The Debate over Regulating the Eurocurrency Markets

The Eurocurrency markets have long been the focus of controversy, and debate over how the markets are functioning has become even more spirited recently. The markets' size, their persistently rapid growth, and their relative freedom from regulation by national monetary authorities are at the root of present concerns. But the debate about the Euromarkets is often confusing, and the arguments made frequently appear diffuse and abstract

The divergence of views has two dimensions At one level commentators disagree about what economic and financial problems, if any, are caused by Eurobanking operations. At another level, even among those who identify the same problems, sharp differences exist regarding appropriate remedies Those parties most directly concerned—depositors, final borrowers, international banks, and monetary authorities of major countries—approach the markets from differing perspectives, and so it is quite natural for them to differ on both their analyses and their prescriptions

This article seeks to offer some perspective on the Euromarket debate and to indicate current differences in viewpoint about the problems involved The objective is not to survey comprehensively all responsible opinion in the controversy, nor is it to identify official positions of specific institutions Rather, the article examines attitudes toward the three broad issues that underlie the debate about the Euromarkets·

- Have the Euromarkets contributed to worldwide inflation by complicating efforts at monetary control for national authorities or by providing a too ready source of financing for expenditures?
- Have the Euromarkets contributed to exchange rate instability?
- How safe are Eurobanking operations?

Inflation and the Euromarkets: monetary control
A number of critics claim that the Euromarkets can undermine or at least complicate national monetary policies in ways that tend to worsen inflation. Basically, that view rests on variations of the argument that the Euromarkets can create money over and above what is created in domestic banking systems Since this line of thought plunges directly into all the ambiguities surrounding the concept of money, care must be taken in choosing the measure of domestic money to compare with Euromarket liabilities

It has long been recognized that a shift of deposits from a domestic banking system to the corresponding Euromarket (say from the United States to the Eurodollar market) usually results in a net increase in bank liabilities worldwide This occurs because reserves held against domestic bank liabilities are not diminished by such a transaction, and there are no reserve requirements on Eurodeposits Hence, existing reserves support the same amount of domestic liabilities as before the transaction However, new Euromarket liabilities have been created, and world credit availability has been expanded

To some critics this observation is true but irrelevant, so long as the monetary authorities seek to reach their ultimate economic objectives by influencing the money supply that best represents money used in transactions (usually M_1) On this reasoning, Euromarket expansion does not create money, because all Eurocurrency liabilities are time deposits although frequently of very short maturity. Thus, they must be treated exclusively as investments. They can serve the store of value function of money but cannot act as a medium of exchange. For instance, if Eurodollars must be converted into United States demand deposits to be used in purchase of goods, services, or assets, and if a reliable relationship holds between the amount of domestic transactions balances and the level of domestic expenditures, then national monetary authorities could in principle influence those expenditures by controlling the domestic money supply.

Yet this point can also be pushed too hard. First, it is possible that shifts of funds from domestic markets to the Euromarkets increase the velocity of circulation of the domestic money supply, although not necessarily in any predictable way. To the extent this is true, the relation between domestic money and expenditures may be unstable. Like other investments that serve as money substitutes, Eurocurrency deposits allow depositors to economize on their money balances. Consequently, the rate of utilization, or velocity, of the domestic money stock may increase. Any given level of economic activity can then be transacted with less money. That can have inflationary consequences if the increase in velocity is not offset in time by the authorities.

Second, whether Eurocurrencies can play the role of transactions balances is basically a matter of market practice. For example, in the Caribbean offshore Eurodollar market, it is customary for branches of United States banks to transfer overnight Eurodollar deposits into immediately available funds without penalty. Under such conditions, overnight Eurodollars are a very close substitute for transactions balances in checking accounts at United States banks. For sophisticated multinational corporations, it is not a large step from the present situation to doing transactions directly among themselves in Eurodollars or other Eurocurrencies.

The important general point is that accepted concepts of money are being changed by practices in the Euromarkets, and not just domestically. This recognition that financial markets are undergoing rapid structural change underlies much of the official concern about Euromarket growth. Potentially, such change can disrupt traditional relationships between money stock measures and expenditure flows. As a result, monetary authorities may end up either seeking to control an inappropriate money measure or finding it difficult to decide how much weight to give to alternative measures of the money stock.

Nearly all observers would concede that rapid Euromarket growth in an inflationary environment makes life difficult for monetary authorities. But many argue that it is not necessary to slow the growth of the Euromarkets to attain better control over world inflation. Rather, traditional domestic monetary policy operations are seen as sufficient to control the growth of bank liabilities worldwide. Any faster than anticipated expansion of the Euromarkets need only be offset by further domestic monetary restraint. This could be achieved more or less mechanically by incorporating Eurocurrencies into domestic monetary aggregate targets in some appropriate fashion.

