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Control of the Euromarkets?

Control of the Eurocurrency markets is once again on the agenda of monetary authorities. At their recent monthly routine meeting at the Bank for International Settlements (BIS), central bank governors had a lengthy and controversial discussion on the If and How of such control. Interest of policy-makers in an issue which is almost as old as the Euromarkets themselves was revitalized by a number of developments in the markets and in the world economy at large which may indeed give rise to some concern.

Firstly, the volume of foreign claims by banks in major industrial countries (including certain of their offshore branches) has now surpassed the \$ 800 bn mark and continues increasing at annual rates of 20 % and more. Thus, at the turn of the Eighties the market volume will come close to \$ 1000 bn, a sum which may well be beyond grasp even of central bankers who are after all used to playing with large sums.

Secondly, in the medium-term Eurocredit market the spread over LIBOR, the London interbank offer rate, has been declining over the past months from an average 1.17 % in the fourth quarter of 1977 to a meager – if not alarming – 0.85 % in the first quarter of this year. At the same time, average maturities have lengthened from seven to almost nine years. As these trends were not paralleled by an improvement in the quality of borrowers one may well ask whether the credit terms and their variances are any more related to the risks involved.

Thirdly, there is concern that the generous balance-of-payments financing provided to deficit countries, and more particularly to developing countries by a highly liquid Euromarket may not only add to the banks' – and indeed the international financial system's – vulnerability, but may also upset the IMF's endeavours to promote timely adjustment measures. Remarkably enough, when developing countries have been drawing on the IMF this was, with but few exceptions, on the unconditional facilities only. This practice can partly be explained by the large expansion especially of "liberal" facilities in the years since the oil crisis. On the other hand, it is also an indication of the relative ease with which many heavily indebted countries have been able to tap private sources of finance.

Fourthly, after some progress made on the inflation front in more recent years, prices are rising faster again on a world-wide scale. It is felt that the high level and growth of private international liquidity may be conducive to this unfavourable development.

And fifthly, since Fall 1977 there have been wide gyrations of exchange rates, particularly of the dollar rate, which turned out to be detrimental to stable business expectations and thus to a sustained recovery of the international economy. Again it is felt that the Eurocurrency market, with its huge pool of liquid funds and the flexibility and sophistication of market participants, is facilitating "speculative" money flows into and out of currencies.

Whereas at first sight these arguments appear convincing to establish a case for more control of the Euromarkets, at second sight – when it comes to specifying the appropriate policies and instruments – the case is by far not so clear. Indeed, it turns out that we know remarkably little about the structure and functioning of the markets and their relationships to national financial and monetary developments. Without such knowledge, figures of \$ 800–1000 bn are nothing but impressive and perhaps worrying. The issue does not become much clearer when from the total external bank claims the "true" Eurocurrency claims, i.e. the foreign

currency assets of banks domiciling in the European reporting area, are singled out, a statistical exercise which cuts the sum down to one half. Whether the market volume and its growth are "too high" (or perhaps even "too low") cannot be determined without suitable criteria about what is optimal.

An indication that at least the market for medium-term syndicated Eurocurrency credits has recently been expanding faster than is compatible with its long-term stability could be seen in the sweeping liberalisation of credit terms. However, the causes for the over-liquidity of Eurobanks which prompted this development are not to be found in the Euromarkets. They are to be sought, firstly, in the abnormally high rate of international saving experienced in recent years as a result of large incomes transfers to low-absorption OPEC-countries and sluggish growth in most industrialised economies; secondly, in a re-direction of part of central banks' exchange reserves away from traditional dollar assets (mainly U.S. Treasury bills) into Eurocurrency deposits, as a consequence of a more conscious portfolio policy; and thirdly, in the ample supply of national and — through the IMF — international money by central banks. It is therefore unrealistic to expect that regulation of the Euromarkets alone, without parallel action (and success) on the front of economic fundamentals, will produce major results.

As to the contribution of the Euromarkets to international inflation and exchange-rate instability it appears that the major causes are also to be looked for elsewhere. Inasmuch as inflation is concerned the situation has fundamentally been changed since March 1973. Since then, monetary authorities have in principle been free to determine the national rate of monetary expansion autonomously in line with domestic priorities, as they are no longer obliged to defend their currency's exchange rate by intervening in the foreign exchange market. International inflation is therefore largely irrelevant from a national point of view. If a central bank chooses to intervene in the market with the aim of keeping the external value of its money from rising this is clearly the authorities' own choice. The resultant creation of base money bears no connection to international money expansion and not the Eurocurrency markets but the authorities should be blamed for it.

As regards "speculative" money flows the role of the Eurocurrency market is grossly overrated, too. Again one should pay attention to the fundamentals first — present and projected price and cost disparities, balance-of-payments disequilibria, interest rates — before blaming market participants for their resolution of keeping abreast of expected exchange-rate changes. What is more relevant in the very context of Euromarket control is that only a fraction of total "speculative" money flows are channelled through the Eurocurrency market. Leads and lags as well as money transfers between national financial markets are likely to be more important for exchange rate movements. Insofar as the Eurocurrency market is involved it performs largely a technical role which cannot be checked by minimum reserves and the like.

Altogether the case for control of the Euromarkets by monetary instruments appears to be based on an erroneous conception of its contribution to national monetary weaknesses, and of an overestimation of the possible role of such devices in checking the growth of a market which is after all largely an interbank market (minimum reserves would apply to non-bank deposits only). With the rapid growth of multinational banking in recent years there is however a case for more comprehensive information on the volume and composition of individual banks' total exposure, i.e. including their branches and subsidiaries abroad, and for integrated prudential control. This is an issue which may be approached by (further) adapting disclosure rules and prudential standards in the banks' parent countries, on a compulsory or a voluntary basis. In addition, the problems ought to be tackled by a better exchange of information among national supervisory authorities which could make use of a "neutral" agency like the BIS for this purpose. Indeed, if central banks are supposed to act as lenders of last resort to multinational banking combines, they are also entitled to receive full information by the potential beneficiaries — banks and foreign monetary authorities — and to set minimum standards for prudential banking behaviour. The one does not go without the other.

Hans-Eckart Scharrer