

Central Bank Interventions and Eurocurrency Markets (*)

1. Definition and Origins of the Euromarket

We generally use the term Euromarket to describe all those operations involved in the creation of deposits and the granting of credit expressed in a currency other than that of the country in which the bank is located. If the operation is denominated in U.S. dollars and the banks do business in Europe, then it is called the Eurodollar market. If, instead, the operation is made in Deutsche-marks and the banks are located outside West Germany, then the market is called the Euromark, and so on.

Conventionally the term Euromarket (or Eurodeposits, or Eurocredits) is also used by many writers when the banks involved not only operate in Europe but also in other parts of the world. To avoid this semantic imprecision, Prof. Machlup has recently suggested replacing the prefix *Euro* with *xeno*, thereby stressing the global and non-European character of the market.¹

With the term "Eurobanks" we are not speaking of a different or, as some might infer, "extra-territorial" banking category. They are in fact the same commercial banks that operate inside the single countries and are therefore subject to each nation's domestic legislation. Eurobanking applies to that part of their balance — marginal or prevalent — denominated in currencies different from that of the country in which they are located. Thus it is

* This paper, with only minor retouches, was first presented as a speech on November 17, 1972 upon invitation of the Université Internationale de Sciences Comparées. It mainly reflects the ideas of Prof. Francesco Masera, the Banca d'Italia's representative in international discussions on this topic. A major contributor of research to these studies has been Dott. Paolo Savona whom I should also like to thank for the help he has given in preparing this paper.

¹ F. MACHLUP, "Eurodollar, Once Again", in this Review, June 1972.

easy to argue that the birth and growth of the Euromarket are mainly due to the permissive attitude of the single countries' monetary authorities who, in practice, have allowed wider leeway for those banking operations typical of the Euromarket.

The origins of the Euromarket go back quite some time. Even before 1914 commercial banks outside the United Kingdom accepted deposits in pounds.² It was not however until fairly recent times that economists began to fully fathom its existence and high development potential. This awareness can be linked with the liquidity crises that the international monetary system passed through in the aftermath of the war, the inability on the part of the large monetary markets in London and New York to carry out their traditional function with only their national currencies and, finally, the greater freedom generally granted the domestic banks to make transactions in foreign currencies. The Euromarket received a strong boost back around 1957, when the British authorities imposed, on one side, restraints on pound-denominated commercial loans for third countries, leaving, on the other, the banks completely free to provide credits in foreign currency when financing the same foreign trade. Its future was made a little later however when the New York market was hampered by the introduction of a broad programme regarding the balance of payments, which also included, starting in 1965, the voluntary curbing of foreign credits.

The Eurodollar market continued to expand buoyantly throughout 1971. This was the upshot of lower interest rates on the U.S. monetary market and a reduction of the U.S. banks' indebtedness on the Euromarket. The prior propelled the Eurobanks to seek out more profitable uses by loaning funds to non-American borrowers. The latter, in turn, were induced by the low rates being paid in the U.S. to redeposit these funds in Europe. The reduction of the indebtedness of the U.S. banks on the Euro-market — which, as we shall see below, plays a role similar to that of compulsory reserves and special deposits in the domestic banking system — gave the Eurobanks even more fuel for expanding credit. Demand for Eurocredits also picked up, mainly on account of the revival of world trade, though not faster than supply. The outcome finally was an interest rate level lower than that of the previous year.

² L. B. YEAGER, *International Monetary Relations*, Harper & Row, New York, 1967.

2. Structure and Functioning of the Euromarket

In order to understand how the Euromarket works we must broaden our discussion to include an overall system comprising six different markets. A key subdivision here is the market of international monetary base (called IMB); notably all those liquid assets functioning within the Euromarket as the monetary base does within the banking system of the single countries.³

Using this approach it has been possible to single out the creators of IMB; i.e., countries which produce gold (the part destined for monetary uses); the International Monetary Fund, within the limits of automatic drawing rights and the distribution of SDRs; the Federal Reserve System, through its credit lines opened to the central banks; the disequilibria of the balance of payments of the countries whose currencies are used as international reserves, especially the United States, calculated on the basis of the creation and absorption of international monetary base. Three broad categories compete for detention of this IMB and are thus its users; the central banks, the commercial banks and the non-banking public.

