Union of Arab Banks

ARAB BANKING
PRESENT AND FUTURE CHALLENGES

Rome, November 18, 1991

I take particular pleasure in attending the annual Conference of the Union of Arab Banks here in Rome, and I feel honoured to have been invited to deliver the opening address. The Conference will cover a broad spectrum of issues, ranging from recent shifts in the economic configuration of the Arab world to bank intermediation, the financing of investment ventures and international trade, liquidity management and monetary policy. The distinguished group of speakers scheduled to address the Conference promises a discussion of great interest.

It would be presumptuous for me to broach all the issues on your agenda. I shall therefore confine myself to a few selected points and examine the recent trends and prospects of Arab banking and of the challenges confronting international banking and finance in the period ahead.

Global saving and investment

Let me make a few prefatory remarks on the balance of global saving and investment, with special reference to how this affects Middle Eastern countries; I will then turn briefly to the main economic features and current developments in the Arab world.

A shortage of saving relative to the demand for funds is a problem looming over the world economy as a whole. Heavy demands are being made by the industrial countries, reflecting both the growing need to invest in infrastructure and environmental protection and the strains that population ageing is causing in pension and health systems. Shortages of investment funds continue to be acute in the less developed nations, which cannot by themselves generate the resources required for economic take-off and long-term development.

The situation is particularly serious for the heavily indebted developing countries, hard pressed by the servicing of their external liabilities; the nations of Central and Eastern Europe, faced with the enormous task of transforming their command economies into market systems and replacing their outdated capital stock; the economies of the Middle East affected by the Gulf war and in urgent need of reconstruction and economic reform.

Although the developing countries can mobilize resources domestically by promoting growth and improving efficiency, the additional saving required for long-term capital accumulation and development will have to be generated in the advanced countries, by both the public and private sectors. Given the complexity of private saving behaviour, which changes mainly in response to such long-term determinants as income growth, the age structure of the population, the availability of social security and welfare benefits and the efficiency of banking and financial systems, reducing government dissaving must be accorded high priority in economic policy.

Recognizing this need, in recent years the leading industrial countries have adopted a policy orientation aimed at achieving fiscal discipline in the medium term. Predictably, more often than not they have encountered difficulties in implementing the policy. Moreover, temporary setbacks due to changing, sometimes unfavourable economic circumstances may be inevitable, as demonstrated by the current increase in public sector deficits as a consequence of the cyclical downturn. But a policy consensus has emerged -- and action consistent with it being undertaken -- that government claims on domestic resources ought to be reduced. In addition to monetary and exchange rate policies, co-ordination at the international level, centered on the Group of Seven, should extend to budgetary action in pursuit of the dual objective of macroeconomic stability and greater saving.

<u>The developing countries and external finance</u>

The pattern of saving and investment in the developing countries changed markedly in the early 1980s. Until then net capital inflows into these countries, estimated by the IMF at 5 per cent of their GDP between 1975 and 1982, had provided a substantial supplement to the resources they generated domestically. During that period, the contribution of external saving in the Middle East was equivalent to about 7 per cent of GDP. However, the onset of the debt crisis in 1982 caused the flow of external resources to decline, requiring more drastic adjustment in the countries that depended most heavily on foreign resources for development. In the Middle East as a whole the decrease in capital inflows was much smaller in view of the area's less burdensome external debt position.

At present a variety of factors impinge on the prospects for a resumption of steady capital flows into the developing countries. Current concern about the adequacy of external financing for these countries stems, in particular, from the relatively stagnant formation of saving in the industrial nations and the rising demand for funds worldwide. As I suggested earlier, budgetary stringency in the advanced countries, coupled with curbs on non-productive public expenditure, including excessive military spending, would help to ease the pressure on capital markets and interest rates, which would support output growth and hence foster saving.

As things stand today, the scope for expanding official assistance appears to be limited. Nonetheless, there are improved prospects for a larger flow of direct investment to the countries that have created a more favourable economic environment, developed their domestic financial institutions and made macroeconomic stability the focus of policy. This view was endorsed in the IMF-World Bank meetings held last month in Bangkok.

Let me just add a few words on one particular issue that has recently attracted great, perhaps excessive, attention: the much-feared "credit crunch". The need to restore a stronger capital base in the banking industry has prompted commercial banks to be more selective in their lending, leading to concern that credit may become not only more expensive but also scarcer as a result of self-imposed restrictions on asset growth. Yet, with economic activity slowing down or contracting, asset values declining and borrowers having debt-service problems, it is hardly surprising that banks should review their loan portfolios and tighten up their lending criteria. But the "world credit crunch" story does not really fit today's situation. Interest rates in world money markets have been declining lately and there is little evidence of creditworthy companies being unable to borrow. Banks' margins have risen, but this is certainly not an undesirable development. The deregulation of the eighties intensified competition and led to relaxed lending standards; the correction of these weaknesses would appear to be in the interest of all concerned.

