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MONETARY POLICY

Monetary Co-operation within the EC

by Alfred Nydegger, St. Gallen*

Two developments are currently shaping Europe's financial and foreign exchange markets: innovations, including the private use of the ECU, and the erratic fluctuations of the US dollar. Professor Nydegger analyses the causes and effects of these developments from the perspective of the world economy.

Let us begin by examining innovations and their origins. What gave rise to note issuance facilities (NIFs), revolving underwriting facilities (RUFs), Euro-commercial paper and the private ECU? The same factors that had earlier led to the creation of the Euro-markets, namely first the best possible interest rates for both investors and borrowers, secondly the lowest possible transaction costs, particularly turnover taxes and bank charges, thirdly the opportunity to circumvent national restrictions on the convertibility of currencies for residents or especially severe minimum reserve requirements, and fourthly the cheapest possible way of hedging exchange risks.

The Private ECU

For example, the private ECU enabled borrowers and trading partners from weak currency countries such as Italy and France to get round some of the national exchange controls that prevented them from engaging in transactions in other foreign currencies, and in some cases still do. In addition, ECUs bear interest at a lower rate than debt denominated in lire and French francs. The exchange risk is still present, but alignment of the weak currencies in the EMS basket is regularly delayed by the intervention mechanism within the EMS. This too works to the advantage of borrowers of ECUs from weak currency countries. The ECU is also viewed favourably by many potential borrowers from outside the EC, such as the World Bank and the Eastern European countries, since for a long time it was a cheaper alternative to the Euro-dollar and it still entails a smaller exchange risk.

On the other side of the coin, investments in ECUs are attractive to investors from strong currency countries

such as the Federal Republic of Germany and Switzerland, because the exchange rate is relatively stable and ECU interest rates are higher than domestic rates.

So much for the reasons for the emergence of the private ECU; the same factors have continued to shape its subsequent development, but more of that later.

Other Innovations

The other innovations are encompassed by the term "securitisation". The factors outlined above – interest rates, transaction costs, the circumvention of regulations and private strategies to counter exchange rate fluctuations – played a part here too, but other factors were also at work, such as the abundance of investible funds or the lack of sound borrowers, given that little new capital is now going to most of the developing countries. This made the international financial markets into a buyer's market, where first-class borrowers could call the tune and dictate their own terms. Fierce competition therefore developed among the international banks, made even more intense by the deregulation of national financial markets and the tremendous advances in telecommunications, which made it not only possible but essential for every bank instantaneously to obtain and process every relevant item of data from anywhere in the world.

There is no contradiction in the fact that regulation and deregulation both spawn innovation. In the sixties and seventies it was national restrictions that led to the creation of the Euromarkets; however, as these new markets and banking centres such as Luxembourg and the Bahamas increasingly competed with traditional banking operations and centres, pressure mounted for national restrictions to be eased in order to keep domestic banks competitive, whether in the USA,

* St. Gallen University. Slightly abridged version of an address delivered at the Sixth Malente Symposium of the Draeger-Stiftung on "The Role of the European Community in the World Economy", held from 27th to 29th October 1986 in Malente, Schleswig-Holstein. This and the other contributions to the symposium will appear shortly as volume 11 in the "Zukunft" series, published by Nomos Verlag, Baden-Baden.

Germany, Japan or elsewhere. Deregulation got under way mainly in the eighties; its natural consequence has been to further accentuate the internationalisation of the financial markets and to intensify competition in those markets.

Impact of Innovations

Let us now turn from the causes of innovations to their impact. One obvious effect has been that traditional loan contracts have been split up into separately negotiable elements, such as talon and coupons or facilities comprising tranches which can stipulate widely differing maturities, interest rate conditions and currencies. Conventional forward transactions are no longer the only way to hedge interest rate and exchange rate risks; futures, options and swaps can now be concluded for transactions of any kind. The volume of interbank transactions for this purpose and for every conceivable type of arbitrage operation has reached enormous proportions. According to the latest figures, only 9 % of the turnover in the London foreign exchange market constitutes customer transactions and 91 % interbank operations. In New York the ratio is 13 % to 87 %. In absolute terms, the combined daily turnover of the London, New York and Tokyo markets totals around \$190 billion, giving an annual total approaching \$50,000 billion, an unimaginable figure. By way of comparison, payments for the entire world trade in goods and services come to something over \$2,500 billion. Hence only 5 % of international foreign exchange transactions relate to transactions in goods and services; no less than 95 % are purely financial deals.