We then have a Eurocredit market in which, on the supply side, a typical item is represented by the IMB in the hands of the banks, and a Eurodeposit market, whose interest rate is linked to the cost of Eurocredit or influenced by the domestic monetary policies of the single countries.

The so-called "indebtedness" of the U.S. banks on the Euro-market takes on special importance in terms of evaluating the reserve position of the Eurobanks. The same also goes for any other liquid or potentially liquid position in a convertible currency other than the dollar held in the country of origin of the currency itself (that is, marks in Germany, etc.) or in the dollar itself within a country whose central bank is willing to cede its reserves in this currency to meet deposit withdrawals from its national banks.⁴

³ Cf. M. FRATIANNI - P. SAVONA, *La liquidità internazionale, proposta per la ridefinizione del problema*, Il Mulino, Bologna, 1972.

⁴ This concept is plainly expressed by G. CARLI, "Eurodollars: A Paper Pyramid?", in this Review, June 1971. Thus the interpretation of the reserve position restricted to deposits in the United States given by F. MACHELUP (*op. cit.*) does not fully reflect the Governor of the Banca d'Italia's standpoint.

The market of interbank Eurofunds makes up a broad swath of the Euromarket and should not be confused with the relations between Eurobanks and U.S. banks or banks of the countries in whose currency the deposits are denominated (mentioned above) and which fall into the IMB markets.

The Eurobond market is a medium- and long-term market, but is linked with the short-term section both because of the role played by the Eurobanks in it as underwriters and because of their direct purchase of these bonds.

Careful consideration must be given to the forces which act within the IMB, Eurocredit and Eurodeposit markets, in order to come up with an organic and convincing explanation of events in recent years.

Let us suppose that the U.S. authorities impose a restrictive monetary policy within their country. Rising interest rates on the United States monetary market implies for the Eurobanks that it is more profitable to keep their liquid reserves invested in the United States and that it is less profitable to expand Eurocredits. A contracting supply of Eurocredits pushes lending rates up which in turn pull deposit rates up too; namely, rates paid on Eurodeposits. The public then tends to move its funds from the United States towards the Euromarket, and parallelly, there is an outflow of capital from the nonreserve currency countries, which erodes official reserves. In such a manner IMB is shifted towards the Eurobanks, which increase their *potential* to expand credit. This in fact took place in several countries up until 1969.

If it is a European country that sets out to impose a restrictive monetary policy, it must first take into consideration what will happen on the Euromarket and try to neutralize this. A rise in domestic rates leads to an increase in the demand for Eurocredits, to an increase in the Eurolending and deposit rates, to a transfer of IMB from the public to the banks and to a greater potential for supplying Eurobank credit. Domestic businessmen can thus easily turn to the Euromarket in the place of internal credit sources. This has been experienced by a number of countries, especially in 1970⁵.

⁵ Cf. W.D. McCLAM, "Credit Substitution and the Eurocredit Market", in this Review, September 1972. To have demonstrated that the Euromarket substitutes internal sources does not however mean that it is not capable of multiplying within itself international means of payment or, analogously, that it does not disturb or neutralize domestic monetary policies. When a market superimposes credit on existing credit, the drop in interest rates neutralizes the superimposition (excess of supply).

If we then insert into this situation an expansive monetary policy on the part of an IMB-creating country, such as the United States, efforts towards an autonomous monetary policy on the part of IMB-using countries will be even more easily frustrated.