Changes in the Arab world

The Arab world is undergoing a profound transition. The Middle East which constitutes a large part of it is a region of great strategic importance. It accounts for 2.5 per cent of world GNP and 11 per cent of the developing countries' output; economic activity has been stagnating for some time now, and population growth in some nations has caused social strains, particularly in urban areas. The area's trade balance is still buoyed by oil revenues, but diversification is increasingly perceived as an urgent necessity. Moreover, there are marked disparities in resource endowment and income and in some instances structural reform has fallen short of intentions, so that the record is disappointing compared with other developing countries.

This year the economies of the region have been hit by the Gulf war. In addition to the serious damage to the countries directly involved in the conflict, neighbouring nations have suffered from lost trade, workers' remittances and tourism, while being burdened by a huge influx of refugees. Although the economic consequences of the conflict are still hard to quantify, reconstruction will impose heavy demands. The order of magnitude of the economic damage can be gauged from the estimates of the IMF and the World Bank, which put the balance-of-payments losses of Egypt, Jordan and Turkey at $12 billion in 1990-91 and the reduction in GNP at more than 15 per cent for Jordan, 3 per cent for Egypt, 2 per cent for Turkey and 1 per cent for Morocco. The oil exporters -- apart from Iraq and Kuwait -- benefited from improved terms of trade, although for some part of the gain was offset by the budgetary costs of the war.

A major effort by the international community is still called for, both in the form of bilateral assistance and through multilateral institutions. New organizational mechanisms for extending financial support are being envisaged, as vehicles for channeling additional resources to Middle Eastern and Mediterranean basin countries. However, it will take time before they can be created and start to operate effectively. For the time being therefore reliance must be placed on existing multilateral organizations -- including regional entities, such as the Arab Fund for Social and Economic Development and the Arab Monetary Fund.

Emergency aid was initially mobilized under the aegis of the Gulf Crisis Financial Coordination Group, with the aim of subsequently coordinating the resources channeled through this Group with adjustment programs supported by the IMF and the World Bank.

The essential point is that physical rehabilitation and economic recovery, clearly still the top priority, should go hand-in-hand with reform of economic management and the gradual substitution of private capital flows for official development assistance.

Official aid should focus on promoting domestic structural reform aimed at liberalization, increased competition and regional integration. The effective cooperation achieved during the crisis could act as a catalyst for progress in these spheres. Indeed, I see great potential for exploiting complementarities in developing region-wide infrastructural projects in fields such as river and sea water control, oil and water pipelines and environmental protection.

On a more general level, closer integration of the

Middle East with the world economy is highly desirable. The region's trade with the industrial countries is limited and declined during the 1980s. The share of industrial countries' exports going to the Gulf countries, Egypt and Turkey does not exceed 3 per cent, and the share of non-oil imports from the region is even lower. For energy, import dependence is obviously much higher: over two fifths for Japan, one third for Italy and one fifth for the United States.

A key ingredient in forging closer trade links, and one which the industrial countries are expected to act on quickly, is open, non-discriminatory access to their markets. Equally important is the transfer of adequate technology and management skills, something that can be achieved effectively through foreign direct investment and joint ventures. In the early eighties such investment was attracted by the prospect of continued high oil prices, but it virtually dried up following the scaling back of oil-related activities in the mid-eighties. I mentioned earlier some of the conditions that could induce larger flows of private foreign investment.

Integration of markets and banking supervision

Let me now turn to the issues that are of more immediate concern to the Union of Arab Banks as an institution, i.e. changes in banking and in the financial structure of the Arab world. In this respect, Arab banking is a microcosm of the broader world financial environment, which has seen radical changes in recent years, with rapid innovation in instruments, trading techniques, market structures and intermediaries. Deregulation and integration of financial markets have created new opportunities and challenges for both operators and authorities. The attendant risks, of which we have gradually grown aware, need to be carefully managed, with adequate prudential rules and close supervision. The soundness and stability of banks and of the financial system as a whole is a public good to be preserved in the interest of all. One prerequisite for appropriate solutions to these problems is a continuous dialogue between market operators on the one hand and regulatory and supervisory authorities on the other.