Money and capital flows have increased rapidly as a result of the wave of innovations in the financial market; capital has become much more mobile. The frontiers between national financial markets have become more permeable and the terms offered in those markets are becoming increasingly uniform as a result of competition and arbitrage. The traditional distinctions between different segments of the financial markets, such as those for short and long-term credits, are also steadily disappearing.

These developments have greatly increased market efficiency from the point of view of both investors and borrowers, particularly the latter. Nevertheless, one must also be aware of the problems that the greater complexity of the financial markets has caused. The supervision of individual contracts and the parties involved has become more difficult; for example, it has become difficult to obtain a clear view of the overall financial situation of borrowers, and to assess their creditworthiness, for the relationship between the

client and his banker is no longer as close as in the past. Risks have become much more difficult for the banks to monitor and assess. The range of risks they have to consider and weigh is wide and varied. First the del credere risk, which has become less transparent, for the reasons outlined above. Secondly the liquidity risk; both the inflow and outflow of bank deposits have become much more volatile and less predictable owing to the high mobility of capital. Thirdly the banks are exposed to the interest rate risk; interest rates have become more unstable and at the same time the banks' interest margins have narrowed owing to intense arbitrage. Fourthly there is the exchange risk, to which the same applies; if Paul Volcker, James Baker or even Henry Kaufman so much as blink, a tremor runs through the stock and foreign exchange markets. Exchange rate fluctuations have undoubtedly become greater and less comprehensible. Fifthly there is a transfer or country risk. Balances worth several hundred billion dollars are locked up in the developing countries owing to a lack of foreign exchange. The banks therefore keep a particularly sharp eye on the transfer risk, at least as far as Latin America and Africa are concerned; it sometimes seems to me that they are less punctilious when it comes to South-East Asia and Australia.

When acting as placing agents for Euro-notes and similar instruments, the banks pass all of these risks on, but when investing for their own account, committing themselves forward under swap operations etc. or purchasing claims on their partners, they are dependent on performance of the contracts by all the other parties. Such chains of contracts are obviously only as strong as their weakest link; a sudden political or economic crisis can easily precipitate a breakdown. The banks are particularly vulnerable to the concentration of all these risks if they grant facilities involving back-up guarantees.

The banks are facing a dilemma. Competition is forcing them to go to the limits of responsible risk-taking; unless they offer keen terms, other lenders will snap up the business, and indeed decisions must often be taken within a matter of seconds. It has become more difficult than ever to remain on the right side of the line. Wilfried Guth, the Chairman of Deutsche Bank, said in a speech that the banks had yet to learn how to recognise and handle the new and previously unknown risks quickly; the learning process would probably not be completed without minor or perhaps major accidents. Eleven months have passed since he delivered that speech. Despite the extreme volatility of interest rates and the dollar exchange rate, accidents have been avoided so

far (if one disregards the collapse of a few banks in the USA, due mainly to the oil situation). Perhaps the favourable course of economic activity and the rise in share prices were essential factors behind this favourable risks situation. There can be no guarantee that this will continue.

It is not only the banks that are being affected by financial innovation and the internationalisation of the financial markets; the banking supervisory authorities and monetary authorities are themselves facing new problems and responsibilities. The banks' balance sheets no longer adequately express the scale of the risks they are bearing, either as a result of back-up facilities or the increase in market volatility. Rapid shifts of portfolios in a growing number of currencies are increasing the volatility of exchange rates and interest rates, but neither this nor the associated increase in risk is evident from the banks' balance sheets. As far as control of the money supply is concerned, it becomes more difficult to monitor or even statistically record the money supply the more its composition is affected, and its boundaries are blurred, by financial innovation.

Implications for Policy within the EC

What consequences are these developments likely to have for the EC's policy towards the financial markets?