If, in the IMB-creating country, a period of monetary expansion follows one of restriction — the latter contrasted by banks in this country with Euromarket debts — what happens is that these banks will move to sharply extinguish their Euroindebtedness. The immediate effect will show up in Eurointerest rates, which will fall as a result. The second, perhaps more violent, will be felt in domestic monetary policies, which will be frustrated if they are restrictive, or in the level of official reserves (which will grow), if the authorities are against revaluing their currency. Therefore, we can reject any interpretation of the market, or expectations in this sense, which foresee a swelling of the volume of Eurocurrencies. Massive repayments, like those carried out by the U.S. banks, therefore affect interest rates, domestic monetary policies, official reserves or foreign exchange relationships. Or the repayment becomes part of a circle feeding the process of multiplying the means of international payment. This is very recent history and does not require much specification.

As regards this multiplying process, we find that deposits in Eurodollars (but the same logic applies to the other Eurocurrencies) are not only created by the decision of a businessman, irrespective of whether he is a U.S. resident or not, to deposit in a Eurobank a sum of dollars received as a counterpart of an export of goods or services, or as the result of a loan taken out in the U.S., or through the conversion of convertible currency. The Eurobanks themselves contribute with their credit facilities to the creation of Eurodollar deposits to the extent that this sets off a process similar to that taking place within the domestic banking systems. This process is obviously based on redeposits made by customers or other eligible parties. On one side, the Eurobanking system's potential for expansion is greater than that of the domestic systems because its liquid reserves are proportionately lower and the monetary base is not controlled by any monetary authority; on the other, the loss coefficient is larger because the beneficiary of a loan in Eurodollars can decide to redeposit these funds in the U.S. thereby taking these funds out of the Eurodollar circuit.

3. Euromarket's Dimensions

There exists statistical information on the six markets mentioned above, though not enough for a complete overview of the Euro-market. Nonetheless, they do make it possible to have a rather precise idea of the subject under focus.

Table 1 shows a good proportion of the supply and demand of IMB.⁶ The most serious blindspot is represented by the absence of information, or better the interruption of this, on demand deposits in Deutschmarks and on similar positions in Swiss francs and other strong currencies.

Table 2 gives figures on:

— Eurodeposits and Eurocredits denominated in dollars and other currencies;

— Interbank Eurofunds in the surveyed area, that is in the eight European countries which provide the BIS with statistics on the Euromarket;

— the portion of Eurodollars absorbed by the United States.⁷

Missing then is information on that portion of Eurocredits invested in Eurobonds. And this is a gap which has already received the attention of the authorities and which financial statisticians are now making efforts to fill.

With the statistics we now have it is difficult to link the IMB market — which should furnish the reserve position of the Euro-banks against their Eurodeposits, that is, the demand for IMB on the part of the banking system of the 8 countries supplying information — with the Eurodeposit or Eurocredit market. In fact, Table 2 groups all the Eurocurrencies, while Table 1 is limited, for the abovementioned gaps, to the dollar and pound sterling, with some information on the Deutschmark.

The Tables speak for themselves. From these statistics we find that, as of the end of June 1972, the IMB, as defined above, amounted to 127 billion dollars. Of these, 109 were in the hands

⁶ The Table is published by the Banca d'Italia, in the Governor's *Annual Report* to the Ordinary General Meeting of Shareholders. In this year's Report it can be found on page 43 (English version, page 31).

⁷ Table 2 is also published by the Banca d'Italia in the *Annual Report*. In addition it comprises an estimate of the market's dimensions net of the other Eurocurrencies, not published in the Table on page 61 of the Report for 1972 (page 36 in the English version).

