

Banks, Ferdinand E.

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Oil, Debt, Banking and the World Recession

by Ferdinand E. Banks, Uppsala*

The threat of a major debt crisis is presently hanging over the international financial community like Damocles' sword. Behind the crisis lies the flood of petrodollars into the financial institutions of the industrial world since the mid 1970s and the consequent large-scale lending to "doubtful customers". A simple solution to the problem is not in sight.

With an ominous, but hardly surprising, speed the world economy has at last been fully confronted with the possibility of a debt crisis. For those interested in parallels it can be useful to refer to the 1920s, when countries as well as firms found themselves heavily burdened with debt in an erratic economic climate. On that occasion the threat became a reality when the repeated application of various protectionist measures (i.e. tariffs and competitive devaluations) designed to protect domestic employment and exchange rates led to a drastic reduction in world trade. With markets crimping or disappearing, debtors eventually lost the capacity to honour their obligations, which in turn bankrupted many of their creditors.

Today's dilemma is based on oil. To be exact, it can be traced back to the huge but unassimilable revenues accruing to the OPEC countries as a result of the oil price shocks of 1973-74 and 1979-80. On those occasions the financial institutions of the industrial world were deluged by a flood of deposits that they could not always put to what conventional banking practice regarded as "good use", and as a result many of these *petrodollars* were lent to Third World governments who used them to initiate, or continue, consumption and "investment" activities with only a marginal capacity for promoting economic and social development. At the present time private banks in Western Europe, North America and Japan have the dubious pleasure of holding at least 300 billion dollars in I.O.U.s from the more poverty-prone countries of the Third World, oil exporting countries reeling under the discomforts of the so-called "oil glut", firms in the Newly Industrializing

Countries (e.g. Taiwan and South Korea) that are temporarily down on their luck, and a few non-prime borrowers in Eastern Europe, particularly Poland and Rumania. Some of this debt is listed in Table 1, along with the interest payment burden. Judging by these sums, and the present economic outlook for some of their borrowers, it might be surmised that sooner or later a stupendous write-down will have to be accepted. Without going too deeply into this matter, let me note that if this operation is bungled, it could have serious consequences for the future of the international financial system, considering that it will probably take place at a time when the health of the world economy is even more precarious than it is now.

Worldwide Capital Spending Low

At the same time that bankers were scurrying about Asia and Latin America, selling loans in the same way that bargain basements in Chicago or New York sell radios and underwear, many first-class corporate borrowers in Western Europe and the United States – particularly those associated with basic industries such as steel and heavy manufacturing – were turning their backs on the generous supply of credit available to them. On the basis of their estimates of what the energy price rises would do to household demand, and consequently their own profits, the managers of many enterprises of this kind came to the conclusion that high levels of investment did not make a great deal of sense; and as a result, in the middle of the 1975-79 upturn, worldwide capital spending was well below what would have been regarded as normal during previous economic recoveries.

* University of Uppsala.

Table 1
Debt Owed to Banks at the End of 1981 and
Interest Payments Burden 1982

	Total Debt (in billion US \$)	Due in One Year or Less (%)	Interest Payments ¹ (as % of exports of goods and services)
Mexico	59.9	49	34
Brazil	52.7	35	40
Venezuela	26.2	61	18
Argentina	24.8	47	35
South Korea	19.9	58	12
Chile	10.5	40	35
Philippines	10.2	56	13
Indonesia	7.2	41	7
Taiwan	6.6	62	4
Nigeria	6.0	34	5
Columbia	5.4	49	20
Thailand	5.1	60	10
Malaysia	4.4	31	4
Peru	4.4	60	20
Turkey	4.2	25	13

¹ Interest payments on total external debt.

Source: IMF and BIS documents.

As for the United States, whose economy seems to have become more crucial than ever for the rest of the OECD, total capital equipment purchases peaked in 1979, reaching 121 billion dollars in constant 1972 dollars just as the surpluses generated by the second oil price shock were enlarging the credit base of the world banking system. Thus, during what might have been an optimal period for banks to commence a restructuring of their loan portfolios, prime borrowing slackened and the major financial institutions were compelled to launch a new wave of lending to the least creditworthy of their customers – although by now loan margins had started to reflect both the demand for higher interest rates by OPEC depositors, as well as insurance premiums associated with the dubious quality of a large part of existing debt.

