

Controlling the Euromarkets

1. - The mammoth increase in oil prices — to use the American Secretary of the Treasury's expression — has generated correspondingly mammoth balance of payments deficits in the main industrialised countries.

This has created serious political problems for Europe. Among these problems, those of a more strictly economic nature require the promptest solution, as the first step towards an easier solution of the others.

The financing of these deficits, at a time when international monetary reform has reached an impasse necessitates, for the most part, market solutions. But any such a solution will create problems in the regulation of flows of international liquidity which exceed the market's capacity for self-regulation. Thus, coordinated action at the official level is also necessary. Such solutions also call for careful decisions on the control of liquidity, bearing in mind the new objectives of the European Economic Community (and not only of them) in the pursuit of economic successes in line with past achievements.

The two problems of regulation and control of international liquidity are very closely linked, but the former is mainly characterised by technical aspects, almost by compulsory choices, whereas the latter involves more complex considerations on the development of a market economy, and hence solutions which are not straightforward, but are often conditioned by ideologies.

2. - If the countries affected by increases in the prices of oil and other raw materials are to maintain a given level of industrial and economic activity, they need at least as large a volume of oil as before. For, of the possible solutions envisaged, deflation has been

rejected as unrealistic. It is generally agreed that, at least in 1974, the best way of dealing with the price increases is by resort of official reserves and international credit.

Gold is, for the time being, frozen instrument (for many reasons which we need not examine here). SDR's and other official instruments are not sufficient in volume, are lacking in flexibility and on some occasions are politically impracticable. We thus have to rely on the market (with its Euro- or xenocredit) and on foreign exchange reserves.

Moreover, we know that, the oil-producing countries prefer liquid and anonymous assets. Eurodeposits, and, more generally, foreign exchange deposits, possess these requisites.

Furthermore, there is a tendency to "officialise" the financing of price rises in oil products, which could well be left to the initiative of the importers, forcing them to use international credit. Finally a preference for prefinancing in view of expected deficits is becoming noticeable.

Should all these hypotheses be confirmed, the deficits would, in a given period of time, be financed by the surpluses, and there would be no problem (as indeed there is none in actual fact) of a potential lack of finance. But the time-lags and the geographical inequalities in the distribution among the deficit countries of the capital arising from the surpluses could become so serious as to cause considerable disturbances in the banking system, both as regards domestic and international interest rates, and, worst of all, set off a spreading of economic disequilibria through exchange rate disturbances. From the latter point of view in particular, temporary difficulties in finding credit could initiate a process of competitive devaluation which has been fairly unanimously condemned by the international community, and is hence to be avoided.

The solution of some of these disequilibria — mainly of those directly affecting banking activity, such as the level of liquidity and interest rates on deposits — is within the power of individual bankers to deal with, or of all of them grouped together in a market, as long as the United States do not change their attitude of benign neglect in regard to liquidity deficits of the banks operating on the xenomarket.

However, there are other disequilibria — mainly those more directly involving the official authorities, especially when they go against interest rate and exchange rate stabilization policies — and

a solution of these is not within the power of the international banking community. In fact, the problem might involve the community in conflicts with the course pursued by national governments.

Those who regard the market as the best regulating instrument would deny the possibility of any such dichotomy. But even upholders of that view must take account of recent monetary developments where there has been an obvious conflict of policy and in which the xenomarket has not always been able to find an autonomous solution of its problems.

It is realistic not to count on the superiority of either the market or of the government authorities, but to accept the coexistence and usefulness of the two criteria, both aimed at satisfying different needs of the community of nations.

For years, the Bank of Italy, through the Governor and high-ranking representatives,¹ has been stressing the need to regulate liquidity flows in the international market. This view is based on a theory which has been subject to empirical verification,² using the concept of international monetary base (IMB) and postulating the existence of a potential supply of international credit equal to a multiple of the IMB initially injected into the international monetary system.

In the light of these studies and of the firm conviction that the world money stock must be kept under control, it is felt that any excessive growth of international liquidity is as undesirable as a lack of liquidity, and expectations of market self-regulation in this sense are unrealistic; this is also because IMB flows, for the most part in dollars, are not completely dependent on the will of the xenomarket, but on both the behaviour of the balances of payments and of the domestic monetary policies of the key-currency countries, in particular of the United States, and on that of the public which can choose between holding IMB or depositing it in the xenobanks. Whereas, however, the behaviour of the public can to some extent be influenced by a shrewd interest rate policy on the part of the banks, so as to steer the distribution of IMB in favour of the banks, balances of

¹ See G. CARLI and others: *A Debate on the Eurodollar Market*, Ente Einaudi, Quaderno 11, Rome, 1973.