Items	Changes								Amounts outstanding end of June 1972
	1969	1970	1971	Semi-annual					
				1970		1971		1972	
			I	II	I	II	I		
Sources									
Monetary gold	76	- 1,749	2,659	- 72	- 1,677	- 213	2,872	- 479	39,128
Ordinary and special drawing rights in IMF	238	4,095	2,453	3,571	524	1,982	471	2,892	16,166
Unused credit lines at the Federal Reserve Bank of New York and the IMF	1,337	- 609	- 1,498	- 180	- 429	304	- 1,802	490	9,582
Liquid liabilities:									
United States	6,295	2,745	14,257	1,355	1,390	2,031	12,226	56	51,060
United Kingdom	89	868	3,908	890	- 22	1,189	2,719	108	10,693
Total	8,035	5,350	21,779	5,564	- 214	5,293	16,486	3,067	126,629
Memoranda:									
Liquid liabilities of Federal Republic of Germany	298	.....	.....	758	.....	.....	.....	.....	(2) 5,996
Other liquidity (of United States and United Kingdom)	1,850	- 1,373	6,668	123	- 1,496	6,138	530	5,868	19,097
Uses									
Official reserves	1,585	9,820	25,719	7,185	2,635	10,529	15,190	2,761	108,633
Monetary gold and other assets	1,651	1,737	3,614	3,319	- 1,582	2,073	1,541	2,903	64,876
Liquid assets against:									
United States	- 275	7,784	20,324	3,415	4,369	7,457	12,867	- 665	38,895
United Kingdom	209	299	1,781	451	- 152	999	782	523	4,862
Memoranda:									
Liquid assets against Federal Republic of Germany	- 38	.....	.....	- 95	.....	.....	.....	.....	.....
Other liquidity	- 242	- 165	7,291	- 112	- 53	3,107	4,184	3,838	11,886
Public	- 636	578	1,903	446	132	268	1,635	- 75	9,763
Liquid assets against:									
United States	- 516	9	- 224	7	2	78	- 302	340	3,932
United Kingdom ¹	- 120	569	2,127	439	130	190	1,937	- 415	5,831
Commercial banks	7,086	- 5,048	- 5,843	- 2,067	- 2,981	- 5,504	- 339	381	8,233
Liquid assets against United States	7,086	- 5,048	- 5,843	- 2,067	- 2,981	- 5,504	- 339	381	8,233
Memoranda:									
Public's and banks' liquid assets against Federal Republic of Germany	336	1,546	515	853	693	- 838	1,353	- 585	5,891
Other liquidity held by the public and the banks	2,092	- 1,208	- 623	235	- 1,443	3,031	- 3,654	2,030	7,211

Sources: Bulletins of central banks, the International Monetary Fund and other government agencies.

¹ Also includes commercial banks' sterling assets.

² The sum of the public's and banks' liquid assets against Federal Republic of Germany at the end of June 1972 and those of the monetary authorities at the end of May, 1970, as reported in the Bulletin of the *Bundesbank*.

EUROCURRENCY MARKET

TABLE 2

Items	Amounts at end of				Semi-annual changes				
	1969	1970	1971	June 1972	1970		1971		1972
					I	II	I	II	I
	(billions of dollars)								
Eurocurrencies including inter-bank accounts:									
Credits	58.3	78.3	100.4	111.1	6.8	13.2	7.5	14.6	10.7
Eurodollars	47.6	60.4	71.7	78.8	4.4	8.4	4.7	6.6	7.1
Other Eurocurrencies	10.7	17.9	28.7	32.3	2.4	4.8	2.8	8.0	3.6
Deposits	56.8	75.3	97.9	109.3	5.7	12.8	7.0	15.6	11.4
Eurodollars	46.2	58.7	70.8	77.6	3.2	9.3	3.2	8.9	6.8
Other Eurocurrencies	10.6	16.6	27.1	31.7	2.5	3.5	3.8	6.7	4.6
Eurocurrencies not including interbank accounts ¹	44.0	57.0	71.0	*82.0	13.0		14.0		11.0
Eurodollars	37.5	46.0	54.5	*66.0	4.0	4.5	3.0	5.5	11.5
absorbed by the U.S.	16.5	12.7	9.3	* 9.9	-0.1	-3.7	-2.3	- 1.1	0.6
absorbed by other countries	21.0	33.3	45.2	*56.1	4.1	8.2	5.3	6.6	10.9
Other Eurocurrencies	6.5	11.0	16.5	*16.0	4.5		5.5		- 0.5
	(unit ratios)								
Eurodollars (Net size)									
Amount absorbed by United States	2.3	3.6	5.9	6.7	—	—	—	—	—
Amount absorbed by { other countries United States	1.3	2.6	4.9	5.7	—	—	—	—	—
	(annual percentage rates)								
3 month Eurodollar deposits	11.0	7.3	6.4	5.1	-1.5	-2.2	—	- 0.9	- 1.3
4-6 month U.S. commercial paper	8.8	5.7	4.7	4.6	-0.6	-2.5	-0.3	- 0.7	- 0.1
U.S. federal funds	9.0	4.9	4.1	4.5	-1.4	-2.7	—	- 0.8	0.4

Sources: Bank for International Settlements, Federal Reserve Bulletin - Board of Governors, Federal Reserve System.

