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be held to be in the interests of a cohesive and developing Community. This is not just a question of the current problem of one Member State: it is a fundamental question of principle for future Community budgets.

The role of the Community Budget is complementary to that of national budgets, but it can still be significant. Strict public expenditure control must, of course, be observed at the Community as at the national level and there should be no unnecessary duplication by national governments of activities transferred to the Community. Community spending on areas such as

industrial and energy policy will and should increase significantly, but if Community taxpayers are to get value for money this must be matched by economies on agriculture. The problems of achieving the right balance are considerable but given goodwill in the Council of Ministers, consistency in the European Parliament and a firm and principled stand by the European Commission in defence of the European interest we can overcome them and make of the Community Budget something which all our citizens recognize as influencing for the better the Europe in which they live.

EUROMARKETS

Weak Spots Must be Removed

by Manfred Lahnstein, Bonn*

Demands for control of the expanding Euromarkets have been voiced for some time. On what grounds are they based? What form could this control take? These issues are discussed by Manfred Lahnstein. Further comments on these problems can be found in the following article by Wilfried Guth.

The international financial markets have grown enormously throughout the past decade. For the year 1978 alone the Bank for International Settlements (BIS), which is keeping an eye on the events in these markets and collecting relevant statistics from the central banks reporting to it, recorded an increase in gross foreign assets in excess of US 200 bn. The banks' outstanding foreign assets thereby rose to a total of over US \$ 900 bn at the end of 1978. These figures do not include the issues of Eurobonds and foreign bonds which the BIS estimated for 1978 alone at a net total of about US \$ 28.5 bn. Impressive as these figures appear to be at a first glance, they require rational interpretation and qualification.

First of all, it has to be pointed out that the events in these markets are in great measure a reflection of the increasing foreign trade and thus of the progressive economic integration of the countries participating in world trade. A large part of these money flows is thus the counterpart of real world-wide growth of international trade. As in the national sphere it is one of the functions of money to bridge the gap between receipts and expenditure flows, so the international

flows of finance serve as a bridge across international receipts and expenditure divergencies. To proceed without frictions world trade will need smooth and efficient financing arrangements also in the future.

Moreover, the figures quoted above give a rather overdimensioned picture of the real situation. If inter-bank transactions, that means the credit links between banks, are omitted from the foreign debts to reporting banks as computed by the BIS, the net total works out at US \$ 540 bn, a significantly lower figure. A further correction for inter-bank liabilities between institutes in and outside the so-called BIS reporting area and moneys passing more than once through the reporting area results in an even lower total. Finally, it has to be borne in mind that part of the increases in US \$ terms during recent years is due to exchange rate movements only – to be more precise, to the higher D-Mark and Swiss franc rates – and to this extent represents no real increment.

The recorded foreign lendings are largely Eurocurrency credits, i. e. lendings in currencies other than that of the banking centre concerned. This part of the international credit flows certainly carries considerable weight, but it must not be overlooked that the traditional foreign credit business – in the national

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currencies of the banking centres – has developed in a very dynamic manner during recent years.

With the Euromarkets now accounting for more than two-thirds of the foreign credit business there is nevertheless good reason to pay special attention to them. Whether these markets are useful or harmful is of course one of the evergreens of the debate on monetary policy and therefore given the same intensive treatment by science and practice, in the main focusing on four issues:

- The importance of the Euromarkets for the national monetary and credit policy and thus also in regard to the dimension of the inflationary development;
- The role of these markets in the “international adjustment process”;
- The significance of the Euromarkets for the events in the foreign exchange markets and exchange rate movements;
- The problems of these markets for banking surveillance and the question of adequate transparency.

All four issues are of course interrelated so that they cannot be viewed in isolation from each other.

The Euromarkets are no isolated phenomenon. Each of the Eurocurrencies should be viewed rather as an “extraneous” part of the domestic money and credit market. Euromarkets and home markets are closely related parts of what is in the final analysis one market as is seen the more clearly the less the links between the two components of the market are disrupted by restrictions on capital movements. This applies to a particular extent to the relationship between the D-Mark and the Euro-D-Mark because the area of the Federal Republic of Germany is virtually free of this kind of restrictions. The two market segments are bracketed by the arbitrage facilities: a rise of the Eurorates causes funds to flow in, which in turn acts as a brake on the rise of interest rates; and if the Eurorates of interest fall, the reverse process takes place.