Every well managed bank will itself strive to pursue an optimum policy regarding risks. It will strengthen its equity base, set ceilings on back-up commitments and will not simply follow the latest fashion as regards securitisation but will also expand its other services in a way that will appeal to customers. The OECD's financial market statistics seem to indicate that a rather more sober mood has already set in. In the first half of 1986 NIFs and other back-up facilities came to only half the figure recorded in the same period of 1985; Euro-commercial paper, on the other hand, showed a marked expansion. However, there are some who regard this change in emphasis as no more than a further attempt to circumvent the controls imposed by the supervisory authorities.

National banking supervisory authorities are trying to extend supervision to the banks' off-balance-sheet activities and to strengthen the requirement to make provision in respect of doubtful international debts. However, keen competition and the integration of national markets mean that they are not free to introduce whatever new regulations they wish, but must co-ordinate their actions at international level, at least as regards provisions affecting competition. This is the objective being pursued by the Committee on Banking

Regulation and Supervisory Practices at the BIS, and the central banks of major industrialised countries have followed similar paths in regulating new market instruments. Co-ordination measures restricted to the EC countries would obviously not do the job.

Nevertheless, I consider the efforts to stabilise share prices and exchange rates to be even more important. Priority in this regard must go to stabilising market expectations about future prices and rates. The Deutsche Bundesbank's more active open market policy aims in this direction. However, individual EC countries have only limited scope to influence opinions that are formed throughout the world. Nor does the EC appear to be the best platform from which to take action, first since it has no uniform financial market and no common policy towards the financial markets, and secondly because efforts to shape expectations must be made on a broader front, including at least the USA and Japan. The Plaza meeting a year ago, the efforts to combat inflation and the various other attempts to harmonise economic policy are important examples of this. As far as the formal manner of proceeding is concerned, I concur with the views expressed by the BIS, which states the following in its latest Annual Report: "It is questionable whether formal agreements (which, by their very nature, require protracted negotiations and the taking of positions on frequently trivial matters) are really what should be sought. Where co-operation is successful, it tends to develop its own momentum, and it may be best to explore further areas where opportunities for successful co-operation exist."¹ "However untidy it may seem, a gradual approach, combining verbal guidance, exchange market intervention and visible signs of co-ordinated policy action, seems for the time being to be the only realistic option, perhaps opening up possibilities of more 'systematic' changes in the longer term."²

Exchange Rate Policy under the Sign of the Dollar

Having dealt with financial innovations, I shall now return to the question of the rollercoasting dollar. The behaviour of the US currency is my second point of reference from which to assess the European financial markets and especially monetary co-operation within the EC from a world perspective.

By the beginning of March 1985 the dollar had risen to DM 3.32, its highest level for ten years, despite the

¹ Bank for International Settlements: Fifty-sixth Annual Report, Basle 1986, p. 7.

² *Ibid.*, p. 186.

record US current account deficit. In normal circumstances, a current account deficit should weaken the dollar, for American importers are selling more dollars in the foreign exchange market to meet their external commitments than the buyers of US exports are purchasing to pay their invoices. The dollar nevertheless rose to such a high level because of massive foreign demand for dollar investments in the light of attractive interest rates, brisk economic activity in the United States and probably also the hope that the dollar exchange rate would remain high. The attractiveness of the dollar was also a sign of unfavourable investment conditions in other countries.

Today the dollar is worth less than DM 2. Interest rates have fallen sharply, in line with inflation. The shortfall on

the US current account and the budget deficit are as high as they were eighteen months ago, but the foreign clamour for dollar assets has eased. The BIS statistics show that the reporting banks' dollar liabilities rose by only 5% in the twelve months to March 1986, whereas those denominated in other foreign currencies increased by 65%. Nonetheless, the dollar still accounts for two-thirds of foreign currency liabilities. The Deutsche Mark contributes 13%, followed by the Swiss franc with 7% and the yen with just under 5%. The ECU accounts for little over 3%. The inflow into the Deutsche Mark caused tension within the EMS. At the time of writing, the immediate future of the dollar and the ECU is still unclear, but in my view it is the medium-term trends that are more important. How will events develop?