¹ Excluding exchanges of interbank funds carried out within the group of eight reporting countries but including estimates of bank indebtedness to non-bank residents and of conversions into or from other currencies.

* Provisional data.

of the national monetary authorities, 10 billion in those of the non-banking public and 8 deposited in Eurobanks. The overall creation of IMB rose by 5 billion in 1970 and 22 billion in 1971 mainly because of the sharp expansion of the U.S.'s liquid liabilities.

The creation of international monetary base in the first half of this year (1972) was almost wholly performed by the IMF. This ideal solution, with numerous proponents behind it, replaces a period dominated by the convertible currencies, that is by the action of the international market. Nonetheless, no one should fool himself into believing that the system is spontaneously evolving towards equilibrium.

In fact, private stockpiling of dollars on the Euromarket has revived with a passion, once again overtaking that of the other Eurocurrencies. Within a short time it may once again become necessary to defend official reserves and exchange rates from undesired conversions of Eurodollars into other Eurocurrencies. And this is what this paper aims at tackling. The result of the first half of 1972 should in addition be convincing proof that the community of nations is faced with a problem destined to repeat performances and not to spontaneously run out of steam, as some analysts have suggested.

As regards the size of the Eurocurrencies market, one can note that, net of interbank credits, it totalled, at the end of June 1972, 82 billion dollars. Of these 66 were in Eurodollars and 16 in other currencies. The same figures in 1969 came to respectively 44, 37 and 7 billion dollars.

An indicator of the multiplier potential of the Eurodollar market can be taken from the ratio of its net size to the portion absorbed by the U.S. (that is, the indebtedness of the American banks, which plays the role of liquidity reserve for the Eurobanks): this ratio which in 1969 stood at 2.3, a not at all alarming level, rose to 5.9 in 1971 and may have reached, according to recent estimates, 6.7 in 1972.

Table 3 shows, finally, a snapshot at the end of 1971 of the Eurocurrencies market in its basic components. Several data should be considered no more than rough estimates and are useful for evaluating the weight of the various operations and the source areas on this market.

It is worthwhile focusing our attention on the percentage of overall Eurodeposits held by the central banks in the reporting

STRUCTURE OF THE EUROCURRENCY MARKET*
(Amount at end of 1971 - Amounts in billions of dollars)

Uses:		Sources:	
1. Outside the surveyed area	37.4	1. Outside the surveyed area	37.6
1.1 Deposits with & loans to U.S. banks & non-banking public	8.3	1.1 Deposits of the U.S.	6.1
1.2 Deposits with & loans to other banks & non-banking public	29.1	1.1.1 by banks	1.1
2. Inside the surveyed area	33.6	1.1.2 by the public	5.0
2.1 Loans to non-banking public	19.1	1.2 Deposits of other countries	31.5
2.2 Conversion of Eurocurrencies into domestic currencies	14.5	1.2.1 by central banks	4.0
3. Net size of the market (1+2)	71.0	1.2.2 by banks	19.5
4. Interbank deposits	27.0	1.2.3 by the public	8.0
5. Corrections on U.S. figures	1.3	2. Inside the surveyed area	33.4
6. Unidentified items	1.1	2.1 Deposits of central banks	5.0
7. Gross size of the market (3+4+5+6)	100.4	2.2 Deposits of the non-banking public	16.2
		2.3 Conversion of domestic currencies into Eurocurrencies	12.2
		3. Net size of the market (1+2)	71.0
		4. Interbank deposits	25.0
		5. Corrections on U.S. figures	0.7
		6. Unidentified items	1.2
		7. Gross size of the market (3+4+5+6)	97.9

