36/ IAI8121

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"The Political Environment and Stability of the International Banking System"

Comments to the paper on
"International Banking: Current Issues in Perspective"
by prof. Alexander Swoboda

Ente per gli Studi Monetari Bancari e Finanziari
"Luigi Einaudi"

Round table: "International Banking. Its Market and
Institutional Structure"

S.A.DI.BA., Perugia, 19th and 20th September, 1981

IAI/36/81

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We should sympathize with professor Swoboda's dissatisfa ction with the tendency to "attribute specific developments to specific events and policies". Indeed when discussing the growth of the Euromarkets only too often reference is made to contingent causes, which in no way can justify the speed and the scope of the development of an international money and financial market. This development must be recognized as a long-term phenomenon resulting from deeply rooted causes.

At the same time, overlooking the historical circumstances in which a long term process takes place leads to the impossibility of understanding some of its specific characteristics. Development of an international money and financial market could take place in many different ways, depending on historical circumstances. Indeed, it is probably true that the development of this international market was not a linear phenomenon, but had some important turning points.

It seems difficult to deny that the shift in the balance of power in the international oil trade and the ensuing increases in crude prices led to such a turning point in the development of the Euromarkets. This development was well underway before that shift, however the turn and characteristic it took in the 1970's were very closely linked to the transfer of financial resources from private consumers and companies in the industrial countries to the governments of the oil exporting countries.

It is often mentioned that this transfer shifted fi-

nancial resources from holders with a relatively low to holders with a relatively high propensity to save. This, however, is but one aspect. It also largely shifted resources from private to official hands-notably central monetary authorities. The latter aspect is what explains - paradoxically - why private international intermediation grew much faster than official intermediation: bilateral financial relations inevitably provoke touchy political undertones, and multilateral channels were-for easily understood reasons - slow to adjust to the new political realities. The same official nature of the Arab depositors goes a long way to explaine the predominance of banking financial intermediation over bond or indeed equity financing. The latter being almost inevitable more visible, thus politically more controversial. Finally it would be difficult to explain the growing importance of balance of payments financing without making reference to the new situation in international payments which is caused by the presence of countries with a structural surplus.

Some of the historical conditions we are referring to are persistent, other might very well prove to be transitory in time. Thus, long-term payment imbalances might eventually abate as oil production is adjusted according to each country's import needs and absorption capacity - but as yet we have seen very few developments in this direction. Also, the balance of payments surpluses of some oil exporting countries may increasingly reflect private or unofficial savings, leading to a change in portfolio preferences: the development of Arab regional financial markets is one consequence.

2. The stress an historical circumstances is not meant to deny that the growth of international banking is of course but one of the aspects of a broader historical process namely in the wards of professor Swoboda, the "general expansion of international economic transactions". Since World War II, there has been a steady increase in economic interdependence among all nations, and international banking is but one aspect of interdependence.

On the concept of interdependence and its political implications there is a vast literature, which I will not attempt to recall here. Still it is important to underline that the growth in interdependence in the financial field took place while policy-making institutions and instruments were lasing much of their effectiveness; and that interdependence necessarily implies a limitation of national independence and autonomy.

The latter point is only too often ignored or denied by politicians as well as professional economists. There is a continuing search for mythical conditions under which purpartedly a country can engage in international economic intercourse without losing any degree of freedom in conducting her economic policy. Professor Swobada does not seem to be immune from this temptation, as on page 26 he states that if "monetary authorities in open economies have typically found it very difficult to conduct an independent macroeconomic policy", "The source of the problem is the fixing of exchange rates and not international capital flows."

While there is no doubt that international capital flows should not be singled out as the cause of loss of independence (a burden they share with any type of international economic link), I think we should resist the temptation to believe that all that governments should do to recover their independence is to let their exchange rates float freely on the markets.