There are, however, practical reservations about this prescription. First is the problem of estimating any stable statistical relationship between a monetary aggregate that includes some Eurodeposits and national expenditures. Second is the problem of collecting sufficiently reliable and timely data about changes in Euromarket liabilities to be of use to monetary authorities in their policy operations. Such detailed information is not fully available. In principle, of course, it can be obtained, but the practical difficulties of obtaining comparable, timely information from many different countries poses no small problem.

Another important problem is the distribution of the effects of greater domestic monetary restraint. Governor Wallich of the Federal Reserve Board has raised this point in the context of United States monetary policy.[1] While conceding that theoretically the effects of Eurodollar expansion can be offset by tighter Federal Reserve open market operations acting on the domestic money supply, Wallich argues that this is not a practical alternative since the incidence of tighter monetary policy would fall disproportionately on expenditures financed by United States banks and borrowers not well connected to the Eurodollar market. Direct measures to control the Euromarkets, such as reserve requirements, would in his view spread the burden of tighter monetary policy more equitably among different kinds of borrowers and lenders.

Inflation and international adjustment

Another important charge made against the Euromarkets is that they contribute to inflationary pressures worldwide by increasing credit availability to deficit countries and thereby impeding adjustment of international payments imbalances. Specifically, deficit countries are said to be able to obtain balance-of-payments financing from banks operating in the Eurocurrency markets without having to take actions to reduce their deficits. As a result, worldwide expendi-

[1] Statement by Henry C Wallich before the Subcommittees on Domestic Monetary Policy and on International Trade, Investment, and Monetary Policy of the House Committee on Banking, Finance, and Urban Affairs, July 12, 1979 See also Governor Wallich's testimony before the Senate Subcommittee on International Finance, December 14, 1979

tures—in particular, consumption expenditures—are maintained at high levels, putting upward pressure on prices in world markets

In this view, Eurocurrency loans serve to displace credits that carry with them conditions on national economic policies—most importantly, borrowings from the International Monetary Fund (IMF). On the demand side, borrowing countries are seen as reluctant to submit to Fund involvement in their policies. As a result, they have a marked preference for bank financing of balance-of-payments deficits. On the supply side, banks are seen as wary of exerting leverage against borrowers by withholding new loans since such a step might jeopardize prospects for repayment of earlier loans and because they are naturally reluctant to get involved in domestic political arguments To the contrary, banks have competed aggressively in recent years in extending new Eurocredits and, at least until very recently, at terms increasingly favorable to borrowers. In any case, individual commercial banks have no mandate for tailoring their lending activities to promote international balance-of-payments adjustment.

At heart, these criticisms apply to international bank lending practices generally They become specific charges against the Euromarkets only because the bulk of bank lending to sovereign borrowers takes place in those markets (especially the Eurodollar market). However, the Euromarkets do have a natural comparative advantage in handling this business.

First, sovereign borrowers frequently need large amounts of funds at once. The most convenient, and often the only, way to accommodate such large loans is the syndicated bank credit. This financing technique has reached its fullest development in the Euromarkets, and it is not clear whether the technique is readily adaptable to domestic banking markets.

Second, both borrowers and lenders often prefer that loans be syndicated across a network of banks from different countries In that way, borrowing costs may be minimized while the risk of the transaction is spread as widely as possible.

Third, from the point of view of the commercial banks, there are often tax advantages in Euromarket lending, compared with strictly domestic lending. In some cases, earnings on loans shifted from the Euromarkets to bank head offices would become subject to additional domestic taxes, which would serve at the margin to discourage banks from extending such loans. For example, earnings on loans booked through the overseas branches of New York City-based banks would be subject to state and local taxes if shifted to the home office books

Consequently, while international lending could in principle be made from domestic offices instead of Euromarket branches, in practice the transition would be uneven. Thus, it is argued, regulation of the Euromarkets could result in less balance-of-payments financing, smaller deficits, and a possible reduction in inflationary spending.