* Source: M. FRATIANNI - P. SAVONA, *A Two-Area Model with an International Market*, mimeo 1972.

countries. The figure is a large one, about 5 billion, but it is certainly not cause and prop of the activity taking place on the Euromarket as one analysis, which has received authoritative backing, claims.⁸ A reduction of this figure — frozen in June 1971 by decision of the governors of the central banks involved — must be set in the framework of a more general and prudent intervention scheme on the part of the official authorities, which takes account of the risks of a liquidity crisis that this would provoke for the Eurobanks holding official reserves as deposits. One must not overlook the possibility that a general withdrawal triggers the banks into seeking

⁸ F. MACHLUP, "The Magicians and Their Rabbits", *The Morgan Guaranty Survey*, May 1971.

further funds from the United States, thereby exacerbating the already pregnant deficit situation, on the basis of net liquidity, weighing upon that country and the international community. Finally, we must not dismiss out of hand that these banks might solicit, even through illegal channels, offsetting releases of official reserves or deny credit or the renewal of loans to the public and private national operators. In sum, the withdrawal of the central banks' deposits might turn out, if taken out of context, to be a dangerous and illusory decision.

The data reported in Table 3 make it clear that the Euromarket is not an "interbank affair", another widely held opinion. Also regarding the fact that in the case of several systems, for example that of Switzerland, the banks hold deposits of modest size — which they do not consider as such, but as funds assigned for their management — which they then deposit in their own name in the Euromarket, it remains statistically true that one cannot speak of the preponderance of one operator in respect to others or of one area in respect to the rest of the world. The market's bases seem sufficiently diversified and at first sight solid and lasting.

4. The Problem of Regulating Eurobanking Activity

The growth of the Euromarket during the 1960s was accompanied by an overall increase in the border-crossing mobility of short-term funds. However, this increased mobility cannot be credited to the Euromarket without some further qualification. Initially, mobility was achieved through greater convertibility of the main continental European currencies and, theoretically, could have been guaranteed by the functioning of the single domestic monetary markets which should have grown in size and evolved a wide range of instruments to meet the situation.

This did not take place, or took place only in part, mainly because the monetary authorities of the single countries did not want to have to cope with the greater risks involved in their currencies acquiring an international dimension. Thus the Euromarket developed, benefitting from the lack of many regulations typical of domestic markets — such as liquidity or compulsory reserve ratios, ceilings on deposit rates, etc. — as well as from the oppor-

tunity to raise lending rates which banks in countries applying credit restrictions are able to pay for additional funds.

The existence of the Euromarket affects the demand for central bank reserves. Here we are not referring to the financial opportunities offered by the Euromarket to the central banks as an alternative to other methods of investing their reserves. The Euromarket has a greater pull on reserve policy. Indeed, the central banks can resort to it at any moment, in the short- as well as in the long-term section, to offset or prevent balance-of-payments disequilibria until their basic cause has been corrected. Such a strategy implies a tight hold by the central bank on the foreign position of banks in its own country and thus, other things being equal, leads to a drop in the demand for official reserves.

However, as shown at the beginning of the analysis, the existence of a vast integrated monetary market, and thus of greater international mobility of funds, seriously hampers the monetary authorities of the single countries when they want to carry out monetary policies which go counter-current to Euromarket trends. Restrictive monetary policy within one country will force the banks and the public alike to acquire abroad those funds they cannot get at home unless they are hamstrung by rigid foreign exchange controls and regulation of the banks' foreign position. One might say that the Euromarket in itself only aggravates the natural consequences of a general move towards the liberalization of capital flows.

The unregulated operation of the Euromarket presents a very real threat when a speculative attack against a currency is being mounted. Were there no Euromarket, the destabilizing attitude of the speculators and arbitrageurs could only be fed by the domestic monetary markets which are able to react and block financing. Instead, the existence of the Euromarket gives these operators greater freedom of action since there is no authority to regulate it and because it seems to have a considerable capacity for expansion, although the limits of this have not yet been fully explored.