Despite all the problems resulting from this unlucky sequence of events, the official (and unofficial) publicists of the financial community were correct when they insisted that their establishments were performing an indispensable service for the economies of the industrial world. Although banks are basically concerned with handling money, their directors have

consistently understood much better than most academic economists that it was not petrodollars the industrial world needed, but OPEC's oil, and this oil would not be forthcoming if the oil exporters' financial surpluses (shown in Table 2) could not be placed in a manner deemed adequate by the authorities of the oil exporting countries.

Low Real Interest Rates

Although many observers are still not aware of the fact, it was a long time before the yields received by OPEC lenders on their financial placements corresponded to the yields they felt they were entitled to. As the following figure makes clear, the average *real* return on investment in the seven major industrial countries has been close to zero for a considerable part of the past 10 years. Apparently, however, unusually high *money* rates of interest have given some OPEC governments, and perhaps many other lenders, the misleading impression that they were obtaining satisfactory incomes from their bonds, treasury bills, and bank accounts – at least up to 1980. Now there are some extremely important concepts here, and by way of clarifying them let me remind the reader that the *real rate of interest* is a measure of the compensation, in goods and services, that a lender receives for giving up present

Nominal and Real Interest Rates Calculated as an
Aggregate From Seven Major Industrial Countries
(U.S., France, Japan, Italy, W. Germany, U.K. and Canada)

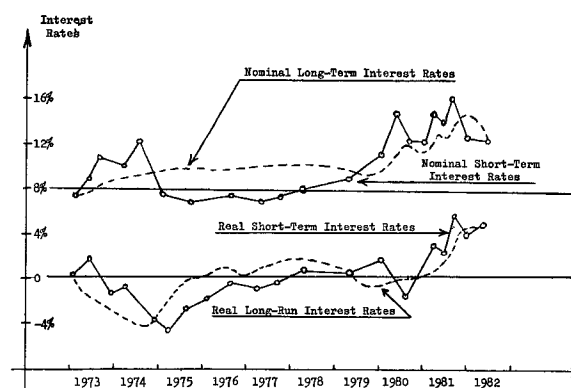


Table 2
Current Account Balances, 1973-1981
(in billion US \$)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	Total 1974-1981
OPEC	6.6	67.8	35.0	40.0	31.1	3.3	68.4	111.2	96.0	452.8
Non-oil LDCs	-11.5	-36.8	-46.5	-32.9	-29.6	-37.1	-56.1	-80.4	-96.5	-415.9
Industrial Countries	19.3	-12.4	17.1	-2.1	-5.5	30.1	-10.7	-44.0	-29.5	

Source: IMF, June 1982

consumption in favour of future consumption. But in the event of actual or expected increases in the consumer price level (i.e. inflation), rational savers will demand a monetary premium (sometimes called an *inflation premium*) to recompense them for the reduction in their future *real* purchasing power.¹ Thus, on the basis of the above, it might be possible to argue that very low real rates of interest can often be explained by information shortages and lender irrationality. However the principal explanation of the phenomenon shown in the diagram was the quantum increase in uncertainty experienced by small, large and institutional savers in the OECD countries, and in particular so-called "target savers" who found themselves contemplating a dramatic deterioration in world prosperity. Many in this group, who were saving to purchase large durables or to provide for pensions, would have been prepared to hold financial assets even had interest rates been negative.

Capital Inadequacy

Next we can turn our attention to the balance sheet malaise of many major banks, which generally goes under the name of *capital inadequacy*. In order to illuminate this expression let us look at the *modus operandi* of the early bankers, who in some countries were labeled goldsmiths. A goldsmith accepted deposits for safekeeping in return for a small fee, and conventionally these deposits were not loaned out. The goldsmith's loans were made from his own funds, or

those of his partners or stockholders. When or if someone defaulted on a loan, it resulted in a simple loss for the goldsmith which, in ordinary circumstances, did not concern his depositors.

Problems arose when bankers began lending the money of other people, i.e. their depositors. Now loans could be expanded until they exceeded the capital of the bank (where bank capital is sometimes called *equity* or *net worth*) and amounted to a large percentage of the bank's deposits. With this arrangement the danger always exists that a default will consume a large part, or even all, of a bank's capital. In theory, if losses are greater than capital, a bank is insolvent – although obviously if a bank's depositors are not aware of this unfortunate situation, or if loans can be obtained from other banks, it need not close its doors. In a typical business cycle downturn the loan losses of banks are generally only a small fraction of total loans and often outweighed by normal operating profits – which are only a portion of the capital of an average bank. Only 20 years ago many banks had equity/asset ratios of ten percent, and it would have taken an epidemic of bad bank management to shake the public's confidence in the credit system.