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Dietrich Keschull

TRANSMIGRATION IN INDONESIA

An Empirical Analysis of Motivation, Expectations and Experiences

The abolition of regional disparities is one of the main targets of Indonesian economic policy. Sub-targets are the utilization of the outer islands' natural resources for economic and social development, the alleviation of the inter- and intra-regional income disparities, and the creation of jobs as well as the reversal of the population migration from the thinly populated outer regions to overpopulated Java. In particular regarding transmigration, special significance is placed on the province of East Kalimantan. Within the scope of the Indonesian-German Technical Cooperation the East Kalimantan Transmigration Area Development Project (TAD) is intended to contribute to supporting this policy. To make successful transmigration projects possible it is necessary to know the economic and social background of the target group in detail. The group's reasons and motivations for transmigration and its expectations are an important input to the planning and design of the whole programme. This study was carried out to support this work – as a first step to gain relevant information. The report is based on interviews with transmigrant families. They were made before transmigration in the so-called transitos in Java and Bali and after transmigration in eight settlements in Riau and East Kalimantan.

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V E R L A G W E L T A R C H I V G M B H - H A M B U R G

Scenario for the Dollar

One scenario in this respect is that the cheap dollar will soon reduce the US current account deficit. Imports into the United States will become more expensive and will therefore contract, while US exports will become more competitive and will thus increase. These adjustments will take a little time. Current import and export transactions must first work their way through the system and new transactions fall due for payment. In a few months' time, however, that stage will have been reached and the current account will be showing the effects of the cheaper dollar. This will stimulate growth in the US economy and restore confidence in the dollar. A fall in the current account deficit naturally tends to push up the exchange rate, for it causes a direct increase in the demand for dollars for current transactions and reduces the volume on offer. Moreover, the present dollar exchange rate is below the purchasing power parity and is therefore too low from the long-term perspective as well. Further upward pressure on the dollar would probably develop if substantial inroads were finally made into the budget deficit and government borrowing in the US capital market were curbed, for this would reduce the volume of dollar assets available to investors while foreign demand would presumably be little changed. There is only one factor that some observers believe might depress the dollar, and that is the fear of a rekindling of inflation, which could be triggered by the rapid growth in the money supply in the United States, accompanied by the cost increases caused by the rise in import prices. On balance, however, I conclude from this scenario that the dollar is likely to appreciate slightly again; furthermore, the exchange rate will not girate as wildly as in recent years, since the distortions that the US economy has caused in the rest of the world economy and in share prices and exchange rates over the last few years are being reduced.

Implications for the Private ECU

What are the implications of this scenario for the private ECU? Perhaps with some degree of exaggeration, I venture to suggest that the private ECU has been nurtured mainly by the disequilibria both within and without the EC. As I have already said, interest in the private ECU came chiefly from EC member countries with weak currencies, mainly on account of restrictions on financial markets and high domestic interest rates. Outside the European Community the ECU was chosen as a means of diversifying out of the unstable dollar and other national currencies. However, the more inflation rates, interest rates and growth rates within the EC

converge, national restrictions on the financial markets are eased and the dollar exchange rate can be assumed to have settled on a more stable course, the more the private ECU will lose its power of attraction. The BIS report on International Banking and Financial Market Developments published in July 1986 already reveals that Italian banks' ECU liabilities towards residents fell from the equivalent of \$3.9 billion in March 1985 to \$2.5 billion in March 1986, a decrease that also led to a reduction in the Italian banks' interbank liabilities. A similar picture is reported from France.

By contrast, Euro-currency business in ECUs outside the European Community has been very active in recent months. However, the same has been true of transactions in the other non-dollar Euro-currencies, i.e. Deutsche Mark, Swiss franc and yen, which has gained a clear lead over the ECU as an investment currency in the last twelve reporting months. The increase in activity therefore simply reflects the shift out of the unstable dollar, a tendency that may even intensify over the short term, in view of US pronouncements to the effect that the dollar has still not fallen far enough. The "favoured" currencies will be those that investors most expect to appreciate. These are certain national currencies, but not the ECU. Apart from the fact that the ECU exchange rate reacts more sluggishly, strains will develop within the EMS between the prized hard currencies and the other members of the basket; such strains have already been evident. Exchange rate realignments cannot be ruled out, and expectations to that effect will dampen the demand for ECUs.

As I have described in the scenario, however, the instability of the dollar and the outflow of capital from that currency should before long abate and the demand for key European currencies, the yen and also the ECU in the Euro-markets should calm down. The private ECU has undeniably established itself in the international financial markets, but in my opinion its share will remain modest and will decline as progress is made in the harmonisation of the economies and economic policies of the western world. The situation would change if the private and official ECUs were fused into a Community currency, but the EC still has a long way to go before that happens.

