Controlling the euro-markets

A slightly expanded version of a talk given by C. W. McMahon, an Executive Director of the Bank of England, at the Financial Times and Investors Chronicle Conference on 'The euro-markets in 1976' on 5 February 1976.

My topic this morning is given as 'Controlling the euro-markets'. This is certainly pithy. It verges indeed on the stark, and I was initially tempted to respond in kind: simply to quote Dr Johnson – speaking I must confess on another subject – 'it would be impossible, if it were endeavoured, and would be foolish, if it were possible'; and sit down. However, I doubt if you would then feel you had got your money's worth. And in any case there is rather more to be said.

We must begin, I think, by asking alike those to whom control in some form is imperative and those to whom in any form it is anathema, what are the problems posed by the euro-markets and in what ways can control – or regulation – or supervision, internationally or nationally, help to solve those problems? To this end it is helpful at the outset to distinguish between two broad areas of official concern in relation to euro-markets.

First, there is concern with the financial health of euro-banks as part of wider official responsibility for the stability of the whole financial structure. This is reflected in *prudential* control or *prudential* supervision – and has in practice been the main focus of attention in the past couple of years.

Secondly, there is concern with the monetary effects of euro-banking. Can it, does it, might it, generate excessive world liquidity and add to inflationary pressure? Or complicate domestic monetary management in particular countries? Or aggravate disturbances in foreign exchange markets? This is a much more controversial subject. Worry about these possible effects has led to periodic pressure for co-ordinated *monetary* controls over the euro-markets. Although such pressure subsided with the onset of the oil crisis and with failure to achieve a full-scale reform of the international monetary system, there have been some more recent signs that this subject will revive.

These two subjects – prudential and monetary control – are, of course, related. Constraints introduced for prudential purposes are not without monetary effect and vice versa; and in some cases – for example, liquidity ratios or mandatory reserve requirements – even the form of possible control may be similar. But the considerations relating to prudential and monetary controls are very different and it is convenient to discuss them in turn.

Prudential control and supervision

There has been much discussion over the past two or three years about the dangers of instability and unpleasant chain reactions in the world banking system. There have indeed been problems – potential and actual. But what is interesting in the present context is the extent to which they have *not* been problems specifically related to the banks' euro-currency activity:

a The spectacular foreign exchange losses incurred by a handful of banks, which brought about a temporary crisis of confidence in the summer of 1974, arose from foreign exchange dealing (i.e. the buying and selling of foreign currency) rather than from euro-currency banking properly defined (i.e. the borrowing and lending of foreign currency).

b At about the same time, doubts arose about capital adequacy of banks. These problems were widely perceived in relation to external foreign currency business, principally because the euro-markets carried such a large part of the initial burden of recycling oil producers' surpluses. (In the first half of 1974 more than 50% of the oil producers' total identified surplus of $22½ billion went into euro-currency deposits world wide, compared with only about 12% out of a total surplus of $16 billion in the second and third quarters of 1975.) Nevertheless, any concern with banks' capital adequacy must properly relate to their total activity, not simply to their foreign currency business.

c A third main source of concern in 1974 was the uncertainty surrounding the division of responsibility between monetary authorities for acting as lender of last resort to foreign bank subsidiaries and affiliates in case of temporary liquidity difficulties. This in turn raised questions about the division of supervisory responsibilities. Again this uncertainty related to the *total* activities of foreign subsidiaries and affiliates, i.e. including their business in local currencies, rather than just to their euro-market activity.

d Finally, the very large expansion of bank credit to developing countries which do not produce oil has given rise to some appropriate caution on the part of many banks recently. But this too was by no means confined to the euro-markets. It was accompanied by a very rapid growth in direct foreign lending by national banking systems in their domestic currencies. For example, from the beginning of 1974 to September 1975, lending by banks in the United States to non-oil less developed countries rose much faster, and by a much greater absolute amount, than UK banks' lending to the same countries in foreign currencies: increases of $8 billion or 100%, compared with $3·5 billion or 55%.

