[redacted] F THE FEDERAL RESERVE SYSTEM

DATE Apr. 29, 1971

TO Chairman Burns

FROM ROBERT SOLOMON

Here is a record of our Saturday morning meeting in Basle on the Euro-dollar problem, which led to the one page proposal that was before you on Sunday afternoon.

You probably would not wish to read this through, but I thought you would be interested to know how the BIS listed the participants on the last page.

RS

Attachment.

~~Confidential~~

INFORMAL RECORD OF THE SECOND MEETING OF THE
AD HOC GROUP ON THE EURO-CURRENCY MARKET,
HELD AT THE BIS ON 17th APRIL 1971

The Chairman opened the meeting by introducing the document which appears in Annex I. He said that he had put down in it, on the basis both of the informal record of the Amsterdam meeting and of the various papers that had been circulated since then, what he believed were the main questions that they ought to take up, to serve as a basis for their discussion. After the present meeting he proposed to draw up a document for the Governors to consider at their May meeting, in which the creation of a standing committee would be suggested and its terms of reference laid down. He then asked if members of the group agreed to the procedure he had suggested.

Dr. Emminger said that in his opinion the Chairman's paper provided an excellent guide for their discussion. Perhaps at a later stage of the meeting they could discuss the suggested timetable for the creation of a standing committee.

The Chairman then proposed to take his paper paragraph by paragraph. After saying that he thought everyone would be able to agree on what was in the opening paragraph, he then asked for comments on Point 1.

POINT 1

Mr. Solomon said that in his view that point was well stated.

Dr. Emminger, after the Chairman had confirmed that BIS placings in the Euro-currency market were covered by Point 1, said that they had now had material which showed a $3 milliard shift of dollar assets by the BIS into the market.

Mr. Morse said that, so far as Point 1 was concerned, the most interesting thing would be to analyse what the central-bank inputs into the market were.

The Chairman then commented that those inputs would have to be studied by the future standing committee. All he wanted to know now was that they agreed with what was said under Point 1 of his paper.

Dr. Emminger replied that he fully agreed. Probably this was the most important aspect of the Euro-dollar for their group, since they could have a major influence on it. He was not sure that they should simply hand this topic to the standing committee for study, since he did not think that there was much more that they would learn about it. Instead they should make concrete proposals to the Governors on this point at a much earlier stage.

The Chairman then suggested that this point could be taken up by the standing committee at its first meeting.

Dr. Emminger commented that, if the committee were set up after the May Basle meeting, its first meeting could not be held until June. But he felt that this problem was a very urgent one and referred to Germany as "a burned child".

The Chairman said he was not against the idea of finalising matters for the Governors at once. He added, however, that it might not be easy to draw up a report for the Governors by the following day.

Dott. Ossola said that it might be dangerous to suggest concrete action without knowledge of the different magnitudes involved in the market. One thing they might do, however, was to put a stop immediately to further central-bank contributions to the Euro-market.

Mr. Solomon said that the remarks of both Dr. Emminger and Dott. Ossola were quite consistent with the US view of the problem of central-bank contributions to the market. A massive reversal of them would be disruptive, but equally he thought that the idea of studying them at leisure was inappropriate. As a first step they could adopt Dott. Ossola's suggestion.

The Chairman said that he would prefer to go through all the points contained in his paper first, before they asked themselves if they were in a position to act more quickly than he himself had anticipated.

Dr. Gilbert was disturbed by the form of Point 1 in the Chairman's paper. The present ad hoc group was set up to see if there was agreement to propose to the Governors the creation of a standing committee. Final action was up to the Governors and the present group could not put things in a form that told the standing committee what the answers to the various problems were. He thought that they might be able to say to the Governors tomorrow that there was agreement on the setting up of a standing committee.

The Chairman repeated that his paper was meant simply to guide the present meeting. After discussing it, they could decide what to propose to the Governors and what sort of terms of reference the standing committee should be given.