This line of argument is sharply criticized by many bankers as well as officials of a number of deficit countries. To them, the problem is not that financing deficits is too easy. Rather, the problem is that, because of successive oil price shocks, international payments imbalances have become so large and intractable that reasonable stability for the world economy requires adequate financing through the Euromarkets Moves to restrict growth of the Euromarkets would inevitably raise the cost of funds to borrowers. But countries borrowing to offset the impact of higher oil prices or of a recession in the industrial world are not in a strong enough position to be very sensitive to borrowing costs in the short run. Hence, such restrictive measures would do little to promote adjustment and would simply make recycling a more costly proposition for borrowing countries In short, those who make this argument say that, without provision of alternative private and official financing sources, measures to restrict Eurolending would disrupt the recycling of oil funds, cause added difficulties for deficit countries, and contribute little or nothing to the reduction of oil price-induced inflation

Between these two extreme views—the Euromarkets as undermining balance-of-payments discipline and the Euromarkets as essential to the recycling process—is an intermediate one. In that view, the Euromarkets have been a major positive factor in smoothing the impact of balance-of-payments disruptions which could otherwise have led to serious economic hardship for many countries. But access to the Euromarkets has also led certain countries to delay fundamental adjustments in economic policies past the point where adjustments could take place gradually The results then were abrupt constraints on borrowing capacities and economic dislocation when the magnitude of the payments imbalances became apparent The proponents of this intermediate view would seek some mechanism to moderate the growth of bank lending in the Euromarkets and correspondingly increase balance-of-payments credits through the IMF. While this general approach has been widely endorsed, specific proposals for striking an appropriate balance between private and official sources of financing have proved difficult to formulate, especially since there is considerable disagreement over what policy conditions should be attached to IMF loans.

Exchange market instability

The coincidence of recurrent exchange market disturbances and rapid Euromarket growth in the past decade has prompted a line of criticism that the Euromarkets serve to amplify, or even generate, foreign currency crises. Few other aspects of the Euromarket controversy have been so confusing as the debate on this point. Often such charges refer to factors that have little to do with the special characteristics of the Euromarkets.

The arguments can commonly be broken down into a number of propositions. First is the claim that the Euromarkets serve as a source of finance for exchange market speculation or hedging activities. Although this proposition has frequently been advanced, it is practically impossible to confirm or deny empirically. Apart from that, however, the proposition has no clear policy implication unless it is assumed that no other source can replace the Euromarkets in financing currency speculation. Yet even a casual analysis of recent economic history suggests that there are many ways to finance speculation and hedging activities, notably through leads and lags in commercial transactions

Another line of thought starts with the presumption that recent foreign exchange crises are dominated by the problems of the dollar. By facilitating the expansion of worldwide dollar liquidity, the Euromarkets have magnified the exchange rate effects of other factors tending to weaken the United States currency: trade problems, increasing dependence on imported oil, stubborn inflation, the longer term relative economic decline of the United States, and official reserve diversification. This argument, however, comes down to being just another version of the earlier claim that Eurodollar banking operations have complicated the conduct of United States monetary policy in a way that promotes excessive credit creation.

A commonly voiced criticism is that Euromarket operations, by virtue of their technical efficiency, have increased the international mobility of capital. As a result, any factor influencing the exchange market in a particular way may induce destabilizing capital flows and greater swings in rates than would occur without the Euromarkets

It is difficult to know what to make of this charge. It is certainly true that the Euromarkets are highly efficient. That is one reason they have grown so fast in recent years. It also is true that the Euromarkets have enhanced international capital mobility, both between countries and between currencies. However, to speak of what might have happened in the absence of the Euromarkets is not helpful. After all, the Euromarkets grew to maturity as a response to the various types of barriers that were put in place in the 1960's to impede international capital movements. Since then, these barriers have been widely relaxed. The conclusion must be that the Euromarkets are less important in facilitating capital movements now than they once were.

What the critics seem to be saying is that a world of free capital movements and exchange rate flexibility is inherently difficult to manage, because sudden shifts in market psychology are capable of producing sharp changes in exchange rates. Sometimes those changes cumulate in one direction. However, skeptics feel there is no evidence that marginal adjustments in the growth of the Euromarkets would do anything to make the exchange markets less volatile. In their view, justification for Euromarket regulation must lie elsewhere.

Safety of Eurobanking operations

The last broad area of argument about the Euromarkets covers questions regarding the safety of banking operations. These are questions traditionally raised by bank supervisors about domestic banking but extended to the international context. The most obvious issue is whether banks are adequately assessing the creditworthiness of borrowers to whom they are making loans After many years of experience, both banks and supervisory authorities have found that the standards of evaluation commonly applied at home can be usefully applied in international lending as well. But, in addition, some characteristics of international banking complicate prudential oversight Consequently, several issues are seen to deserve special attention. These include maturity mismatching and interest rate risk; "country" or, as it is sometimes referred to, "transfer" risk; capital adequacy and bank earnings; foreign exchange risk, interbank or "name" risk; and the question of who fulfills the role of "lender of last resort" in the Euromarkets.

