Extract from a speech by the Governor

Delivered to the Bankers' Club of Chicago on 27th April 1971

The title of my talk tonight is "The current international financial picture". This is, of course, an enormous subject and I cannot attempt to cover it in a talk of this nature. What I propose to do is to talk about one aspect of the current international financial scene, that is, the euro-currency market.

It is a truism that the world is getting smaller. It is getting smaller in some ways that are spectacular, such as the simultaneous screening throughout the world of television pictures that may have their source many miles away from the earth itself. Less spectacular, but no less real, has been the way in which, in the last decade or so, the financial markets of developed countries have become bound increasingly closely together. This is true to some extent of bond and equity markets, but the principal agency through which it has come about is in the shorter-term markets in euro-currencies and, above all, in euro-dollars.

If these wider implications were not sufficient reason for me to choose as my topic the development of the euro-dollar market, there are other more parochial reasons that make it appropriate. In so far as the euro-dollar market can be said to have a geographical location, London is its centre. Chicago banks, as you all know, are well represented there. Perhaps their presence has led some of our own institutions to appreciate the importance of Chicago as a financial centre; certainly one of our largest banking groups, and one of our best-known stock exchange firms, have now opened offices here. And my final reason is that, though I well know that my subject is one that many people find confusing, I am confident that it will hold no terrors for an audience familiar with the mysteries of the Cook County tax dates and the impact they have had on U.S. money markets over many years.

I spoke just now of the financial markets of developed countries being bound increasingly closely together. It is easy to understand why this has happened, but less easy to explain why it has happened so largely through the agency of the euro-dollar market. I shall do my best to offer an answer, and see to what conclusions that answer leads. But, first, why the coming together?

It is not, of course, an entirely new phenomenon. The phrase 'hot money' was, after all, coined to describe the funds that flowed so readily between different national money markets in the 1920s, and that was many years before the expression 'euro-dollar market' was born. But there then followed two decades of retreat behind national frontiers. First, in the thirties, reactions to the financial and economic disasters of 1929 and 1931 caused national economic policies, and those of investors, to be predominantly inward-looking. Then followed the Second World War and the period of austere post-war reconstruction. It was not until the 1950s that countries outside the American Continent began systematically to dismantle the array of controls on foreign transactions that had been imposed –

both quantitative controls on trade, and controls on the free movement of money. The principal milestone came at the end of 1958, when holdings by non-residents of sterling and other major European currencies, arising from current transactions, became freely convertible. Many obstacles remained to the completely free flow of capital across national frontiers, and still do. Only Germany and Switzerland among developed countries allow unrestricted convertibility of holdings of their own currency by their own residents, something that has been denied to U.K. residents for many years, and to U.S. corporations more recently. But none the less, after 1958, the stage was set for the development of international financial business in one way or another, and all that was needed to bring it about was a sufficiently international outlook among investors, corporate businesses, banks and other types of financial institution.

The early post-war years had been characterised by what was known as the 'dollar gap'. By a variety of means, notably through Marshall Aid, the United States took steps to close the gap. By the middle and latter fifties, dollars were becoming more plentiful. Some countries holding foreign exchange reserves, notably Russia and other Communist countries, had their reasons for not holding dollars directly with banks in the United States. But though they held their reserves with banks in other countries, they insisted all the same in holding them in the form of dollars. They valued the dollar for its strength and its world-wide usability. Ironical though it may seem, that was the beginning of the euro-dollar market; the world-wide usability of the dollar laid its foundation and remains its keystone, but a number of other factors have played a great part in its development.

The first such factor I will mention is the existence of restraints on the borrowing or lending of money through other channels. I do not need to look far for examples. Historically, interest rate conventions or constraints in the domestic banking systems of various countries have encouraged borrowers to tap other sources, a response that has become all the more natural as the business of corporations has itself become multinational. My own country has had continuing controls on the freedom of its residents to finance investment overseas from domestic funds but has allowed such investment much more freely if it was to be financed by borrowing overseas. Your country now has a similar system. These controls have added to the demand for funds in the euro-dollar market. But their effects were in time dwarfed by that of the tight money policy in the United States, accompanied by the limitations of Regulation Q on the banks' access to domestic funds, which led to a rapid growth in their borrowing from the euro-dollar market to a peak of about $15 billion in mid-1969.