And again through the Euromarket, the same official exchange rates, in a system where the dollar is used as intervention currency on the foreign exchange market, are exposed to upward pressures not based on real value shifts. In sum, in a system where a market mechanism can legally create unlimited monetary means denom-

inated in dollars, this currency will flood the market and the other currencies will implicitly rise in value.⁹

It is difficult to evaluate the importance of the Euromarket's role in the recent events which led to the dollar and international monetary system crisis. And this is basically why there is so much room for conflicting opinions: for each argument there exists a counter-argument with the upshot that all initiatives grind to a halt.

And yet one need only recall that in the Euromarket no central authority exists to systematically regulate the market as in domestic banking systems. Often the single central banks intervene on the market to dictate certain patterns of behaviour to banks of their own country operating in foreign currency. But rarely is this intervention coordinated to increase market stability during times of tension. This observation should persuade the authorities to draw up a plan for regulation; and in fact, recently certain attitudes among the authorities indicate a growing move in this direction.

Moreover, there is the danger, no longer met on the domestic markets, that the collapse of one dealer will also pull down behind it large sections of the market; not to mention the greater risk, which we refuse to face, of a sudden and general loss of confidence in the dollar which, given the large disproportion between Eurodeposits denominated in dollars and the dollar reserves of the same Eurobanks, would create serious difficulties.

For all these reasons the authorities must feel the necessity of regulating Eurobanking activity. However, since this term evokes in dealers' minds visions of restrictions or prohibitions, action in this direction must be clearly explained in order to forestall unfounded suspicions.

5. Nature and Content of Possible Intervention by Official Authorities to Regulate Eurocurrency Flows

Some of the possible official interventions for regulating Eurobanking activity are of a general nature and aimed at protecting domestic monetary markets. They are in essence lines of defence,

⁹ G. CARLI in *The Eurodollar Market and its Control* (Address to the Swiss Institute of International Studies, Zurich, Feb. 14, 1972) gives a complete analysis of this possibility.

which isolate one market from the others to varying degrees, ignoring the difficulties of others and sometimes even aggravating them. They in no way solve the problem of regulating Euro-banking activity and, if all countries were to apply them at the same time, the outcome might be control of the Euromarket through its paralysis. Briefly, if these interventions are to have a logical basis it is necessary to hypothesize, for the Eurosystem's survival, one country which is more liberal than the others with regard to receiving Eurocurrency flows and which, in the final analysis, will accept the brunt of the others' defensive behaviour. In spite of this, as things now stand this is the basis of the defence barrier national markets have built up against Euromarket activity.

The only instruments used in these interventions are well known and need only be listed, without adding long explanations:

- a) widening the fluctuation margins around parities;
- b) interventions on the forward foreign exchange market;
- c) two-tier exchange market;
- d) regulating the net foreign position of resident banks;
- e) lowering rediscounting ceilings, in inverse proportion to the extent of the banks' recourse to the international market;
- f) prohibiting the payment of interest, or ordering the banks and other dealers to set up special reserves in order to neutralize the spreads between domestic interest rates and international market ones.

In addition to these instruments, or instead of them, one can draft specific interventions on the Euromarket which are coordinated at an international level and which, on one hand, mitigate the effects of present domestic interventions and, on the other, ensure a balanced development of the volume of Eurocurrencies. On the whole, it is felt that concerted action on the international level, if equally effective in each country and in respect of market forces, will allow businessmen greater freedom of action than they presently enjoy.

The instruments for this concerted action can be summarized as follows:

- a) regulating swap operations between commercial banks and official authorities;

- b) regulating central bank deposits on the Eurocurrency market;
- c) enlarging compulsory bank reserves against foreign currency deposits;
- d) open market operations on the international level.