Maturity mismatching and interest rate risk

Sudden sharp increases in short-term money market rates can result in serious difficulties for banks by driving up the cost of funds used to back longer term loans whose rates are locked in at lower levels for a period of time. Banks are subject to such interest rate risk from the normal banking operations of borrowing short and lending long. However, mismatching of maturities on assets and liabilities becomes a serious problem when some prudent limits are exceeded. The definition of prudence is likely to change in accord with a wide variety of factors, including the variability of market rates. Most of the debate in this area reflects different perceptions of what is prudent banking practice in the present market environment.

The maturity mismatching of Eurobanking operations is singled out by some observers as an object of concern. The structure of Eurobank liabilities is dominated by short-dated money. Bank of England data indicate that about 40 percent of Eurobank liabilities in London is of one-month maturity or shorter, with half of this at eight days or less. The weighted average maturity of total liabilities in London is probably between three and four months. By comparison, the typical syndicated bank loan in the Euromarkets calls for the interest rate to be adjusted at six-month intervals.

This fact alone, however, says nothing about the safety of present balance-sheet structures, which is a matter of interpretation. Defenders of present practices dismiss concerns about maturity structure as exaggerated, pointing out that no unambiguous trend toward greater mismatching can be seen Others argue that increased variability of interest rates has compounded the risk of maintaining current maturity structures and that present mismatching practices should be curtailed.

It is important to note that, although the Euromarket portion of bank balance sheets shows maturity mismatching, the risk faced by any given bank depends on the structure of the consolidated balance sheet While available evidence is inconclusive, the maturity structure of domestic office assets and liabilities, appropriately adjusted for stable demand deposits, may tend to reduce any interest rate risks resulting from Eurocurrency operations.

Country risk

Country risk identifies a set of banking problems dealing with the exposure of Eurobanks to official or private borrowers and lenders from countries other than the banks' home countries The general focus of concern is whether banks have made an excessive amount of loans to countries that are likely to repudiate debt, to impose controls on outflows of funds, to delay repayments, or to take other actions to jeopardize the capital value of bank assets or the earnings on loans. The specific country borrowers that are sources of concern change with economic and political events. In principle, however, payments difficulties may arise with any borrower, so that the problem is a general one and not confined to any group of countries.

An important aspect of the country risk problem is identifying the appropriate extent of commercial bank involvement in recycling oil funds. This problem can be distinguished from the one cited earlier concerning the Euromarket role in delaying international adjustments in payments imbalances Few would suggest that oil-importing countries should take restrictive measures to eliminate the balance-of-payments effects of oil price increases in the short run. Since such adjustments must involve longer term changes in energy demands and supplies, financing oil deficits in the short run is appropriate. So debate centers less on whether recycling should occur than on whether it should occur primarily through the Eurobanking system.

It is commonly accepted that the international banking system performed very efficiently as an intermediary of oil funds after the first round of extraordinary petroleum price hikes. Although debt-servicing problems did develop in a number of well-known cases, such as Zaire, Peru, and Turkey, the absence of any general debt problem is cited as a factor supporting the role of commercial bank recycling. In fact, actual losses on international lending have been relatively small.

Commercial banks are probably in a better position to manage their international exposures that they were a few years ago. A number of them have taken steps to upgrade internal information systems and their analyses of economic conditions abroad. Information available to regulatory authorities on the country exposure of bank loans has also been improved in recent years, most notably through country exposure lending survey reports coordinated by the Bank for International Settlements (BIS) that cover banks in major countries. Hence, monetary authorities are seen as having sufficient information to monitor international lending and to detect excessive concentrations of lending before severe problems arise that could threaten the solvency of an individual commercial bank

Critics of private sector recycling argue that the very success of the commercial banks during the last round masks the severity of the problem. The general extent of the debt problem has not been revealed in widespread debt-servicing problems only because banks have extended further loans or rescheduled old ones to maintain servicing flows. Furthermore, the case of Iran reveals that payments disruptions cannot be easily anticipated.

In essence, critics of recycling through the Euromarkets argue that the sheer size of the prospective problem—estimates of the 1980 OPEC (Organization of Petroleum Exporting Countries) surplus run as high as \$80 billion-\$100 billion—and the fundamental uncertainty regarding political elements of country risk combine to put the international banking system in an increasingly precarious position. Based on this, they recommend that controls on the Euromarkets to limit the involvement of the banking sector in the recycling process should be combined with expanded official methods of intermediating the flow of oil funds and with incentives to promote direct lending by OPEC countries themselves. To advocates of this approach, the answer to the problem of country risk exposures in the future lies in spreading the risks across a greater number of institutions and toward the official sector.