Freely floating rates will lead to the possibility of independent conduct of macroeconomic policy only under the assumption that imports and domestic production are perfect substitutes. But in the real world a share - most often a large share - of the imports of each country cannot be substitued with domestic production, and freely floating rates will not cancel payments imbalances, not even in the long run, unless they are accompanied by an appropriate shift in domestic macroeconomic policy. The latter is to an increasing extent the key instrument used to influence balance of payments results, which is tantamount to saying that no independent macroeconomic policy is possible.

At the same time consideration should be given to the micro level, not just to aggregate variables. Here freely floating exchange rates inevitably send contradictory price messages to the industry, causing growing difficulties in the investment decision making process, and stimulating a short term approach to management. Also, as we do not live in a perfectly competitive world, prices are easily increased and seldom reduced; ratchet effects are at work diffusely

in the industrial system, translating currency fluctuations into a permanent inflationary pressure.

The negative effects of floating exchange rates are seen in the fact that profits of a number of large multinational corporations are increasingly determined by the way they manage their international currency transactions rather than by their strictly industrial decision making. In the long run a perpetuation of this state of affairs will inevitably have negative consequences on industrial investment, and encourage monopolistic behaviour.

Thus floating exchange rates are certainly no solution, even if they did perform a useful function in the aftermath of the sudden increases in oil prices. Indeed, in a situation of growing economic interdependence there is no way in which an individual country can maintain the same degrees of freedom she might have enjoyed previously. The only solution is coordination among nations and the establishment of international multilateral institutions entrusted with the task of governing interdependence.

Whenever this basic truth is not recognized, as it was not in the past decade, and still is not today, an increase in interdependence leads to a crisis in the existing national and international policy instruments. In the field of international money and finance while international flows and linkages grew bigger and bigger we saw the collapse of the Bretton Woods system and the rapid decline of the relative role of both the International Monetary Fund and the Inter-

national Bank for Reconstruction and Development. Confronted with a growing number of limits to their freedom of policy-making imposed by the international economic environment, governmen ts were less and less inclined to admit new realities and try to recover some control through international coordination and multilateral institutions; each sough its immediate interest, thereby slowly eroding the international order of the '50s and '60s. The spread of nationalistic inclinations and neo-mercantilism led to the well known consequences of beggar-thy-neighbour policies: in the end all governments found themselves less and less capable of effectively implementing whatever economic policy they chose to follow.

The growth of international banking must be seen against this background, and is indeed a characterizing feature of the overall picture. Because of the inability of multilateral organizations and national authorities to cope with the new problems arising in the international economic environment, the international private banking network was called to perform tasks which do not properly belong to it, or at least not to it alone. While this allowed for an unprecedented pace of growth, it also laid the seeds of new problems ahead.

3. However, professor Swoboda is not even satisfied with the statement that growth of international banking is an aspect of the "general expansion of international economic transactions". His final suggestion is that one possibile cause of speedier relative growth of international banking is that "there is a general perception that banks will not be allowed

to fail", which acts as a perverted incentive.

It is always hard to take issue with - or support - any statement on perceptions, yet I find it difficult to accept that there is such a perception. After all, failure is an extreme case, and before coming to it we should discuss the hypothesis of losses, possibly large, but still not fatal to the institutions concerned. Should we push the argument to the point of saying that there is a widespread perception that banks are guaranteed against losses? Perhaps it is so, but then the reason is that the guarantee-and the perception of it - does not apply to the banks but to the countries they are lending to.

If we consider the list of the countries which are the largest borrowers on the international market we may see that they have at least one thing in common: their political or strategic importance. In other words, for each of them - although for specific reasons which may be completely different in each individual case - we may say that if default were imminent or indeed inevitable it would be in the overriding interest of the industrial countries of the West at large to find a cooperative solution, essentially through one form or another of refinancing. This vague but real guarantee applies to the countries, and only indirectly to the banks. The latter would not be guaranteed if they lent money to countries which are perceived as nonimportant politically and/or strategically, nor does it apply to losses incurred in other operations such as forward exchange rate dealings.