Mr. Morse then said that in that case it would be desirable to discuss the substance of Point 1 in the Chairman's paper. He then distinguished the following types of central-bank placement in the market:

1 (a) when a central bank takes dollars from New York and places them in the Euro-dollar market;

(b) when a central bank takes dollars from New York, converts into another currency (recently, notably the Deutsche Mark) and places that other currency in the Euro-currency market;

2. The practice of swapping dollars out through commercial banks. In this connection he specifically mentioned the Deutsche Bundesbank, adding that some other central banks, too, had done the same thing.

He then asked the question, what was wrong with these placements? Two criticisms in particular had been made of them. The first was that they produced expansionary or inflationary monetary effects. That remark applied to all the types of placement that he had mentioned. The second criticism, which he described as presentational, was that they produced an exaggeration of the size of currency reserves in relation to the size of the US payments deficit. That effect was only produced by 1(a) and (b) above.

The suggestion that had been put forward for limiting these placements amounted to a self-denying ordinance on the part of central banks represented around the table, while recognising that other central banks, too, were putting funds into the market. He added that the BIS had a very special position in all this and they would have to see what the effects of its actions were.

Dr. Gilbert then asked whether the suggestion of limiting central-bank placements was intended as something permanent, or whether its purpose was simply to handle some current difficulty.

Mr. Coombs commented that the appropriateness of such a limitation depended entirely on the circumstances at any given time.

Mr. Solomon asked what was meant by describing the second of the criticisms mentioned by Mr. Morse as being presentational.

Mr. Morse replied that in describing it in that way he had not meant to play it down. On the contrary it was a very real problem. On the other hand, he was not convinced that the first criticism was a very important one.

Mr. Inoue agreed that central-bank placements in the market could lead both to double counting of international liquidity and to excess creation of domestic liquidity. But if they started restricting such placements that would mean controlling where reserves were placed. In his opinion countries should be free to place their reserves where they wished.

Mr. Joge said that Sveriges Riksbank had never placed dollars in the Euro-dollar market. That was not because of the effects on international liquidity, but because it would amount to allowing the use of monetary reserves for investment purposes. He thought the problem was therefore a permanent one. Could they not agree to refrain permanently from placing more of their dollar reserves in the market and, in the more distant future, actually withdraw what was already placed there? Furthermore, could this rule not be recommended to all central-bank shareholders of the BIS and not just to those represented at the present meeting?

Mr. Morse asked whether Mr. Joge had meant that in the longer term central-bank dollars should only be placed in US Treasury bills.

Mr. Joge replied that if a central bank placed dollars anywhere in the US money market he presumed that the Federal Reserve took it into account as regards its effect on the domestic money supply. Central banks should therefore be free to place dollars in any US money-market instrument.

Mr. Hay said he saw great advantage in the creation of a standing committee. It could discuss what they were at present discussing, in order to see what central-bank policy should be at any point in time. He did not, however, see how they could influence the policies of central banks outside their own group, except perhaps those who were BIS shareholders. As to whether or not central banks should buy commercial paper, he thought that was hard to say. Finally, as regards central-bank swaps with commercial banks, he thought that they were somewhat different in nature, especially if they were very short-term.

The Chairman then said that he concluded that, if the Governors decided to set up a standing committee, the problems mentioned under Point 1 of his paper would be a very important and useful item for the committee to discuss. It should follow developments in this field and if necessary suggest action. He then asked whether the group agreed with what he had just said.

Mr. Solomon asked whether that meant that all problems would have to wait until the standing committee was set up.

Professor Kessler, referring to central-bank swapping of dollars with commercial banks, asked if it was not true that this was very different from central-bank deposits of dollars in the Euro-dollar market. Such swaps meant, from the commercial banks' point of view, the conversion of domestic liquidity into foreign liquidity. In the case of central-bank deposits, however, the commercial banks received increased resources, and in such a way that those resources would find outlets through the granting of credits to non-residents. He added, as regards the timetable of work, that even if they could not draw up a mandate for a standing committee by the following day, perhaps some group could do some thinking and drafting during the next weeks in order to gain time. Otherwise, as Dr. Emminger had said, discussions would begin only in June.