The deposit rather than the loan side of bank balance sheets may also raise what amounts to a country risk problem. Recycling of oil funds has resulted in a heavy concentration of bank deposits in the hands of official institutions of OPEC countries. The chief risk in this situation is that one or more oil exporters may for political reasons withdraw their funds from some individual bank or from the banking system of some nation. A popular misconception views such a withdrawal as analogous to a run on a bank by depositors, having all the deflationary effects associated with hoarding. This view, which became prominent again during the threat of Iranian withdrawal of funds from United States banks, is misleading and exaggerates the costs of deposit transfer. The withdrawn funds are not hoarded but are redeposited in other Euromarket banks that are then in a position to supply funds to the institutions suffering the original withdrawals. As a result, the original banks exchange direct deposits for interbank borrowings. This, however, is not without costs; the original institutions may have to pay a premium to raise an extraordinary amount of funds in the interbank market and their profits may fall as a result. So some risk attaches to concentrated deposit holdings by country as well as to concentrated claims positions.

Adequacy of bank earnings and capital

Another prudential concern is the adequacy of returns to banks on international lending and the associated implications for bank capital. This matter has come to the forefront with the easing of terms on syndicated Eurocredits. In the past few years the average maturity of Euroloans has increased and the average spread over LIBOR[2] for loan rates has fallen steadily to levels near the historic lows of late 1973 and early 1974. Furthermore, the markets have been characterized by a narrower range of loan spreads across different borrowers than prevailed in that earlier period of easy terms This relaxation of lending terms has occurred in step with a strong expansion of Eurocredit volume

Market observers differ on the reason for the emergence of a borrowers' market One view sees the spread as a price that balances the supply of and demand for loanable funds in the Euromarkets It puts the responsibility for lower spreads on the increased supply of loanable funds in Euromarkets created by deficits in the overall United States balance of payments. As a corollary, the correction for narrowness in spreads lies chiefly in policy measures to reduce the United States deficit rather than in imposition of any controls on Euromarket operations. However, there are serious problems with this view. It is questionable why an increase in the amount of funds supplied to the Euromarkets should affect spreads on loan operations rather than rate levels. In any case, this theory cannot account for the continued erosion of spreads in the first half of 1979 when the United States recorded a sizable surplus on combined current and private capital accounts.

Another view looks to greatly increased competition among lending institutions for international business as the cause of narrower spreads. New entry and aggressive pricing to expand market share by Japanese and European banks are frequently cited as the factors behind easier terms

Still others maintain that the reduced spreads are an appropriate reflection of lower risk resulting from the generally good repayment record on international loans and therefore pose no problem This view is strongly disputed, however, by those who are concerned by the easing of credit conditions in the Euromarkets. They feel that it impairs bank earnings, thereby reducing the banks' ability to maintain adequate capitalization ratios. Some market participants have also stressed the need for caution. A number of prominent United States banks announced their reluctance to lend at narrower margins in 1978, and the volume of international credits extended by United States chartered banks and their overseas branches expanded at a much slower rate in 1979 than in earlier years.

These steps are cited by some as indications of market limitations to the erosion of lending terms that make unnecessary formal Euromarket controls. It is also suggested that decreasing spreads exaggerate the change in total costs to borrowers by neglecting the behavior of fees and other charges that may have increased to offset the fall in spreads. Moreover, some expect spreads to widen in response to the market pressure of increased demand stemming from the latest round of oil price hikes.

Critics of present Euromarket pricing practices find little reassurance from these arguments They point out that spreads remain narrow despite strong demand for credit, and they question whether bank earnings are adequate compensation for whatever increases in risk may be associated with a period of greatly enlarged deficits over the next couple of years. In short, there is virtually no consensus on this issue at the moment.

[2] LIBOR is the widely used acronym for the London interbank offer rate, the rate at which banks operating in the Euromarkets lend funds to each other In Eurobanking practice, loans to nonbanks are priced as a markup or "spread" over LIBOR

Foreign exchange risk

Banks assume foreign exchange risk in their operations when the currency composition of their assets does not match that of their liabilities, thereby leaving them vulnerable to losses from unanticipated changes in exchange rates. While this area has remained a background concern in the recent Euromarket debate, it does not claim the prominence as an issue that it had earlier. Monetary authorities have already taken a wide range of measures to address concerns about bank foreign currency exposures. These actions stemmed in large part from the collapse of Germany's Herstatt Bank in 1974, which had a deep effect on official and market attitudes toward Eurobanking operations generally and foreign exchange operations in particular In the wake of that bank failure, authorities in many countries imposed quantitative restrictions on open currency positions of their commercial banks or required considerably expanded reporting of such open positions. These steps, together with heightened caution on the part of many banks, have muted foreign currency exposure as a major issue.