R. OSSOLA: "Central Bank Interventions and Eurocurrency Markets", in *Banca Nazionale del Lavoro Quarterly Review*, March 1973.

² See M. FRATIANNI - P. SAVONA: *La liquidità internazionale - Proposta per la ridefinizione del problema*, Il Mulino, Bologna, 1972.

payments and monetary policies are only to a slight extent influenced by the xenomarket.

Since there is no guarantee that the balances of payments and monetary policies operate in the way desired by the international community, that is, to create or destroy IMB in the amounts and at the costs believed to be appropriate at a given time, it is preferable for "someone" to be given the responsibility of regulating in time and (why not?) geographically the flows of international liquidity. This regulation, it has always been maintained, should not necessarily take the form of administrative authorisations or prohibitions,³ but should be capable of providing international liquidity as efficiently as it can sterilise or redistribute it.

In the past, the proposal to regulate international monetary flows, coming at a time of high market liquidity (which prevailed from 1970 to 1973), was interpreted, almost without exception, as an invitation to curb the rate of expansion of the Euromarket. In fact, this was the economic implication of the proposal at that time; however, stress has always been laid on the need for a longer term consideration of the proposal, so as to embrace the inevitable periods of scarce liquidity, with the consequent need to expand the corresponding flows.

At the time when these discussions took place, it was certainly not possible to foresee that, owing to the oil crisis, the second case would raise the most serious problems. But, however that may be, this case should be dealt with in such a way as to be applicable to any economic situation arising (i.e. abundance or scarcity of liquidity).

If the assumptions of this "technical" analysis are confirmed by events, and especially if the authorities finance deficits before they occur, the first impact on the Euromarket (or xenomarket) will be a huge drain of liquidity from these markets, should the authorities retain, as they usually do, their dollar deposits in the United States or their other foreign currency deposits in the countries of origin. When this financing is used, that is, bit by bit as the deficits occur, the liquidity would re-enter the circuit, and the market would retrieve its lost resources. If, in the meanwhile, the system wishes to maintain its ability to grant credit and, implicitly, to defend the existing interest rate level, it must find a way to borrow the new

³ A detailed analysis of the ways in which this can be obtained in practice is given by F. MASERA - P. SAVONA: "Outlines of a Common Policy for Intervention on the Eurocurrency Market", in G. CARLI and others, pp. 21-35.

IMB in the countries which create it (for example, dollars in the United States).

From this point of view, the continuation of a policy of benign neglect by the United States and the withdrawal of the Interest Equalisation Tax should be regarded as a promising condition helping to ensure the immediate solution of the above problem.

However, it would be better if the central banks kept their borrowed funds deposited in the Euromarket in order to avoid encouraging the xenobanks to acquire new IMB, as illustrated above. This would be in order to avoid an immediate worsening of the Net liquidity deficit of the United States and a longer term increase in the credit potential of the xenobanks. For, if a European central bank takes out a loan from a Eurobank and keeps the deposit in New York, and if the Eurobank acquires in New York a new deposit which restores its credit potential, there is during the first phase (central bank - Eurobank) an exchange in the ownership of a deposit in New York (from IMB^b to IMB^a in Fratianni-Savona language) which leaves the volume of IMB unchanged, but which alters its distribution among those operating on the market. In the second phase, that is in the case of a new fund-raising operation by the Eurobank, the system's liquidity, i.e. the volume of IMB, increases, and thus a new deficit is created in the American balance of payments calculated on Net liquidity.

If the European central banks belonging to the Club of 10 are to be able to deposit funds on the Eurodollar market and thus avoid the above consequences, the Standing Committee on the Eurocurrency Market will have to suggest to the Governors of the banks on the Committee that the June 1971 directive be revoked, since it runs counter to the present objectives. It will also be necessary to eliminate restrictive attitudes as regards the swap operations which the central banks carry out with the commercial banks.

All these measures and arrangements are valuable in helping to solve, in the short time, the financing of the mammoth oil deficit, but they do not solve the problem of market regulation, nor do they prevent exchange rate crises. The huge volume of international liquidity which will be necessary to provide advance financing for the deficits creates a xenocredit potential which would make its full impact felt as soon as the surpluses recycle international liquidity. At that point, excess liquidity could flow towards the weakest or the strongest currencies and create serious problems in the maintenance

of foreign exchange parities in a situation already strained by the existence of the deficits.

This movement from one currency to another would not, however, solve the problem of excess liquidity, which could only be eliminated if it was channelled to the country of origin or if its purchasing power was curtailed by inflation. The latter is the solution for which we are heading, recent experience suggests, and in the not too distant future, unless we take remedial measures.

