an average price increase of about 11.0 percent. Only in 1979, did LIBOR at 12.0 percent exceed a rise in the price of primary products (excluding oil) of 10.4 percentage points. Of course, the experience of some countries is bound to have differed from these averages. Because of these differences, the real interest rate, defined as the nominal interest rate minus the expected rate of inflation over the life of a loan, in an international context, is less meaningful than in a domestic context.

But despite negative real interest rates, the familiar debt ratios have tended to increase. From 1973 to 1978, the average ratio of gross debt to GNP rose from 17 to 23 percent, that of net debt (after deducting reserves) to GNP from 11 to 17 percent, and debt service requirements to total exports rose from 14 to 17 percent, for a group of 99 non-oil LDCs. Recognizing the wide variance of these ratios among countries, as well as great differences among countries in their ability to handle debt, and keeping in mind also the limitations of any form of ratio analysis, these data nevertheless signify some deterioration up to the end of 1978.

It is at this point in the story that the rising price of oil threatens to raise the deficit of non-oil LDCs from \$25 billion (including official transfers) in 1978 to perhaps \$50 billion (including official transfers) in 1980. To me, this suggests a different response to the problem of deficits than was widely adopted in 1973-74. If at that time the principle was to finance rather than adjust, today it may need to be reversed. Many developing countries will be well advised to stress balance-of-payments adjustment in preference to additional

financing. Some adjustments are already underway, as witness the devaluations in Brazil, Chile, and Korea. Such adjustments should be easier to make in today's environment than in 1974-75 because world economic activity is better maintained presently than it was then.

My main concern here today, however, is with the lenders rather than with the borrowers. How much of the borrowing of the developing countries will the bank be able and willing to handle? Outstanding claims on non-oil LDCs of all banks reporting to the BIS rose at an average rate of 23 percent per year from December 1975 through June 1979. Such a rate of growth exceeds, of course, the rate of overall credit expansion that can be sustained by any banking system not in the grip of galloping inflation.

For instance, total bank credit in the United States, over the same 3-1/2 years, grew at an average annual rate of 10.9 percent. Shifts in the composition of assets, implying faster growth of some and slower growth of other components are, of course, always going on and are indicative of the flexibility of the banking system; but as particular components, such as LDC loans, come to constitute an increasing share of the total, their growth necessarily must slow down. Thus, the rapid growth of LDC lending had some of the characteristics of the filling of a vacuum. Lenders, borrowers, and regulators all have an interest in seeing that this vacuum is not converted into a compression chamber. That is implicit in the dynamics of any growth pattern. In the case of bank lending to non-oil LDCs, it is the consequence also of particular limitations encountered by banks in terms of their risk exposure with respect to particular borrowers and their overall ratio of capital to assets.

U.S. banks already have substantially slowed their lending to developing countries. Between December 1975 and June 1979, their share in total international claims on non-oil LDCs of banks reporting to the BIS dropped from 54 percent to 38 percent. Their share in annual net new lending (after repayments) dropped from 46 percent (\$13 billion) to 15 percent (\$6 billion). The U.S. bank share in claims on oil-exporting countries dropped from 52 percent to 35 percent; their share in net new lending dropped from 58 percent to 5 percent.

The substantial slowing that has taken place in LDC lending by U.S. banks sometimes is overlooked when attention is focused on the geographic location of the lending office instead of on the nationality of its control. For example, U.S. balance of payments data on bank claims cover all banking institutions located in the United States, including the U.S. agencies and branches of foreign banks. Thus, while these data are useful for capital flow analysis, they do not necessarily reflect the office of the bank responsible for the lending decision, nor the country of the bank which bears the ultimate exposure to risk on a loan. Control of lending policy, as well as risk exposure, of course, runs to the bank's head office independently of the country in which the lending office happens to be located.

The slowing of LDC lending by U.S. banks no doubt reflects in part their often-voiced concern about the inadequacy of spreads on syndicated Eurocurrency credits. It reflects also the stronger demand for funds in the U.S. domestic market. Finally, it may reflect tightening monetary policy and rising interest rates in the United States as well as greater monetary ease in many foreign countries, although to the extent that

foreign banks make dollar loans, the volume of their lending is also influenced by U.S. monetary policies.

Capital ratios and LDC risk exposure of American banks may also be assumed to have played a role in their decision to slow LDC lending. The ratio of equity capital to total assets of the nine U.S. banks with the most international business, after improving from a low of 3.7 percent in 1974 to 4.3 percent in 1976, once more deteriorated to 3.9 percent by mid-1979. Bank earnings have been inadequate to keep bank capital growing in line with the inflation-driven volume of bank assets. Assuming a dividend payout of one-third, banks would have had to earn 18 percent on assets in order to keep up with the approximate 12 percent average growth of bank assets during the years 1976-78 if they are to rely almost exclusively on retentions. But new stock issues, which could relieve this situation, have been very difficult to make, given the very low price/earnings ratios characteristic of leading American banks. These reflect, in turn, the market's realization that the real value of bank capital and, therefore, bank earnings is reduced by a factor of about 3/4 of the going rate of inflation, making allowance for nonmonetary assets equal to only about 1/4 of capital that could protect that capital against inflation.