There exists thus an interrelation between the internal and external rates of interest for the currency in question. The by and large parallel movements of the domestic and Euromarket interest rates for the D-Mark, for instance, illustrate how close this connection is in actual fact. The result is that these markets cannot develop a money circulation in complete severance from the monetary policy of the central banks. They

cannot lead a separate life because the currency of the note-issuing bank in question is as a matter of principle the ultimate source of liquidity.

Closely connected with this fact is a question often discussed in the literature: Can a separate money or credit creation multiplier be derived and calculated for the Euromarket? A point against such a separate multiplier is that, as has just been pointed out, because of their close substitutionary relationship the Euromarket and the domestic market must not be regarded as separate. Another point against it is that the reserve base (analogous to the minimum reserves) and the outflows (analogous to the cash outflow) cannot be clearly delineated as criteria for the design of a money or credit creation multiplier.

As money and credit creation on the two market segments can only “sprout” from one liquidity base – which is “preset” by the central bank – the problem for the credit policy is, essentially, narrowed down to the question whether the credit creation taking place in the Euromarkets is merely an alternative to the internal money circulation or whether it contains additive components. Put differently, would the credit volume (including Eurocredits) be of the same dimension if the Euromarkets did not exist?

Theory provides an answer to this question: The lack of a minimum reserve for foreign liabilities in the Eurobank centres enables the whole banking system, domestic and Eurobanks together, to erect on a certain liquidity base (controlled by the central bank in question) a higher credit pyramid than would be possible without the Eurocurrency component. The crucial empirical question whether the greater credit potential existing in theory is in fact used so as to provide a larger total credit volume than the domestic banks would have created by themselves is not clarified by this answer.

Problems for the Central Banks

The problem which the Euromarkets pose for the central banks in this context emerges clearly. Through the above described arbitrage mechanism their policies impinge on the section of the Euromarket which deals with the particular currency but the effects are asymmetrical. An expansionary policy attended by a lowering of the minimum reserve tends to reduce the Euromarket dealings as this measure deprives the external market of a part of its comparative advantage. And conversely, in the case of a restrictive monetary policy attended by an increase of the minimum reserve

the restrictive policy can be compensated by an increasing shift of banking business to the external market. The higher the minimum reserve requirement inside the country the greater is the incentive to circumvent it by Euromarket deals.

The Euromarket component must therefore, as far as possible, be taken into consideration in fixing the objectives of domestic monetary policy. If the latter is oriented towards abatement of the money expansion, monetary policy must grip the harder in the domestic market the larger is the external circulation of the currency. The inevitable result is that the domestic borrowers without access to Eurocredits are hit harder than would otherwise be the case.

The more weight the minimum reserve carries as an instrument of national monetary policy the more gravely will its efficacy as a means of monetary policy be impaired. The FR Germany has a great interest in a reasonable solution of this problem on account of the great importance of the minimum reserve as a monetary instrument of the German central bank and also because the FR Germany imposes hardly any restraints at all on capital movements.

Whatever technical solution is arrived at for this problem, it will be crucial to restore some lost ground to the monetary policy by alleviating the distortion of competition in the segmental markets of one and the same currency due entirely to administrative factors and thereby to weaken the incentive to seek an escape in the Eurobanking centres. This objective – the aim of ensuring the applicability to the whole currency area of monetary instruments which are in the national ambit as a matter of course recognized to be necessary – is important and also legitimate.

To be realistic, it must be acknowledged that the conflicting interests of the countries with Euromarket centres and the home countries of the Eurocurrencies do not make it any easier to resolve the problem. Nevertheless, even if the existence of Euromarkets adds to the difficulties of monetary policy, the ultimate responsibility for what happens to a currency lies with the central bank concerned. Excesses in the Euromarket must therefore be regarded in the main as a reflection of actions or omissions of monetary policy and not exclusively of independent activities by banks operating in the Euromarkets.