The crux of the matter is however that no explicit "value" (price) is formally attached by our governments to the political and strategic importance of any country, for reasons which are easy to guess. The end result is that banks are obliged to formulate implicit estimates of this value, and pass judgement on matters which do not belong to them. Bankers may improve their "feel" and awareness of political opinion through the informal or semi-formal channels which have been developed through the years (think of the Trilateral Commission or the Bilderberg conferences, to name but two) still they end up engaging in what is essentially a political behaviour without a formal political backing.

This leads us to raising the issue of assessment of country or sovereign risk. The most widely known and publicized methods of measuring country risk, such as the various rating systems that are offered by numerous institutions, can only be called primitive. They generally consist of an average between some economic and some political indicators. The economic indicators are based on simple ratios, such as debt service, wich are often statistically unreliable and anyhow provide only elementary and inconclusive information on the medium and long-term economic prospects of country. The political variables are " educated guesses" based on easily criticized concepts such as "political stability".

Is it possible to measure country risk? In the short term, it is normally possible to spot in advance those countries in which things are turning sour and difficulties may arise; at

that point in time, however, banks may find it impossible to retreat. In the medium and long term, which of two countries is more risky is more a matter of opinion. The number of relevant variables, including those related to the behaviour of other countries which may have dramatic consequences on the country under consideration, is so large that no method can clain to have a scientific base. What most analysts and bankers do, I submit, is not properly predicting what will happen to a country in the medium and long run, but rather implicitly measuring the importance of that country to the industrial West, assuming that if a country is important the system will find ways to accomodate her. This may be a reasonable assumption, although there are examples to the contrary, Iran being foremost.

The issue is of key importance, because after all a great deal of the discussion on the fragility of the international banking system and on the need for regulation and a lender of last resort is based on - in the words of professor Swoboda - "the perceived increase in country risk". Is such a perception at all warranted? Does it reflect a general worsening of economic conditions or deterioration of political systems? I doubt this case could be made. I am ready to accept that such a perception exists, but I submit that it simply reflects the demise of multilateral organization and the creeping nationalistic attitudes of the industrial countries, which lead to a situation in which these countries are less able to define and defend their collective interests, and end

up behaving towards the rest of the world in a inconsistent way. As a result it is more difficult to have a firm opinion on the importance of some the major borrowing countries, and it is less clear that important countries will somehow be accomodated.

As will be pointed out by Helmut Mayer, the fact that a country is a heavy borrower on the international market does not imply that she will be unable to service her debt. The crucial question is to what uses the borrowed money is put, and sometimes positive effects on the balance of trade may appear only in the longer run, as in the case of nuclear energy or hydroelectric power. The end result depends to no little extent on the trade policies of our countries, it being impossible to service even a small debt if exports are hindered through tariffs and quotas.

4. On the basis of the arguments listed above it is easy to see that a solution cannot be sought simply through an improvement in methods of assessing country risk. We should rather try to modify the international economic environment in order to provide greater confidence to and in the international banking system.

A first necessary step in this direction is the reversal of the trend toward a decline in the importance of official, multilateral international financial institutions. The political difficulty of this task lies in the need to forge anew a broad consensus on policies to adjust the balance of

payments and criteria to rate the performance of national economies. The lack of a broad consensus on these issues has led to an erosion in the position of the IMF. Countries are increasingly turning to the international banking system rather than accepting IMF conditionality; the dangers implicit in this development cannot be underestimated. If here were a broad consensus on IMF conditionality, the IMF would, by its normal operation, provide guidance to the international banking system. To the other extreme, if no agreement exists on this point, it is very difficult to see on which grounds supervision of the international banking system or provision of emergency liquidity could be organized. Inevitably, we would fall into one of two extremes: either restricting the growth and operations with a system of essentially arbitrary and irrational rules; or providing an unconditional garantee.

A second necessary development is that the national governments of the industrial countries play a more active role on the international money and financial market through appropriate agencies. If there is an excess of liquidity on these markets, there is no reason why our governments should not be able to coordinate their actions to drain liquidity, by deliberately increasing their borrowing. If there is an excess of short-term funds available while long-term finance is lacking, our governments should drain short-term funds and provide them in a more appropriate form to the countries that have a long-term need for finance.