Foreign banks in many instances are less constrained by capital than are American banks and thus can accept lower spreads. In some countries, lower capital ratios than in the United States are characteristic of most banks. In some countries also, foreign banks receive better protection against inflation by a greater ownership of nonmonetary assets such as participations and real estate. Maintenance of capital ratios has been easier for such banks because a better inflation-protection

of earnings has permitted stock issues. In some countries, finally, banks are owned and backed by their government.

But it is probably in terms of risk exposure with respect to particular borrowing countries that U.S. banks have encountered some of their most obvious limitations. The in-house country limits set by banks, arrived at normally on the basis of careful country risk analysis, are, of course, fairly flexible. But banks nevertheless have to watch carefully their concentration ratios, which are monitored by means of the Federal Reserve - FDIC - Comptroller of the Currency's country risk evaluation system. These focus on the percentage of capital exposed to risk in each particular country. For most industrial countries, regulatory considerations are not particularly inhibiting. Exposures over 25 percent of capital funds in any such country are "listed" in examination reports, but usually no comment on such exposures is made. For most G-10 countries, lending by many U.S. banks exceeds 25 percent of capital.

For many LDCs, however, exposures even to most of the financially stronger borrowers, would be "listed" if the level exceeded 10 percent of capital funds, and exposures in excess of 15 percent receive special comment in the examination reports. The largest LDC borrowers would be subject to such comment in a number of U.S. banks. Comment does not necessarily imply that there is an inherent credit weakness, but is made to alert management to exposure levels. While banks are not prevented in any way from making loans to LDCs in excess of the comment level, a decision to raise exposure significantly is properly one to be taken in full awareness of the facts by senior management. Qualitative differences in exposure, as inherent for instance in the difference between short-term, trade-related credits and long-term, syndicated loans, are important.

If banks with exposures above the comment level wished to avoid an increase in these exposures, their lending could increase only in proportion to the growth of their capital, i.e., roughly on the order of 10 percent of present lending levels. For the group of banks having much the largest part of the loans to Brazil and Mexico, for instance, such an internal decision would mean an increase in loans to Brazil of about \$1.5 billion over the next year.

Broader participation in LDC lending by larger numbers of banks would help to make more flexible the supply of bank loans for LDCs. The reduction in the share of U.S. banks in this lending, accompanied by strong expansion, at least until recently, by banks of many other countries, represents one such form of diversification. However, within the confines of U.S. banks, there has been no broadening of participation in foreign lending generally. On the contrary, the share of the nine largest money center banks in loans to foreign banks and nonbanks remained virtually unchanged at 68.2 percent in December 1977 and 68.6 percent in June 1979. The share of these banks in loans to LDCs stood at 63.9 percent and 64.5 percent during the same period. Meanwhile, 15 regional banks reduced their share in total loans to foreigners from 17.4 percent to 16.5 percent while that in loans to LDCs remained constant at 18.7 percent. Other banks, accounting for relatively small amounts, reduced their share of lending to LDCs.

So far, the slower LDC lending by U.S. banks seems to have been compensated by more aggressive lending on the part of the banks of other countries. If the slower expansion of LDC lending by U.S. banks has continued since mid-1979, there would nevertheless be room in the

portfolios of banks in other countries or the obligations of creditworthy LDCs. Most of the large non-U.S. banks still appear to have a lower ratio of foreign assets to total assets than do large U.S. banks. They should be able therefore to accommodate a relative increase in foreign lending. It seems likely though, that lenders will have to be offered better terms and that borrowers may have to look toward adjustment rather than financing to an increasing degree. In this regard, it might be noted that Japanese banks have recently also curtailed their foreign lending.

For the longer run one must ask whether the world's banking system can meet increasing demands by the LDCs even if these demands reflect genuine investment financing rather than the financing of consumption-oriented oil imports. The banks have, in a sense, pioneered LDC lending. Their lending practices have many desirable attributes that would make a continued strong role of the banks in LDC financing constructive.

There is no shortage of funds in world financial markets, thanks not only to OPEC surpluses, but to the demonstrated ability of the Euromarkets to draw funds from all over the world by offering attractive interest rates. Nor is there a shortage of high quality assets in which OPEC and other surplus countries, if there are any, could invest these surpluses. The difficulty resides in recycling these funds toward the deficit countries, where they would be at some risk. It seems incumbent on OPEC to assume some of the risks inherent in the process.

New forms of bank pioneering may be needed. For instance, banks might take on the role of arrangers or brokers of loans. The risk of

such loans would fall on the ultimate lender, instead of a bank substituting its own credit for that of the borrower. Such activities would not strain the banks' capital ratios.

The IMF may have to play a larger role. Banks have been partly at fault in creating a situation in which the IMF has been brought into the financing picture only after the banks have vanished from the scene as willing suppliers of a weakening borrower's credit. Banks have seemed to act as if countries were either creditworthy, in which case they got all the money they wanted, or they were not, in which case no further credit was offered. Some form of cooperation with the IMF, which would strengthen the borrower's performance through IMF conditionality, would be preferable to such an all or nothing approach. As we look toward the longer-run future, more new forms of LDC financing, will probably need to be developed.

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