The second factor was, paradoxically, a lack of restrictions. In this case, I mean restrictions that would prevent an adequate supply of funds flowing to the market, or restrictions that would bite upon the activities of banks engaging in euro-market operations. Absence of the latter has been a feature of banking in London, though London is by no means unique in this respect. But London has provided freedom of establishment and banks of good repute have been welcomed – one result of which has been that the number of U.S. banks with branches in London has risen from nine in 1963 to thirty-one today, not counting those multinational banks in which there are U.S. interests. Such restrictions as we have found it necessary to operate have concerned the use of sterling – either domestically, or for use overseas, or for conversion into other currencies. Banking conducted wholly in other currencies has been free from restrictions, and in that sense the market has been extra-territorial. The supply of funds has come from a variety of sources that were unrestricted by any balance of payments constraint from being invested in the euro-dollar market.

The third factor in the growth of the euro-dollar market is, I believe, not unrelated to the second. It is the capacity that those who operate in the market have shown to innovate, to be flexible and inventive. There are countless examples. The structure of the banks themselves is one; it was the euro-dollar market that gave birth to the multinational consortium bank, specialist institutions bringing together into one market place the combined knowledge and skills of banks in many countries, and existing to serve the needs of customers even more widely. Their number has multiplied to the point where it must now be getting difficult to find a distinctive name for a new international bank, and the web of inter-bank connections through joint interests in such banks is indeed tangled. New procedures have been developed for meeting the needs of euro-market customers, typically big international corporations whose global credit needs cannot always be met from purely domestic banking systems. Among these are roll-over credits, floating rate notes and, more recently, an infant market in euro-dollar commercial paper.

There can be little doubt but that the euro-dollar market has met a real need in mobilising international sources of finance, and in devising new and flexible ways of making it available to those who require it. It has been able to do this first because it developed as a unified market with a stock in trade – U.S. dollars – that could be freely traded in wholesale quantities; and secondly because it succeeded in creating within that unified market a remarkable diversity in the services and facilities that it could offer.

After that tribute to the achievements of the market, it must now seem rather churlish of me to go on to ask this question – do we, after all, really like the consequences of it? It has to be admitted that there are many observers who are uneasy. Their disquiet is aroused on two scores – doubts about the stability of the market itself, and uneasiness about the effects of transactions in the market on the satisfactory conduct of national economic policies. On both counts, disquiet has undoubtedly been fed by the extremely rapid growth of the market in the last two or three years. It may seem small and insignificant to you, when set beside the stock of money in the United States, but the euro-dollar market is now equal in size to the money supply of France. Some eminent central bankers are among the people of great experience and respected judgment who have expressed concern about the implications of the market's development, and their concern calls for serious consideration.

First, can we be confident of the stability of the market? It extends across national frontiers, so that there is no one national banking authority that can supervise its operations, insist on sound practices and stand ready, in emergency, to be a 'lender of last resort'. By the same token, it cannot be easy for lenders, whose inter-bank lending is unsecured, to know much about the creditworthiness or the full financial commitments of the ultimate borrower. One big failure, it is sometimes said, could lead to a chain reaction bringing down all in its path. Is there a need then for some unified central banking presence to supervise the market?

Our tradition in Britain is of a less formal system of supervision of banks than is customary in some other developed countries; and my long experience has not weakened my faith in this tradition. Of course supervision is needed from time to time; and a central bank must always be watchful and well-informed. But it is plainly impossible to draw up and enforce rules that can give complete protection against the risk of failures. Ultimately, the stability of the market depends on the judgment, prudence and self-discipline of those who participate in it. External controls have to be very skilfully, and in my view sparingly, applied if they are to reinforce rather than undermine those qualities.

Those who are uneasy at the absence of a 'lender of last resort' in the euro-dollar market are probably giving to that expression a rather specialised meaning. Classically, the 'lender of last resort' stands ready to buy for cash unmatured paper of certain types held by the domestic banking system. The need arises because banks have liabilities to their depositors which are at sight or short notice, but invest in assets of longer term. Euro-currency banking is, and should be, rather different. Deposits repayable on demand or at very short notice are, in comparison with domestic banking, proportionately small. It is possible, and indeed customary, for banks to maintain a fairly close maturity-matching between their liabilities and their assets. In Britain we have taken steps, by way of periodic surveys of their maturity structure, to assure ourselves that euro-currency banks in London are, by and large, observing that custom.[1]

The meaning intended nowadays by some who use the expression 'lender of last resort' may be not just the provision of liquidity to a bank whose paper is simply unmatured, but the support of banks which, because of the failure of customers, may be in danger of insolvency. Of course no central banks of developed countries acknowledge a formal obligation to rescue any of their banks. A commercial bank's responsibility to its depositors and shareholders requires the exercise of sound judgment in the assumption of risks which the certainty of rescue might impair. On the other hand, central banks, with their wider responsibility to the nation as a whole, would have to weigh all the circumstances very carefully before allowing a major

[1] The results of the latest survey, relating to the end of February 1971, are summarised on pages 218-23 of this issue.

default in their banking system whether due to domestic or external operations.