Since that time, as shown in Table 3, there has been a sharp reduction in equity/asset ratios. Not only that, the quality of many of the loan assets held by some of the largest international banks has deteriorated to a point where they are about to cross over into the "non-performing" category reserved for such treasures as bonds issued by the sovereign state of Mississippi prior to the civil war in the United States. The simple truth of

¹ Accordingly we should have: Money Rate of Interest = Real Rate + Inflation Premium.

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Table 3
Equity/Asset Ratio at Various
United States Financial Institutions
 (in %)

	1960	1968	1972	1976	1980
Money Centre Bank Holding Companies	9.0	6.3	4.9	4.0	3.6
All United States Commercial Banks	8.1	7.0	6.4	6.2	5.8

the matter is that during the past decade many of the largest banks in the United States carried out almost half their lending in the international markets; and total loans to non-oil less developed countries, and firms in developed countries whose balance sheets are distinguished by a surfeit of ambiguous entries, have now reached a level where much of the capital of these lending institutions can be regarded as "mortgaged" – particularly if the banks are treating these loans realistically. In addition, a major default by a country could have nasty consequences even if private and central banks were prepared to mount a joint rescue operation in the event that some large financial institutions floundered. This is so because in the interest of safeguarding their capital, banks could hardly avoid resorting to an accelerated downgrading of the credit ratings of many of their actual and potential customers, which would immediately be reflected by a rise in interest rates and a shortening of loan maturities. Furthermore, since medium and even small savers are now vaguely aware that the security of their savings is somehow associated with the quality of loans held by the banking system, and apparently these are not always of exemplary pedigree, a widely publicized bank crash or near crash could initiate a chain reaction beginning with a massive transfer by individuals and organizations out of deposits and into what they believed to be superior stores of value, such as gold and cash. The *impact* effect of this kind of behaviour could be a credit squeeze of draconic proportions that would be traumatic for countries trying to renew existing loans, and also for many large firms in the same predicament. Thus we are back to the situation described in the first paragraph of this discussion.

Concluding Remarks

That brings us once again to oil, and a few closing remarks. In 1978, with the OPEC surpluses rapidly drying up, financial institutions were spared the need to consider how their clients would service their loans by the eruption of the Iranian revolution, which produced a new flood of liquidity by its effect on oil prices. Nothing of

this variety is in sight today, which is probably just as well, and so other adjustment mechanisms will have to come into play. GATT, for instance, is in favour of the worldwide promotion of investments in such things as metal processing and manufacturing, so that the economic activities indulged in by less developed countries would take on a new aura of profitability, and thus eventually provide them with the means to pay their debts. Given the time factor involved, and the protectionism that is being proposed by even responsible politicians these days, this is a distinguished non-solution that in every way is typical of the lack of comprehension shown by GATT's parasitic and pretentious research "elite" over the years.

The New York investment banker Felix Rohatyn wants a new Reconstruction Finance Corporation. This organization would be capitalized at 5 billion dollars (with an additional 25 billion borrowing authority) to handle United States problems. On the international scene he calls for a conference of creditors to deal with Third World debt. The problem here, as I see it, is that some of the major borrowers possess assets (e.g. oil, gas and other natural resources) that are going to be worth a great deal of money some day, regardless of their present prospects; and the question that must be asked is whether the taxpayers of the industrial countries really want to accept a debt settlement in which they are swindled in favour of luxury consumption and military spending in some of the less developed countries at some point in the future – perhaps even the near future. *If* this arrangement is satisfactory, however, then it simplifies everything, because neither the United States government nor the governments of the other large industrial countries are prepared to see their most important banks go out of business, with or without the taxpayers' consent.

In his recent speech at the Institute of Economic Affairs, in London, Milton Friedman once more expressed the belief that in the long run, if nature is allowed to take its course, everything will come out all right and, most important, nobody will come out on the short end. Certainly, Nobel Prize winners whose high priced but worthless advice has left devastation in its wake from one end of the world to the other do not need to lose any sleep over what appear to them to be minor cracks in the international credit system. As for myself, however, I would feel a lot better had Friedman spoken to an empty room; and the bankers and civil servants in his audience had been at home trying to work out just what they were going to do and say if country 'X' notified bank 'Y' that it, bank Y, would not be receiving a cheque in the mail that year.