I have gone into this distinction at some length because there is a tendency in relation to prudential supervision, as in relation to monetary control which I shall discuss later, to make the euro-markets a scapegoat for problems that in fact go very much wider. This tendency leads all too easily to calls for prudential controls – at the national or, more often, the international level – to be imposed specifically on euro-market operations. But it follows from the interconnections I have mentioned that a bank's euro-currency operations are just a part of its total activity for purposes of supervision. From this point of view, the present arrangements whereby the bank's euro-currency operations are indeed subject to supervision by the country in which the bank is registered, typically without distinction

between those operations and the bank's domestic business, seem to me appropriate. There are, of course, considerable national differences of supervisory technique and tradition; and it will be appropriate for the supervisory authorities to place special emphasis from time to time on certain types of activity in which the banks they supervise engage. But the fundamental objective is everywhere the same. Rather than attempting to establish identical control over particular activities, what is needed is close co-operation between national supervisory authorities to ensure that *all* aspects of international banking are subject to appropriate surveillance.

We have in fact made substantial progress in this direction in the past two years. Part of the response to the loss of confidence in the summer of 1974 was a tightening of national supervision over capital and liquidity provision and, more especially, over foreign exchange dealing in a number of countries where particular problems had appeared. But there was also an encouraging advance in international co-operation on matters of banking supervision generally.

This co-operation resulted in the September 1974 statement by BIS Central Bank Governors that they were satisfied that means are available for last resort provision of temporary liquidity to the euro-markets which would be used if and when necessary. Although the precise nature of these arrangements varies from case to case to take account of differences in national legislation, the broad principle on which the arrangements are based is that of parental responsibility. This is to say that it is accepted that parent banks have a responsibility, not merely to their overseas branches, but towards all overseas banking operations in which they have a direct stake; and further, that the central bank of the parent bank also has an indirect responsibility for such overseas operations. A parent bank's responsibility for its offspring abroad had long been taken for granted in the United Kingdom, but this responsibility was subsequently made explicit through assurances obtained from the parents of consortium banks and wholly-owned subsidiaries of foreign banks.

The BIS Governors also agreed on the need for intensified exchange of information between central banks on international banking activities and, for this purpose, established at the beginning of 1975 the Standing Committee of Experts in Basle, often called, from my colleague, its chairman, the Blunden Committee. The initial role of this committee was to consider ways in which an international early warning system might be set up. But it has in fact concerned itself with much wider and more continuing matters. The Governors' mandate to the committee was not that it should try to set up a fully harmonised, cut-and-dried international supervisory system covering banking operations in all the major centres of the world. This would be hopelessly cumbrous and crude, even supposing that existing legal and institutional differences between countries could be overcome. The Governors asked the committee rather to help the central banks and supervisory authorities learn from each other – by exchange of information and by a steadily deepening process of co-operation and understanding. I think it is fair to say that the committee has clearly demonstrated its value. Most participating countries can already point to small ways in which they have been able to improve their own supervisory arrangements as a result of its discussions in Basle.

These arrangements – together with the tightening of the commercial banks' own internal supervision that was prompted by the alarms of 1974 – have strengthened the international banking structure. There are areas in which more needs to be done (e.g. in relation to supervision of overseas branches and of operations through offshore centres); and, of course, current concerns are constantly changing (e.g. the comparatively recent emergence of the non-oil LDC problem and of the tanker financing problem). And the contribution of the monetary authorities to the stability of the markets goes beyond just its responsibility for supervision. The collection and publication of more comprehensive statistics can facilitate the assessment of risks. The authorities can help to avoid undue strain on the commercial banking system by ensuring that adequate official finance is available in situations of large international payments imbalance. But by and large I believe that the present machinery of national supervision, supported by international co-operation between supervisory authorities, is the right framework, and that is does provide for adequate prudential supervision over banks' international activities. The outstanding questions are essentially concerned with the way in which that machinery operates in practice and with its steady development and improvement. I cannot see a need for the introduction of new forms of prudential control over the euro-markets at the international level.