Without resorting to administrative regulations, govern

ments can easily influence the behaviour of the market simply by being active on it. While coordination is essential, the scale of the operations that government agencies would have to engage into in order to provide a perception of greater stability is probably rather small.

This kind of government interference with the market would provide a stabilizing intermediation on maturity and, if couped with national development aid policy in order to provide interest subsidies, on interest as well. It would also provide a useful political guidance in the distribution of the bulk of the credit, that would still be extended by the banks.

Finally, if governments were to follow this road, one might hope some greater degree of consistency in their decision making on questions which are relevant to the countries involved. The reality of today is that only too often governments pressure private banks to provide credit to some countries because of their political or strategic importance, while at the same time adopting policies which seriously undermine the economic prospects of the same countries. If government agencies were more directly involved in borrowing from the international banking system and providing long term finance, they may encourage a more consistent approach.

G. Luciani, intervention morning session Sept. 20th

Most of the participants seem to have misgivings about the role governments might play in supporting the international banking system. The fear of crippling regulations and undue interference may be understandable, but it should not lead us to forget that the relationship of international banking to national governments is one of symbiosis.

As it has been pointed out, there is nothing new in the existence of a large international financial system. A similar situation existed in the second part of the XIX century and the early decades of the XX. At the same time, we should not forget that this system collapsed once governments took to adopting protectionist policies. And a new negative turn of the system of international economic relations cannot be ruled out, it being quite possible that the present situation of creeping neo-mercantilism may lead to an exponential growth of protectionist policies. Thus the international banking system needs governments that provide an appropriate economic and political climate in which they can continue to expand and indeed to survive.

The problems that we face and discuss arise because the international political environment has deteriorated. I have mentioned the deterioration of multilateral economic institutions and the shortsighted behaviour of most governments on economic affairs, but we should not forget that the international environment has deteriorated at the strictly political level as well.

It is important to stress this point because it introduces a fundamental difference between the international banks and national governments. It has been said that national governments are in no better position to measure country risk than the large international banks are. True, but while banks may only try to measure country risk, governments crucially affect this risk through their collective behaviour and the kind of international environment they create. If the international environment is solid, as it was in the 50's and 60's, then country risk is both reduced and easier to predict.

One necessary ingredient of a more solid international environment is an adequate supply of long-term finance. The issue of long-term finance (more specifically project finance, the so called program finance being questionable in this respect) should be kept clearly distinct from short term balance of payments adjustment and/or financing.

It is the insufficient supply of long-term finance at the global level that caused a growing confusion between development needs and balance of payments problems. With time, this led to the erosion of a previously existing broad consensus on circumstances under which adjustment should prevail over financing. Countries refused to adjust their balance of payments because this was contrary to their development needs, and while in some cases the balance of payments deficit was indeed the result of insufficient supply of long-term finance, in others it was simply the result of economic mismanagement. Being unable to clearly separate mismanagement from genuine development needs

brought to the outbidding of the IMF through growing recourse to the international banking system. The latter is indeed lending long while pretending to lend short, and is lending to mismanagers as well as to sound investors.

To this state of affairs the IMF is reacting by easing the rules of conditionality, inevitably worsening the confusion. If the cause of the problem is the insufficient supply of long-term finance, then more long-term finance should be offered, not easier short-term relief. The increase of long-term finance supply is the necessary precondition to reestablish the role of the IMF as a watchdog of balance of payments policies, which is in turn a precondition to offer international banking a better environment in which to operate.

The need to increase the supply of long-term finance points to a growing role of the World Bank and of the other multilateral institutions which engage in this kind of intermediation. It points as well to a growing role of national agencies of the industrial countries which should be called to borrow short on the international markets and lend long to countries requesting long-term finance, thereby also draining the excessive short-term liquidity which is helping to undermine the effectiveness of the IMF.

These developments are the only credible alternative to the hypothesis of administrative regulation of the international banking system, and the latter should view them with favour.

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