Dr. Emminger then said that, in order to be clear as to whether speedy action was needed, they had to go into the substance of Point 1 in the Chairman's paper. He agreed with the distinctions between types of central-bank inflow that Mr. Morse had made. But for him the most important aspect of these inflows was not the statistical inflation of reserves but rather their potential inflationary effects and the way in which they undermined countries' credit policies.

Referring to the first type of inflow distinguished by Mr. Morse, they had to include the BIS in considering this. He then asked whether the BIS should not look at the monetary effects of its actions and not just at relative interest rates. Of course if no monetary problems were at stake, that would be a different matter.

Turning to the second type of inflow distinguished by Mr. Morse, Dr. Emminger said that during 1970 the shift into Deutsche Mark reserves had amounted to the equivalent of $1 milliard. And it was probable that another $1 milliard had been added to official DM holdings so far this year. These shifts, unless the funds were held with the Bundesbank, undermined German policy. At the same time, they led to double-counting of foreign exchange reserves. The German authorities had considered reciprocating these actions of other countries, by converting some of its own reserves into the currencies of such countries. To do that, however, would produce a further doubl counting, and this process could go on without limit. He concluded that the major central banks should do such things only in consultation with one another, so as to avoid working at cross-purposes. The public would become alarmed if the volume of reserves were escalated in this way.

So far as concerned the third type of inflow to the Euro-market distinguished by Mr. Morse, he mentioned the recent experience of the Bundesbank. There had been a huge inflow of funds into Germany on 1st April this year and the Bundesbank's first reaction had been to swap the dollars out again with the banks, so as to avoid an alarmingly large rise in reserves. They had now had time to see the effects of these swaps, and it had in fact turned out that there had been no increase at all in the foreign assets of the German banks. All that had happened was that there had been a completely circular flow of funds, with no shift of the banks' domestic liquidity into foreign liquidity, and that the banks had earned some extra money. Consequently, that would be the last time that the Bundesbank would try the policy of swapping inflows out to the banks.

As for whether the proposed limitation on central-bank placements should be temporary or permanent, he had some sympathy with Mr. Joge's analysis. But he suggested that they should leave that question aside. Any decision taken should be on the basis of the existing circumstances, and should be subject to possible review and change.

<u>The Chairman</u> then said he thought the group would agree that

(1) if a standing committee were set up, Point 1 should be included in its terms of reference;

(2) problems of timing should be left to the end of their meeting.

<u>M. Janson</u> said that in his opinion it would be a good idea to try and visualise what the consequences of central-bank deposits were for the Euro-dollar market. If central-bank attitudes to the market were to change, e.g. if they were to withdraw their deposits, that might create

a new problem by stimulating further outflows from the United States. He agreed that better supervision of the market was called for, but warned against creating new problems in the course of dealing with existing ones.

The Chairman then proposed that they should turn to Point 2 in his paper.

POINT 2

Mr. Morse asked what was meant by gross and net outflows in Point 2(a).

Professor Kessler replied that the paper entitled "The supply of international short-term credit" submitted by the Federal Reserve mainly looked at the net supply of funds. His impression was that in that paper two different flows were netted out, viz. on the one hand lending by Euro-banks to non-banks or deposits by Euro-banks with other banks and on the other hand deposits made in Euro-banks of the country to which the lending was directed. In his opinion it was important to look at the gross outflows and not deduct any return flows that might occur. Of course, such return flows were of some importance since they could enable the gross outflows to continue. He added that, in looking at gross outflows, lending to non-banks was more expansionary than the making of deposits with other banks. This was because non-banks received extra funds which they could spend, while banks that received funds were always under the supervision of their own monetary authorities.