Monetary control

I turn now to the question of monetary control. The main controversy over the euro-markets concerns their monetary effects. There are generally reckoned to be advantages in the international integration of capital markets; and the positive contribution made by euro-credit flows to the expansion of world trade and investment is acknowledged by most people. Moreover, it is generally accepted that euro-markets have played a constructive part in financing international payments imbalances and helping to avoid excessively rapid or self-defeating moves towards international adjustment – to take an obvious example, their recent role in recycling. But attitudes are often schizophrenic. It is also argued that the international mobility of capital through the euro-markets has been excessive and that they have been an independent source of monetary instability. Whether the euro-markets are currently viewed as good or bad often depends on the particular set of surrounding circumstances and, in this sense, there is a danger that one is looking at the symptoms rather than the disease. Nor is it always clear that the criticisms are directed to euro-markets in particular rather than international capital flows more broadly. But the euro-markets are too large and important for criticisms of this kind to be lightly dismissed.

Before considering them, it is perhaps worth saying something on the size of the euro-markets. Measurement of the size of these markets raises all sorts of conceptual and practical problems. In both absolute and relative terms it is often exaggerated. The measure usually quoted is the BIS estimate of *gross* market size for eight European reporting countries: on this basis, the market at the end of September 1975 totalled about $240 billion. A more meaningful, but still rough and ready, measure of the *net* euro-credit flow from original lender to final borrower excludes inter-bank redepositing within the reporting area: on this basis, the size

of the market at end-September 1975 was about $200 billion. But even these data need careful interpretation, e.g. the country coverage is to some extent arbitrary; the figures include official assets and liabilities which may be inappropriate for some purposes of monetry analysis, etc. It is important to remember too that euro-market activity is based to a large extent on time deposits, which would typically be excluded from figures for the narrowly defined domestic money supplies with which euro-market liabilities are sometimes compared. One has to be careful therefore about drawing conclusions based on direct comparisons with national banking systems. To put the euro-markets into perspective, the increase in net market size in 1974 of $45 billion compares with an increase in the broadly defined domestic money supplies of the five largest countries combined of $150 billion.

Bearing these relative magnitudes in mind, let us look at the criticisms of the euro-markets for their alleged malign monetary effects. The most serious and perhaps the most common allegation is that the euro-markets have greatly expanded the total volume of the world's bank credit and thus – by not necessarily obvious extension – represent an independent source of world inflation.

Much of the discussion of this topic has concentrated on the narrow question of to what extent banks operating in the euro-markets can expand their deposit base through their own lending operations. Learned economists have argued about the size of the deposit multiplier of the euro-markets – on the analogy of the familiar deposit multiplier in a closed domestic banking system; and various attempts have been made to resolve this argument by empirical estimation, though – partly because of the difficulty of interpreting the available statistical data – these attempts have been inconclusive. Some commentators believe that the euro-currency multiplier is quite large. Others, with whom I associate myself, are impressed by the scope for leakages from the euro-markets into domestic banking systems. Such leakages occur, for example, when a final borrower from the euro-market, or the eventual recipient of the funds, makes payments directly to the country of issue of the currency in question. Or the borrower, or eventual recipient of, say, a euro-currency credit, may convert the funds for use in a local currency and it would then require a deliberate decision on the part of whoever had acquired the dollars to return them to the euro-markets (typically as time deposits) rather than to hold them, or use them, in the United States. To the extent that one can properly regard such decisions as part of a process of endogenous credit creation at all, they would certainly suggest that the leakages are likely to be larger than would typically apply within a domestic banking system, and hence would imply a pretty small euro-credit multiplier.

But even if one conceded the possibility of a large multiplier, this in itself would not imply a *net* addition to *world* credit. Account must be taken of the impact of inflows and outflows of euro-funds on domestic credit markets, which in turn involves assumptions about the response of national authorities in their domestic credit policies.

Certainly one could envisage situations in which world credit would be increased by euro-market intermediation. For example, a shift of dollar deposits from banks in the United States to euro-banks would increase the credit base of the euro-markets with no immediate corresponding contraction in the credit base of the US banking system (because the counterpart of the deposits placed with the euro-banks would, in the first instance, be deposits of the euro-banks with banks in the United States). This process, of course, can work – and has worked – in the opposite direction. On the other hand, capital outflows from other countries into the euro-dollar market would often (depending on how the dollars are provided) be accompanied by a contraction in the credit base of the domestic banking system of the country from which the outflow occurred; and the effect on world credit would then depend upon whether or not the domestic authorities acted to offset the tightening of domestic bank liquidity. Conversely, countries experiencing inflows from the euro-markets might or might not seek to neutralise their effect on domestic bank liquidity. In either case, and depending on the actions taken by national authorities, credit extended through the euro-markets would tend in some part to be a substitute for domestic credit rather than a net addition to the sum of world credit.