Interbank positions

Interbank depositing is a prominent feature of the Euromarkets Using the difference between gross and net measures of the markets according to BIS definitions, about half of gross Euromarket liabilities is accounted for by interbank positions Despite its size, the interbank market is only infrequently an object of discussion in the Euromarket debate

In part, this is undoubtedly because interbank positions are neglected as a matter of course in discussions dealing with the inflationary consequences of Euromarket expansion Most analyses treat interbank Eurodeposits in the same way as interbank domestic deposits, which leads to their exclusion from any "Euro" monetary aggregate Only a few unconventional critics would treat interbank deposits as ordinary nonbank deposits and argue that their growth leads to growth of spending on goods and services A second factor dampening concern about interbank positions is a general characterization of them as highly liquid and easily reversible balance-sheet items that arise out of the natural arbitrage operations of an efficient market.

Nevertheless, this extensive network of interbank positions does translate the risks faced by any one bank on its operations into risks faced by all other banks. That this kind of risk—name risk, for short—is a real matter of concern was also demonstrated by the Herstatt failure, which temporarily resulted in a complicated tiering in the structure of interbank rates on the basis of the perceived quality of bank names.

However, questions remain about whether the amount of interbank business has become excessive in recent years. Some would say that the stability over time in the ratio of gross to net measures of the Euromarkets argues that interbank positioning is not aggravating risks in Eurobanking Others would reply that this stability in the aggregate measures is reassuring only if the structure of interbank positions has not changed in a marked way—that is, only if banks with risky features on the rest of their balance sheet are not becoming relatively more active borrowers of funds in the interbank market.

Even under detailed supervision and reporting requirements it is difficult for monetary authorities to assess the structure of name risk on a timely basis. At the very least, it calls for continuing, frequent international consultation among bank supervisors, a process that has gone forward under the auspices of the BIS.

Lender of last resort provisions

One of the traditional responsibilities of any central bank is to act as lender of last resort—to supply funds to a solvent bank or to the banking system generally in an emergency that threatens a sharp contraction of liquidity This role normally has been framed with respect to commercial banks in the domestic banking system. But the emergence of the extraterritorial Euromarket created ambiguities about which central bank would be responsible for providing lender-of-last-resort support for overseas operations

No final resolution of those ambiguities has yet been reached, and it is doubtful that central bankers will ever codify their respective roles or lay down conditions for lender-of-last-resort assistance. It is important that techniques of assistance be free to evolve as institutional arrangements and forms of financial activity in Euromarkets change. Moreover, it could be counterproductive to specify what banking behavior would or would not qualify a bank for emergency assistance.

Important steps have nonetheless been taken to eliminate needless ambiguities and anxieties about central bank preparedness should liquidity problems threaten Central bankers from major industrial countries, who meet regularly at the BIS, have examined the issues involved and concluded that "means are available for that purpose [i e., providing temporary liquidity] and will be used if and when necessary". In addition, major central banks have recognized the status of foreign branches as integral parts of banks: for example, the Federal Reserve has declared its readiness to extend to a solvent parent appropriately secured funds when temporary liquidity is needed to relieve strains encountered in foreign as well as domestic markets. Furthermore, central bankers and other regulators have developed a cooperative framework within which they share views about their prudential and lender-of-last-resort responsibilities.

Although ambiguities do remain, a common understanding of the problem is emerging from the deliberations of responsible authorities. It emphasizes the mutual interests of all central banks, which extend beyond national borders.

Positions and policies

Eurobanking operations are not governed by any systematic regulations achieved through international agreement. This does not mean, however, that they are completely free from regulations. National authorities have occasionally put in place rules or have reached gentlemen's agreements with private market participants that have affected the operations of Eurobanks By and large, however, such steps have been taken with only national policy considerations in mind and little regard has been given to fashioning rules in a wider international context

A prerequisite to an international agreement on regulatory action is the achievement of a consensus on the overall role of the Euromarkets But the variety and technical complexity of the issues in the Euromarket debate make it difficult to move from individual arguments on specific issues to a broader synthesis—what might be called a "position" toward the markets in general Indeed, a number of thoughtful analysts have admitted (with some candor) to having views on one or more of the issues but having no overall position However, in the interest of summarizing where the debate now stands, it might be useful to define a few stylized positions that do not necessarily represent anyone's expressed position but do give the flavor of the range of judgments. The list is by no means exhaustive and certainly does not presume to anticipate new ideas that might emerge

The juggernaut view

At one extreme is the judgment that the Euromarkets are fundamentally out of control, generating excessive credit creation globally and fostering overly competitive lending practices that pose a threat to the stability of the international monetary system Out of this view come recommendations for internationally coordinated policies to limit directly the growth of Euromarket operations and to impose restraints on the structure of Eurobank balance sheets as well as the types of loans that can be made.