The Official ECU and the EMS

Finally, let us examine the official ECU and the European Monetary System. It is useful to distinguish between internal and external relationships and to compare the present state of affairs with the more or less openly declared final objective, or ideal, of a common currency.

Internal Relationship

For internal purposes, that is to say within its own economic area, a currency serves as a unit of account, a standard and store of value and a medium of exchange. For the Community authorities and within the EMS mechanism, however, the official ECU is no more than a unit of account, and an imperfect one at that, given the adjustability of the underlying basket and the abstention of the United Kingdom from membership of the mechanism. A genuine currency is not a basket; or can you imagine a Federal German Mark composed of the Marks of Bavaria, North Rhine-Westphalia and so on, subject to periodic revaluations and devaluations?

A common monetary area obviously presupposes the existence of a fully-fledged common economic area with completely free movement of goods, services, labour and capital and a uniform economic and monetary policy under central authority, rather than one that is merely harmonised. The sovereignty of member states would be limited more or less to the level exercised by the Länder in the Federal Republic of Germany. Once that situation had been reached, the distinction between the official and private ECUs would obviously be superfluous.

If this description is compared with the present state of affairs, it can be seen that the European Community still has a long way to go before the requirements for a common currency have been fulfilled. In stating that, I am not in any way disparaging the value of the EMS. It has significantly reduced exchange rate fluctuations between the currencies in the basket and hence greatly facilitated trade among EC countries. It has undoubtedly also induced the governments of member states to shape national economic policies in such a way that their currencies remain as far as possible within the EMS band of fluctuation. In other words, the EMS is a highly effective means of harmonising the economic policies of member countries. However, the opposite is also true; the better harmonisation works, the better will the EMS function and the sooner can it be developed further. The debate whether monetary integration must be achieved before economic integration within the EC can be completed or whether economic policy harmonisation is a precondition for monetary integration overlooks the fact that both developments must proceed in tandem, albeit cautiously and in stages. Hence the findings of the BIS with regard to policy towards the international financial markets also apply to Community policy.

The important thing is that the steps be taken in the correct sequence. In my opinion, one measure that is overdue is the sanctioning of ECU accounts for

residents in Germany. Other steps to be taken are the extension of resident convertibility in France, Italy and Belgium. On the other hand, I believe it would be premature to transfer powers over monetary policy to a central Community body, for a common money supply policy will not produce a meaningful Community policy on the stabilisation of prices and economic activity until the other mechanisms and measures affecting prices and cyclical conditions in all member states have been harmonised; this applies especially to fiscal policy, wages policy and pricing policy for areas of the economy dominated by the state.

External Relationship

These factors also determine the immediate and probably also the medium-term future of the official ECU and the EMS in their external relationship with the rest of the world. The EMS acts as a valuable buffer against exchange rate shocks from outside. The official ECU is not directly affected, however, since it is not an intervention currency for external purposes; the European Monetary Co-operation Fund cannot support the dollar by selling large quantities of ECUs in exchange for dollars in the international foreign exchange markets, although non-EC central banks can hold official ECUs. As in the past, the shock waves emanating from the Euro-currency and foreign exchange markets directly affect individual currencies in the basket, and especially the strong ones. This causes exchange rate movements within the EMS, and it is here that the EMS mechanism acts as a shock absorber, although even then realignment becomes unavoidable if the shock waves are so strong or long-lasting that the scope for intervention within the EMS is exhausted.

It is conceivable, however, that in the not too distant future it will be proposed that the official ECU be declared an intervention currency in the international exchange markets alongside the currencies of the member states in order to ease the pressure on them and dampen their exchange rate fluctuations. That would probably also be the time to amalgamate the official and private ECUs, first by allowing swaps between the two and then through interest rate and price arbitrage. If this were proposed, it would have to be realised that the intervention body would gain some powers over the money supply through the back door. Furthermore, exchange rate fluctuations in the Deutsche Mark and other national currencies would be reduced only to the extent that ECUs appearing in the foreign exchange markets as a result of intervention were not immediately converted back by their buyers into Marks and other strong national currencies.