In my view, however, there is a much more important consideration than either the size of the multiplier or the possibilities for national authorities to offset the effects of flows of euro-funds. A good deal of the discussion of the euro-markets in isolation tends to imply that if those markets did not exist, the international flows channelled through them would not take place at all. That clearly is not the case. International credit did not originate with the euro-markets, nor is it monopolised by them: in fact, in the past two years the external claims in domestic currency of countries such as the United States and Western Germany have increased at a much faster rate than have the euro-markets. It cannot be too strongly emphasised that the euro-markets are very largely an alternative channel for, rather than a net addition to, credit flows that would take place in some form or another in any event.

All these considerations lead me to reject the analysis which suggests that the euro-markets have had a major impact on the volume of world credit, and hence the main case for global controls over euro-market activity. But I also question the practicability of the controls that have been advocated. Many variants have been suggested but most involve the imposition of internationally agreed reserve requirements in some form to be held against euro-currency deposits. Their initial effect would be to reduce the profitability of euro-currency operations to the banks, which would react by raising their lending rates or lowering the rates paid on deposits, in either case tending to reduce the volume of lending through the controlled areas of the euro-markets.

But this would not necessarily mean a slower expansion of world credit. The effect would more probably be to induce the banks to divert a large part of their business through alternative channels, perhaps particularly through brass-plate companies established in offshore banking centres outside the scope of the control. In principle, this avoidance of control could be prevented by more elaborate controls – of the Bardepot type – on foreign currency borrowing by residents of the control area. But there is a danger in piling control on top of control, which could have a severe impact on international financing to the extent that it was in fact successful. There is also a range of questions about how

reserve requirements could be applied, e.g. should the reserve ratio seek to equalise conditions between euro-banks and banks in the country of issue of the currency in question, or between euro-banks and banks in the country of origin of the funds? These sound very technical but they involve large questions of equity and efficiency. To achieve the required tightening of liquidity it would, moreover, be necessary to ensure that national authorities did not respond to banks' converting local currency to acquire the necessary reserve assets, by easing domestic liquidity.

A second, related, area of debate has been about the impact of euro-markets on domestic monetary management by national authorities. If one believes that euro-markets have been a major source of net credit creation, then it is reasonable to argue that they pose a particular threat to national monetary management. But if one takes the contrary view – as I do – then this question merges with the wider one of the complications raised by international capital movements generally for national policies. And this question cannot then be resolved by simply tracing international flows statistically through the euro-markets.

On the wider question, of course, we are conscious of the disruption to an independent national monetary policy that may be caused by external capital flows. We have long experience of coping with fluctuations in external holdings of sterling. By and large though, we have not been troubled by UK residents' transactions in foreign currencies, which are regulated – in the case of both banks and non-banks – by foreign exchange controls. These serve to police the frontier between the euro-markets, and for that matter the national banking markets of other countries, and our domestic monetary system. Most other countries have similarly protected themselves – at least during periods of particular pressure – by national policy action with equivalent objectives. I believe it is much more appropriate that these problems be dealt with at the national level through policies adapted to the particular local circumstances than through global controls on the euro-market element alone.

Similar considerations apply to the third main area of criticism of the euro-markets, namely, that they have added to exchange market speculation. Such speculation has usually been prompted by severe underlying disequilibrium in countries' balance of payments. In any event, though the euro-markets may have acted as the channel for movements of funds during periods of currency upheavals, there is little evidence to show that they were an original source of disturbance.

May I then sum up. Euro-markets are conspicuous because of their rapid growth and there is a natural temptation to hit at what we can see. But, as repeatedly emphasised in this talk, the euro-markets are part of the wider whole of the international banking system, which itself operates inseparably from the national banking systems of the world as a whole. We will not get either the analysis or the policy prescription right if we look narrowly at the euro-markets in isolation from this wider context. More positively, although a good deal of progress has been made recently on what may be called the official side of the international financial system, it is very difficult to imagine how the system could have stood up to the stresses and strains of the last few years without the underpinning of robustness and flexibility that the euro-markets have provided. I am sure that these markets will continue to play a similar major role in the period ahead.