The hybrid banking system view

In this judgment, the essential problem is that the Euromarkets frustrate the intention of monetary authorities who recognize the growing internationalization of banking markets but want to preserve distinct elements of their domestic banking systems. In one sense, this intention represents a clear, but less than wholehearted, break from the official consensus of the 1960's, when separation of a "domestic" banking market from an "international" banking market was an explicit policy goal. The hybrid system arose as capital controls programs of the 1960's were dismantled while most national regulations on domestic operations were kept in place The Euromarkets remained, by and large, free from those domestic regulations. That freedom created incentives to shift banking operations from domestic markets to the Euromarkets. With monetary policies placing greater emphasis on aggregates management, these shifts in banking operations came to be seen as a growing problem for monetary control.

To those subscribing to this position, the contradictions created by such a hybrid banking system could be remedied in three ways. Regulations could be imposed on the Euromarkets to make them more like domestic banking markets. Or, regulations could be eliminated on domestic banking markets to make them more like Euromarkets Or, both Euromarkets and domestic banking markets could be changed in a variety of ways to assure a convergence of practice and incentives In any case, the markets would tend to become unified and could then be treated as such from the point of view of monetary policy The choice of approach would depend on what is feasible and what is compatible with national laws and customs on bank regulation

The "take it to the Cooke Committee" view

This position sees the Euromarkets as basically well-functioning markets without need for systematic regulation The extraterritorial nature of the markets, however, demands an organized framework for ongoing close cooperation among the interested national monetary authorities to coordinate supervisory practices and share information. The Committee on Banking Regulations and Supervisory Practices (the "Cooke Committee", named after its present chairman, a Bank of England official), set up under the auspices of the BIS, is seen as providing a sufficient degree of official involvement Proponents of this view would support improved reporting requirements and would try to strengthen supervisory practices as warranted to deal with prudential concerns

The status quo view

Finally, at the other extreme is the position that the Euromarkets have demonstrated not only their efficient functioning as financial markets but also their indispensability as a mechanism for dealing with the problems of recycling surpluses and financing international trade and economic development. In this view, there are no equally suitable alternatives for achieving these ends. Any attempts to tamper with the Euromarkets would run the risk of seriously upsetting the recycling mechanism or even driving much of the business now conducted through the international banking system into nonbank channels that are less regulated and not systematically monitored. According to this judgment, it has not been proved that the Euromarkets pose problems of monetary control but, if further evidence pointed to such problems, they could be adequately handled by traditional monetary policy

Conclusion

Obviously, this characterization of the range of positions is a strong abstraction. It does not capture all possible positions nor does it serve as the only possible characterization. But it does give a flavor of the range of views that underlie the discussion about what steps, if any, should be taken to control the Euromarkets.

One lesson comes through clearly from the Euromarket debate up to this point: there is little chance that progress can be made in designing specific regulatory measures until there is agreement among the principals involved about the ultimate objectives of Euromarket regulation So far, that has proved elusive

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Principal Features of the Euromarkets

The Eurocurrency markets are a global network of banks, bank branches, and other bank affiliates that make loans and accept deposits in currencies other than that of the country in which the business is booked Euromarket transactions are generally for large amounts, and virtually no retail banking is done The markets overlap in large part. but are not synonymous, with international banking markets For example, a sterling loan made by a bank in London to a firm outside the United Kingdom is clearly an international banking transaction but not a Euromarket transaction A dollar loan made by the same bank to another British resident is a Euromarket transaction but not strictly speaking an international banking transaction.

Size

Estimates of the size of the Eurocurrency markets vary somewhat depending on which bank claims or liabilities are counted and on which countries are covered A common definition consists of total foreign currency liabilities, including those to domestic residents, reported by banks in Europe, Canada, and Japan plus the external liabilities reported by branches of United States banks in selected offshore financial centers, principally the Bahamas and Cayman Islands On this measure, gross Eurocurrency liabilities (inclusive of interbank deposits) totaled about $900 billion in mid-1979, based on data collected by the Bank for International Settlements (BIS). Net of interbank deposits among reporting banks, the Eurocurrency markets totaled some $450 billion. However, even this net size estimate includes substantial amounts of liabilities to banks, primarily to those outside the BIS reporting area. Thus, Eurocurrency liabilities to nonbanks were less than $200 billion as of mid-1979.