International Adjustment Process

There can be no doubt that without international money and credit markets the world economy would in

all probability have been hit even more severely by the collapse of the Bretton Woods system and the oil crisis of 1973. During and after the oil crisis in particular there might easily have occurred cumulative adaptive deflations and protectionist restrictions on trade. Difficult as the situation was at the time and in part still is today, governments rarely reacted in this way, and part of the credit for this must certainly go to the Euromarkets which have proved of value as a turntable for surplus petro-money in search of investment opportunities and turned a large part of these capital flows into regions which would otherwise have been unable to pay their oil bills. The latest oil price rise is likely to present the Euromarkets with another test of their capabilities.

These remarks must however be qualified insofar as quite a number of countries with relatively high inflation rates and matching balance of payments deficits have fallen into the somewhat precarious habit of borrowing money from Euromarket sources which enables them to refrain at least temporarily from restrictive policies aimed at lowering their payments deficits. By facilitating such borrowings the Euromarkets are certainly giving a boost to world-wide inflation.

The main problem for the developing countries is in this context that they want far more foreign goods and services than sound financial practices allow them to obtain – even if the development aid is stepped up. If borrowings from the international banking markets are made too easy, these countries may draw too liberally on foreign currency capital and imported real resources and make uneconomical use of them. Many countries are still looking on the international financial markets as a prolific – perhaps too prolific – source of funds with the help of which they can stealthily get around the conditions on which international authorities usually insist when they provide balance of payments assistance. The result is that the adjustment process which is often long overdue is delayed still further.

Cause of Currency Turmoil?

When speculative capital movements occur and exchange rates in consequence of these come under pressure in one or other direction – as has happened time and again in the recent past – it is regularly asked what role the international financial markets play in this connection. Needless to say, a central bank does not find the choice of policy any easier if it has the option of either giving way to the pressure on the exchange rate of its currency or else engaging in foreign exchange

market operations which may seriously disrupt the initiated course of domestic monetary policy. If however the international financial markets are regarded as the real cause of currency turmoil, it has to be asked whether cause and effect are not confused.

The cause of erratic capital movements will usually be found in disparities in the basic conditions of the national economies involved and in therewith related expectations or apprehensions. These have however little to do with the existence of the international financial markets as such but arise by reason of disparate national priorities. Once speculation bestirs itself, these highly volatile markets are admittedly being used as a channel for corresponding capital flows. But it must not be overlooked in this context that capital movements which interfere with monetary policies may be fuelled by other sources such as the US money market or the foreign currency holdings of central banks wishing to diversify their reserves. The international financial markets are in this connection to be seen as a mirror and catalyst of deeper-lying causes of currency turmoil rather than as the true cause itself.

The expansion of the international financial markets creates new tasks also in the sphere of banking surveillance. The supervisory authorities must ask themselves how banking crises can be avoided in these markets, for they may not only spill over into the national credit systems but impair the viability of the world-wide banking business.

The banks operating in the international financial centres are for the most part branches or independent subsidiaries of big national banking groups which are – *de jure* or *de facto* – answerable for possible losses. It is a main cause of concern that transactions in the international financial markets have lately involved greater risks as a result of, for instance, extended maturities, increased risk concentration – especially in a few countries short of foreign exchange – and a critical narrowing of profit margins. How the risks involved in international banking transactions can be discerned better and kept within limits is therefore a topical question.

Improved Transparency

The risks involved in international banking transactions cannot be detected by the resources of the national authorities responsible for the supervision of the banks alone. The information on the indebtedness of certain countries and the total

indebtedness of individual borrowers to all banks together, which is needed to form a judgment on the risk concentration, can be procured only by means of an international exchange of information.

The Bank for International Settlements has been carrying out statistical inquiries into the risks presented by individual countries since 1976. Their evidentiary value has so far been limited because they do not embrace all credit transactions and say little about the structure of the debts of the countries kept under review. These surveys have therefore to be improved. There is a special need for an international credit recording system in which data on the indebtedness of big borrowers are stored and evaluated so as to ascertain their total indebtedness to all banks all over the world at any given time.