The most effective way of implementing a compulsory reserve mechanism would be to require a non-interest bearing deposit of monetary base of the country in whose currency the Eurodeposit is denominated. In this way the total amount of dollar deposits (for example) would be limited to the amount of monetary base the public is willing to leave in the banks. There would be the problem of distribution between domestic deposits and Eurodeposits in a given currency but the national authorities would not be hard put to find a solution to it. Less severe methods of enforcing reserves would be to require that a time deposit be set up in the country of origin of the currency in which the Eurodeposit is denominated, or that the reserves be interest-bearing. In the first case intervention would be completely ineffective were *benign neglect* to be practised in the country of origin of the currency; that is, if the country's authorities did not insist on the setting up of compulsory reserves against deposits by non-resident banks or were *at all times* ready to provide the monetary base which the various domestic banks need to fulfill their reserve commitments, arising from opening a foreign bank deposit, even if in one of their own branches.

It has often been pointed out that the most desirable method of intervention on the Euromarket is by systematic open market operations. In 1970 the United States, at first with the Eximbank and then with the Federal Treasury, carried out operations of this kind for an amount equal to circa 3 billion dollars. At the end of 1971 the securities sold to the Eurobanks at the time matured and were cashed in.

Again considering the dollar — although these arguments are intended to apply to all Eurocurrencies and the authorities responsible for each of them — it is felt that, according to the logic of the intervention scheme put forward here, monetary flows in dollars originating in the United States should be entirely or in part "recycled" by that country; this must be so if we are to

achieve an effective result from open market operations which otherwise must be carried out by the other countries for flows of the same nature produced by the Euromarket multiplier and currency exchange activity. In fact, it would be unthinkable, and undesirable from the U.S. monetary authorities' standpoint, that the rest of the world control the overall level of liquidity in dollars — that is, the supply of money denominated in this currency — with the sole aim of achieving the amount of dollars which best suits the international dealers and regardless of the actual requirements of the U.S. economy.

The performance of open market operations raises the problem of utilizing the funds obtained by those international agencies while carrying them out. There are two hypothetical solutions to this:

— depositing the funds in the United States (or in the country of origin of the currency, if other than the dollar);

— releasing the funds to national dealers; exchanging them against domestic currency at the country's central bank; depositing the foreign currency in the country of origin.

In the first case the bank involved would undergo considerable expense, which the countries should announce their intention of taking over. However, where no interest is paid on the compulsory reserves, as previously hypothesized, the fact that their deposit in the country of origin does pay interest might make this decision unnecessary and, on the whole, the yield on the reserves might offset losses from open market operations.

In the second case, the cost would only be hidden, in the sense that the official reserves would be enlarged by inconvertible (today) currencies.

The plan outlined so far presupposes that the entire international community take part in solving the *xenomarket* problem. If this were not to occur, it would become necessary to protect the activity of the banks and financial markets, hampered by restraints, against those which, freer, would be at an obvious advantage.

The most effective and already tested instrument seems to be:

(e) imposing a compulsory deposit in cash (or bardepot) against the indebtedness of the non-banking public in the regulated area vis-à-vis banks and other external lenders.

The aim of this instrument is to re-establish a spread in favour of the rates in the regulated area to protect Eurobanking activity, and not to regulate the volume and distribution of the Eurocurrencies — which is the implicit aim of the other instruments on deck. For the same reason, the deposit may be set up in national currency and must not bear interest. In sum, according to a basic tenet of economic policy, an instrument must be applied as quickly as possible in order to achieve a single aim.

We feel it is fair to conclude by extending an invitation in particular to the European countries, and that is: if we intend to use the Euromarket to further economic development, we must regulate, just as for every other human occurrence, the flows it gives rise to. Otherwise the resulting monetary chaos, as we well know from experience, will undermine the objective itself.

We also hope to have shown, as far as concerns the Euromarket, that the coordinated action of several countries will minimize the cost of action and maximize dealer freedom. If, instead, the single countries are left to defend themselves, this will not only weaken the spirit of international cooperation but also bring about a situation where one or more countries take over the burden of safeguarding the Euromarket at the cost of domestic monetary equilibrium. And when their will bent, the Euromarket would vanish; not because it sought international control but because it persistently rejected it.

Rome

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