Growth

The Euromarkets grew rapidly during the 1970's All the measures of Euromarket size increased at annual rates above 25 percent. By comparison, a broad measure of the United States money supply that includes large negotiable certificates of deposit (CDs) and time deposits grew at an annual rate of about 10 percent between 1970 and mid-1979, as did a broad measure of the German money supply

Currency composition

By far the largest Eurocurrency market is in United States dollars, accounting for nearly 75 percent of all Eurocurrency deposits The Euro-German mark market, accounting for about 12 percent of the total, is the next largest The Euro-Swiss franc market accounts for somewhat less than 5 percent, and other major currencies represent even smaller shares. Recently, however, a Euro-Japanese yen market has begun to grow rapidly, following relaxation of certain official restrictions on the international use of that currency.

Location

London is the center of Euromarket activity, accounting for more than one third of Eurocurrency business London was a natural focal point for the development of Euromarkets, reflecting the combination of relative freedom from regulation over foreign banking operations, a favorable geographic location, and the considerable financial expertise in the London banking community

In recent years, the offshore Eurodollar market, centered in Nassau, has become a major rival to London for dollar business because of operating advantages (*e.g.*, the same time zone as New York) and relatively favorable tax features The offshore Eurodollar market is dominated by United States money center banks, who in fact conduct their business out of their headquarters in New York, Chicago, or California and simply book loans and deposits to their Caribbean branches—which are commonly shell branches rather than ordinary full-service ones

The major center of the Euro-German mark market is Luxembourg, which stands in relation to Germany much as the Caribbean market does to the United States Germany itself hosts very little Euromarket activity because of local reserve requirements and other regulations that discourage Eurocurrency business Other Euromarket centers include Paris, Amsterdam, and Zurich in Europe, Singapore and Hong Kong in the Far East, Bahrain in the Middle East, and Panama in Latin America

Nature of borrowers

Public borrowers—governments, central banks, nationalized or public-sector corporations and financial institutions—predominate They have accounted for about 80 percent of all borrowings through syndicated bank credits in recent years.

While borrowers from developed countries still account for the bulk of outstanding Eurobank credits, the pattern of new borrowing has changed noticeably in recent years In 1979, industrial country borrowers accounted for about one third of new Eurocurrency credits, compared with 70 percent in 1974 Over the same period, the shares of credits going to nonoil developing countries and to communist borrowers both doubled—to 40 percent and 10 percent, respectively OPEC members (Organization of Petroleum Exporting Countries), which accounted for less than 5 percent of Eurocredits in 1974, took more than 15 percent of total borrowings in 1979

Nature of depositors

Oil-exporting countries, not surprisingly, have become a principal source of funds to the Euromarkets, but the industrial countries as a group are still the major source of funds. Most of these deposits flow through the interbank network, but direct deposits by nonbanks account for perhaps 20 percent of gross Euromarket liabilities. The developing nations as a group are also an important source (as well as user) of funds This reflects to a great extent the depositing of part of their official reserves in Eurobanks The central banks of some industrial countries also place part of their foreign currency reserves in the Euromarkets, although by agreement many do not

Nature of Eurobank assets

Short-term financing is commonly extended by Eurobanks through lines of credit Medium-term loans, most commonly of three to five years' maturity, are usually extended on a revolving credit basis, and credits are "rolled over" every three or six months. In addition, large loans are extended through what are called syndicated credits These syndicates involve the participation of many banks from different countries Loans are for fixed maturities (usually three to seven years, but occasionally as long as ten years or so), but interest rates are revised every six months in line with changes in market conditions Some loan agreements have a multicurrency option that allows the borrowers to draw funds in a number of different currencies

Interest rates are expressed as a markup, or spread, over LIBOR, the London interbank offer rate It is the rate at which Eurobanks lend funds to one another Spreads vary according to bank assessments of the creditworthiness of the borrower On syndicated loans, borrowers also pay additional fees, such as a front-end management fee to the banks putting together the syndicate or a commitment fee on any undrawn portion of a loan

Nature of deposits

Euromarket liabilities range from overnight and call deposits at the short end of the maturity structure to time deposits of five years or occasionally longer The bulk of deposits is relatively short dated About one third of deposits to nonbanks have maturities of eight days or less and nearly 90 percent have maturities of less than six months In addition, Eurobanks in London have issued some $40 billion of negotiable CDs that can be traded on a secondary market