To obtain an accurate overall picture all important banking countries, including the “off-shore centres” in particular, will have to join such a record system. It would be a significant first step in this direction if at least the countries which possess already national credit record systems would exchange their data.

Bank Supervision

In view of the fact that possible difficulties of foreign banking establishments may have repercussions on their parents and the national credit systems of their parents' countries it is incumbent upon the supervisory authorities of the latter to make sure that legally independent subsidiaries abroad do not involve banking groups domiciled in their countries in unfathomable risks. In other words, there has to be a proper relation between the risks at home and abroad and the equity capital base of the banking groups concerned. The supervisory authorities of all major banking countries are by now agreed that this control can be exercised most effectively by reference to consolidated figures of the liable equity capital of the parent bank and its foreign establishments on the one hand and their outstanding world-wide loans on the other. To these consolidated figures would have to be applied appropriate rules on equity capital and the spread of loans.

Several important banking countries, including the Netherlands and the USA for instance, are already practising a surveillance of banking groups engaging in international operations on a consolidated basis. The Federal Republic of Germany lacks as yet the legal prerequisites for this. Introduction of a consolidated system of bank supervision is one of the topics due to

receive prime attention in the deliberations on a third KWG (Kreditwesengesetz = Banking Act) amendment foreshadowed for the next legislative period. Besides, the international cooperation should be extended and intensified.

The object of all these reflections, whether concerned with monetary policy or with bank supervision, is not to curtail the freedom of the international financial markets. These markets are

serving a useful economic purpose as they have proved more than once. Nor is it their object to relieve the banks of their own responsibilities. On the contrary, we trust that the banks will in their own and the general interest be able to arrive at a correct assessment of the risks springing from their transactions abroad and to keep them within controllable dimensions. Only the weak points which may spell trouble for monetary policy and the international credit system need the pruning-knife.

Do the Euromarkets Need Controlling?

by Wilfried Guth, Frankfurt*

It is remarkable that at the annual meeting of the World Bank and the International Monetary Fund in Belgrade last autumn, not one of the prominent spokesmen of governments, central banks and international institutions except Finance Minister Matthöfer of the Federal Republic of Germany touched on the problem of "control" over the Euromarkets. Instead they all stressed that the impending extensive tasks of financing and recycling in the world cannot be accomplished without a substantial contribution by the private markets. What a difference from last spring! After the second oil shock and the attendant changes in the international economic outlook, great care will clearly have to be taken if and when new regulatory measures are initiated. Otherwise the undeniable advantages of the Euromarkets for the balancing of international accounts will be lost.

What then is the purpose of this Euromarket "control" as it is called? At first sight, the term itself seems inappropriate in two ways: for one thing, because it is often associated with dirigistic interference by the authorities with the market mechanism – a policy which is certainly not intended; for another, because it suggests that the Euromarket – or, to be more precise, the *Eurobanking* market which the discussion is about – has "got out of control", as if

it were in fact some kind of "uncontrolled" jungle growth. Neither is true. So far at any rate, the Euromoney and Eurocredit markets have been working smoothly on the basis of self-discipline and responsible policies of the participating banks. Moreover, there exists an extensive network of – albeit diverse – regulations by national supervisory authorities in the home countries of the international banks as well as in the foreign Euromarket centres where they have set up their branches and subsidiaries.

The – rather nondescript – catchword "Euromarket control" does however serve to remind us of the fact that there are a variety of causes for the unease about the Euromarket's rapid growth in recent years and that by the same token a variety of remedies are being suggested.

First of all, there is a wish for more *transparence*, for more information about this transnational market with its special forms of lending and refinancing, of debtor and creditor structures and its specific risks which are accentuated by the absence of a formal official lender of last resort. This wish is widespread and understandable and fully supported by the banks.

Yet, greater transparence alone is incapable of preventing the possible undesirable side-effects of rapid Euromarket expansion which are causing concern and giving rise to calls for "controls". The emphasis here is on three aspects:

* Member of the Board of Managing Directors of Deutsche Bank AG.
– The article was written in December 1979.