I do not wish these remarks to be interpreted as meaning that I think nothing could or should be done to make the euro-currency markets more secure. The greatest scope for improvement in this regard probably lies in the systems for reporting on creditworthiness, in obtaining adequate and accurate information on the financial standing of prospective borrowers. But I am not persuaded that that task, or indeed the general need to see that sound practices are observed, requires the setting up of a whole new machinery of central bank supervision.

That proposition, it seems to me, must stand or fall on the contribution it could make to eliminating the second ground for disquiet about the euro-market – its effects, supposedly adverse, on the conduct of national economic policies. Among the adverse effects from time to time attributed to the market are: that it enables countries, by inducing inflows of exchange in response to high interest rates, to conceal a lack of balance in their external payments, and defer taking action to correct it; that it augments the speculative outflow, when a country's exchange parity is suspect; conversely, that it magnifies the speculative inflow into countries that are seen as candidates for revaluation; that it provides inflows which serve to undermine policies of tight money or high interest rates, depriving countries of control over their domestic economy; that, quite apart from transmitting inflation from one country to another, it is itself an independent source of inflation. A formidable list!

It will not have escaped you that two of the features that recur in that list – the possibilities of changes in exchange rates and of contrasting monetary policies in different countries – are ones that cannot be present in a single, unified political region. A dollar in Chicago is the same thing as a dollar in Dallas, and monetary conditions in New York and San Francisco can never get seriously out of line with each other. It is for that reason that the beguilingly simple idea of creating for the euro-dollar market something akin to the Federal Reserve System – a sort of Federal Open Market Committee for euro-dollars – is premature. It could not solve the problems I have mentioned so long as the possibility of exchange rate changes exists, and so long as there are different national monetary policies each based to a considerable extent on domestic needs. The political integration of the developed world lags behind the integration of its trade and finance. Without common objectives to pursue, concerted attempts to regulate the euro-currency market by central bank intervention, analogous to that undertaken by the New York Fed. in your domestic markets, would not be workable. The limited amount of central bank 'intervention' that has to date taken place has been directed mainly at overcoming temporary problems in the domestic markets of the individual country concerned – for example, at balance sheet dates at the end of the year.

Nevertheless, the problems caused to individual countries from time to time by large capital flows through the markets, outward or inward, are real and can be severe. Even when speculative motives are entirely absent, these flows can be of a size to jeopardise the operation of domestic monetary and economic policies. The most recent victim – if that is the right word – of inflows has been my own country, putting us into a position with which other countries, notably Germany and Canada, are rather more familiar. If I may be permitted, I should like to digress and make a few remarks about this novel situation in the United Kingdom. It results from a combination of very considerable success in one aspect of our economic affairs – the balance of payments – with equally obvious lack of success in another area, the course of domestic costs and prices. As a result of the success, we have been able to make very substantial progress in repaying the short and medium-term indebtedness that was built up prior to and in the first months after the sterling devaluation of November 1967, and the clouds that hung over sterling until well into 1969 have dispersed. But the continuing struggle on costs and prices has obliged us to persist with policies of high interest rates and monetary restrictiveness at a time when conditions in other countries, especially the United States, were becoming notably easier. We have in many ways been following a similar path to yourselves, though somewhat different in timing and in extent. We know from our own experience, as you do from yours, that cost inflation can persist for a very long time after any excesses of demand have disappeared.

Be that as it may, we now know something of what it is like to be on the receiving end of substantial capital flows. We have, early this year, taken steps to limit the extent to which U.K. residents may build up short-term liabilities in foreign currencies. We believe that that measure, together with the other controls that operate on the domestic extension of credit, will enable us to avoid having our attempts to contain domestic inflation disrupted by external influences – whether transmitted from other countries or independently generated by the extra-territorial forces to which Professor Friedman and others attach such importance. This illustrates one possible approach for countries that are troubled by problems of external capital flows – controls applied to their own residents. The advantage of this approach is that it enables controls to operate just at those points where difficulties have arisen and, if they are used with restraint, avoids the need for more generalised restrictions on the freedom of capital movements.