This is why the mere regulation of flows is insufficient and why a control of international liquidity is necessary. In other words, we must decide on the volume required, at various points in time, in the light of the balance of payments objectives of the world community. To that end, it is essential to convene at the earliest possible moment a second World Monetary Conference — a new Bretton Woods — which would lay down the terms of an agreement, particularly as to exchange rate and international liquidity policies. It is to be hoped that we do not have to wait for such a conference until the "Great Stagflation" descends on us.

3. - It has been suggested above that the problem of controlling the volume of international liquidity is a highly political problem, not devoid of ideological content.

Nevertheless, it also has a technical content, and this aspect should be our starting point.

There is, by now, more than one theoretical demonstration, and also numerous practical examples, of the fact that a country cannot remain for long in a position in which it is in surplus on current account without setting in motion mechanisms which absorb it.⁴ There was still some doubt about this as regards reserve-currency countries, but this has been dispelled by the recent experience of the United States.

Given the importance of two of the mechanisms of surplus-reabsorption, it seems worth considering them at some length. The first mechanism is linked with the effect of increases in financial wealth (created to counter-balance the current account surpluses) on either consumption (impact effect), or on the behaviour of political forces or trade-unions in encouraging the domestic use of the surpluses (induced effect), and thus on overall demand. The second

⁴ See, in this connection, F. VIGARELLI: *Moneta, Ricchezza e Bilancia dei pagamenti*, Edizioni dell'Ateneo, Roma, 1971.

mechanism is linked with the tendency of capital to move towards countries registering a surplus on current account as being considered economically sounder and more likely to register a growth of domestic demand — thus creating over the long run, a double pressure towards revaluation of the exchange rate.

Pressures in the opposite direction (a fall in consumption, or, more generally, in overall demand, and capital flight) occur in deficit countries. But there is more to be said for the idea that the process originates mainly in the surplus countries and finds a favourable soil in the countries with the corresponding deficits. These mechanisms which act on the quantity or on the prices of internationally traded goods cannot be neutralised through a "guided" policy of "qualified" expenditure abroad of the foreign exchange surpluses — like the policy which, for convenience sake, we will call of the Japanese type, and which is designed to accumulate raw materials — since it concentrates the demand for goods in certain sectors, thus setting off inflationary processes abroad which aggravate their own surpluses, rather than helping to reabsorb them.

The situation which is mainly the consequence of the price rise in oil products is such that the oil producing countries (since they are not prepared to spend their incomes on goods but wish to accumulate monetary and financial assets) make it possible to finance the balance of payments deficits and leave a margin in the economies of oil-consuming countries for domestic expenditure (and indeed encourage these measures) to compensate for the curtailed purchasing power due to the increase in oil prices. Since the monopolistic policy of the oil producing countries does not immediately redistribute the available real resources, the countries affected are "forced" to sustain the level of overall demand in order to defend the present level of employment. But even supposing, which is doubtful, that, within these countries, this process can take place without sectoral and overall disequilibria, the world would go on accumulating additional amounts of financial wealth which, within a few years, would be on a gigantic scale. The international community should realize that it is highly probable that — in two or three years time — the stock of Eurodollar deposits will be more or less equal in volume to the M1 stock of the US monetary system.

If the economic mechanisms connecting monetary and financial assets to the volume of real goods, operate as experience has shown

so far, then we must expect, after a certain lapse, the holders of financial assets to exert pressure on real resources.

Initially, there will be a change in the composition of financial wealth away from one currency into another; then the switch will continue towards goods such as houses, land, jewellery and raw materials, and thus an inflationary process will be set in motion, which will tend to reestablish the preexisting relation between financial assets and real resources.

Economists, are not yet in a position to prophesy at what level of newly accumulated financial wealth, and therefore at what point in time this will take place; nor are politicians able to programme a more rational use of this wealth. In consequence, it is only reasonable to expect that disequilibria in the balance of payments will be settled through highly inflationary process.

If this is the direction in which the world economy is moving, the control of the quantity of money remains almost the only dynamic and flexible method, provided we can use it with a certain skill and unity of purpose.

On a national level, we are ready to make use of it, although to varying extents. There are decision making centres and instruments to which we can have recourse. On an international level, on the contrary, we are totally unarmed or, rather, we must rely on the far sightedness and coherence — assessed on the basis of the way they manage their domestic economies — of the international reserve centres.

To conclude, a simple regulation of flows would by itself avoid tensions in interest rates and exchange rate relations. This task could even be carried out by the market, if adequate measures were taken by the authorities. In the not far distant future, we will need to have some idea of the volume of international currency required by the international community in terms of its objectives and taking account of the behaviour of some of its members. And a particular timing will be called for in accelerating and decelerating it. It is vital, therefore, to lay down the "rules of the game" for the high-cost energy era which should be as sound as those fixed at Bretton Woods. Instruments are needed to apply these rules, and centres to use these instruments in accordance with the dual criteria defined above.

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