This Conference testifies to the importance of that dialogue and I shall therefore touch upon some of the issues raised by innovation and deregulation and examine how supervisors have responded to the evolving situation.

While innovation and sharper competition have had many beneficial effects -- including enhanced efficiency, reduced borrowing costs, broadened opportunities for investors, improved product quality and increased productivity -- the task of policy-makers is to make sure that the benefits to individual operators are not outweighed by greater systemic risk. Even in countries where innovation has progressed fastest and furthest, it has been widely accepted that prudential rules and supervision of financial markets and institutions are still needed to protect savers and the stability of intermediaries.

To this end, in 1988 the central banks of the Group of Ten adopted the proposals formulated by the Basle Committee on Banking Supervision requiring international banks to achieve a minimum capital ratio (8 per cent of assets) by the end of 1992 at the latest. The arrangements in force in many industrial countries already comply with the provisions of the Basle agreement. All the EC member states will implement it fully with the adoption of the relevant Directives. The agreement is also in effect in a number of Middle Eastern countries.

International banks have responded well to the challenges of market innovation and risk and many of them are now in a stronger position to withstand competitive pressures; they have strengthened their capital bases both by retaining earnings and by raising equity in capital markets; they have also substantially increased their provisions against losses on sovereign and other loans.

The Basle Committee is not the only international forum of bank supervisors. Over the years a network of regional groups has emerged covering most of the world. The Gulf Cooperation Council constitutes one such group. Close, informal working relationships now exist with the Basle Committee, which should be further developed on matters relating to capital adequacy, exchange of information between supervisors and large exposures.

The 1988 Basle agreement was primarily designed to strengthen prudential rules, raise capital standards and assess capital adequacy in relation to credit risk. Work is now also under way on harmonizing the prudential treatment of market risk, i.e. interest rate, currency and securities trading risks. This task has proved fraught with difficulty, for the concept of assigning capital weights to market risk positions was unfamiliar to both banks and supervisors. The question of position risks in debt securities and equities is complicated by the need to consider the status of the non-bank securities firms with which banks compete. The aim is to create a level competitive playing field for both banks and non-banks, while preserving the prudential effectiveness of both systems of supervision. Close coordination between banking supervisors and the regulators of non-bank firms is required if agreement is to be reached on a set of basic capital adequacy rules for all operators. Although we still do not have completely uniform standards among national securities commissions, a good deal of joint work has already been done.

Another area of common interest is the supervision of financial conglomerates. As the lines of demarcation between intermediaries become blurred and traditionally specialized institutions widen the range of their activities to new financial services, including banking, it is important that they should all be subjected to the same regulations on a consolidated basis. When the parent company is a bank, the matter is relatively straightforward: the home country banking supervisory authority exercises consolidated control over the whole group. But difficulties arise when the parent firm is a securities or insurance company, subject to minimal and separate regulation. Periodical meetings between bank supervisors and other regulatory authorities are taking place; the next major step forward could be full cooperation, in the form of exchanges of prudential information between bank and other supervisors. Finally, it would be most desirable if agreement could be reached on a set of common principles regarding the conduct of supervision.

Most of the world's major financial centres have recently been shaken by a string of irregularities involving banks and securities firms. Further repetition of such disturbing events could seriously damage investor confidence in financial markets and institutions; it could also undermine public confidence in monetary authorities if they were perceived to be ineffective in carrying out their supervisory responsibilities.

Action will have to be taken to forestall this threat. In individual countries offences should be defined unambiguously and laws enforced more consistently; prudential rules for banks should also be made more effective. But most of the recent episodes underscore the need for greater coordination among national regulators, especially as regards off-shore banking centres and the supervision of banks with extensive international activities. The issues involved include: the application of the principle of consolidated supervision within the framework of the Basle Concordat; the sharing of information between home and host country supervisors, especially in times of stress; the adequacy of the current distinctions between the roles and responsibilities of the two categories of supervisors; and the complexity of the procedures for liquidating banks operating in many different political and legal jurisdictions.

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In view of its size, membership, range of interests, and volume of resources, the Union of Arab Banks has a key role to play in the proper functioning of our increasingly integrated global financial and monetary system. The challenges arising from new developments in international banking and finance require central banks worldwide to pay close and continuous attention to both monetary policy and supervision. Good working relationships between your institutions and ours are very important.

I therefore welcome meetings such as this one; I believe they make an invaluable contribution to fruitful cooperation in the common interest. In closing, let me thank you once again for the privilege of making these introductory remarks and extend my best wishes for the success of the Conference.