The alternative approach, advocated by many critics of the euro-dollar market, is so to regulate operations in that market that external influences affect national economies less acutely. Such regulation would amount, in effect, to a generalised restriction on the freedom of capital movements, but – its sponsors would argue – only a modest one. Their argument rests on the belief that the euro-dollar market adds a whole new dimension to the international transmission of economic and monetary influences. It is held to be different in kind, not just in degree, from anything that has existed in the past or, presumably, from any conceivable alternative mechanism that could develop in the present or the near future. I have my doubts about this thesis. As I mentioned early in my remarks, the flow of funds between conventional national money markets gave rise to just these same problems in the 1920s. The same could happen again today, but it would undoubtedly be enormously magnified by those other features that I have also mentioned – the growing internationalisation of corporate business, the growth in international trade and payments, and the inventiveness and ingenuity of the banking community. If we attempted to solve the problems of international adjustment by legislating the euro-dollar market out of existence, we should discover one of two things. Either the attempt would be largely ineffective, because the euro-dollar market would simply shift its location to an unregulated centre; or its effects would be quickly undone, as other mechanisms came into being to take its place.

The danger of concentrating attention on the euro-dollar market is that it distracts attention from the real causes of international maladjustment – for any problem that is transmitted must have underlying causes quite independent of the agency through which it is transmitted. There is no denying that we still have a lot to learn about how to manage what is known as 'the international adjustment process' in this world of convertible currencies. We need to explore further the operational possibilities for greater co-ordination of national economic policies over a wide field. That certainly includes policies affecting the development of financial markets and their institutional structure, and questions concerning the manner in which official exchange reserves are held. We are prepared to play a full part in any such studies.

Short of heavy-handed attempts to control it, the euro-dollar market has a promising future. It could, I think, survive the disappearance of some of the conditions that enabled it to get established in the first place – even the ending of restrictions on capital outflow from the United States. I take this view because I believe that the facilities and services that the market is now providing, and above all its ability to transfer funds on a large scale from lender to borrower with only a modest margin in the interest rates, would enable it to withstand the challenge of competing markets. Its future would be in jeopardy, on the other hand, if there were to be a return to a non-convertible world or to extensive restrictions on capital flows. I do not regard that eventuality as remotely likely, except in one, also unlikely, circumstance – the fear of which might be said to constitute a third ground for uneasiness among those who see dangers in the euro-dollar market. That would be a loss of confidence by investors and bankers in what I have described as the world-wide usability of the dollar.

It seems to me that to relate that fear simply to potential dangers in the euro-dollar market is to miss its wider implications. For if we ever came to that unhappy situation, it would be the whole fabric of the post-1945 international monetary system that would be in danger. That system has served us pretty well. It is a system that puts the United States in a unique position – whether one describes it as a dollar exchange standard or simply as a dollar standard.

The unique position of the United States may be described, according to one's point of view, as one of special privilege or as one of special responsibility.

Since I prefer the latter version, I was encouraged to see that in President Nixon's foreign policy statement to Congress in February he said "The size of the United States in the world economy and the dollar's key role in the international monetary system levy a special responsibility on us. We must manage our own economy responsibly for international as well as domestic reasons".

However, perhaps I may be allowed to point out that gaps may and do emerge between promise and performance in this respect; there may also be different views on different sides of the Atlantic (and the Pacific) as to what constitutes taking adequate account of international considerations when formulating U.S. domestic policy. Clearly, it is unreasonable to expect the balance of payments to be as important a factor for U.S. policy makers as it must be, for example, in my own country, or in other European countries, where the foreign sector accounts for a much larger share of G.N.P. Further, we must always recognise that the adjustment of international balances of payments is a matter for which all countries, including those that are in surplus, share the responsibility.

Even so, there are, in my view, two areas in which their 'special responsibility' applies at present to the United States. In the short run, there is a need to deal with the problem of the large outflows of short-term capital from the United States in 1970 and 1971. These outflows I would regard as largely the reversal of an unnatural position built up in earlier years. One should not complain at a return to a position that will in the long run be more tenable, but there have been dangers that the outflows might go too fast and too far. I have, therefore, been encouraged to see both the sales of 'Exim' notes and U.S. Treasury certificates for euro-dollars and the recent strengthening of short-term interest rates in the United States. I welcome in particular the sales of U.S. Treasury certificates which represent a clear and visible sign of the Administration's concern about the U.S. balance of payments. For the longer run, it is disappointing that the current account of the U.S. balance of payments has not improved more during the period of restrictive policies. A further and sustained improvement here – and in the long-term capital account – clearly depends to a large extent on your Administration's success in putting the U.S. economy back on to a path of non-inflationary growth. To the problems posed by cost inflation I have no easy answers, but I am sure that 'benign neglect' is no more appropriate there than it is in respect of the balance of payments. . . .