Mr. Solomon said that to him it was clear that inflows to Euro-bank were just as important as outflows from them. Furthermore, he did not think that it was for the present group to make judgements. What it had to do was to agree on what the tasks of the proposed standing committee should be. As regards Point 2(b), what was important from the point of view of monetary policy was lending to, and receipt of funds from non-banks.

Dr. Emminger then remarked that while the German authorities had some means of countering unwanted inflows to the banking system, it was much harder to offset money going to non-banks. He agreed that the distinction between these two types of flows that was made in Point 2(b) should be retained.

Dott. Ossola asked if by outflows was meant outflows from the Euro-market to national markets.

Professor Kessler said that outflows included a Euro-bank making deposits with commercial banks in other countries, or its making additional loans to residents of other countries. It could also include a Euro-bank increasing domestic credit with the use of Euro-deposits; but he added that the latter was under the control of the monetary authorities. Until now, they had all not bothered about their commercial banks' lending to non-residents, since they had thought that it did not affect them. However, they had now found out that it did.

Mr. Solomon said that in his opinion Point 2(a) should include the effects of inflows from the countries of the group into the market.

The Chairman then proposed that they should move on to Point 3.

POINT 3

Mr. Solomon remarked that here too a conclusion seemed to be being suggested. Some study would be required before he could agree to this point and in any case it seemed to him a little hard for the present group to suggest what the conclusion should be.

The Chairman then said that if Points 1 and 4 from his paper were put into the standing committee's terms of reference, sooner or later what was in Points 2 and 3 would come up for discussion. So Points 2 and 3 did not need to be mentioned in the standing committee's terms of reference. He then proposed that they go on to Point 4 in his paper.

POINT 4

Mr. Morse, commenting on Point 4, said that they ought to get not only the wording of it, but also its atmosphere and flavour right. It was possible to exaggerate, as well as to minimise, the problems arising out of the Euro-currency market. He then listed the following exaggerated fears that had been expressed about it.

1. The idea that its size has grown with terrifying rapidity. He thought that the BIS paper "Joint Supervision of the Euro-currency Market" put this in the right perspective by comparing the growth of Euro-dollar credit with the growth of private credit in all OECD countries. Furthermore, not all of the growth in the Euro-currency market represented an increase in credit.

2. The idea that the market was something quite new. The problems of flows between countries were bound to arise anyway in a system of convertibility and freedom. The most that could be said about the Euro-currency market was that it amplified these flows.

He added that non-banking flows, and in particular those of funds belonging to multi-national corporations, created just as many problems as did more strictly banking flows. They should therefore approach this wh matter in a cool way. He agreed with Mr. Solomon that the paper to be presented to the Governors should not contain leading questions. And he was not sure either that the right way to tackle the problem was by reducing the market's credit-creating potential or that by doing so they would reduce the problem. He would therefore like Point 4 to be expressed in a much more general way.

Dr. Gilbert agreed that what the group should present was not conclusions, but rather suggestions for the work of the standing committee. Referring to Mr. Morse's remark that in a convertible world flows of funds between countries were to be expected anyway, he said that flows took place through the Euro-dollar market precisely because of limitations and restrictions on convertibility. There was a broader convertibility in the Euro-market than elsewhere; that was why it grew so fast.

Mr. Morse again denied that the growth of the Euro-dollar market had been so extraordinary.

Dr. Gilbert replied that $50 milliard in ten years seemed a big figure to him.

Mr. Coombs then asked how much world trade had grown during those ten years.

Mr. Solomon said he supposed it would be agreed that in 1969 the flows through the Euro-dollar market had had a contractionary rather than an expansionary effect. He therefore concluded that Point 4 should be more broadly stated.

The Chairman agreed.

Dott. Ossola then asked why in Point 4 the use of exchange controls had been excluded?

The Chairman replied that he had left that out for practical reasons. He did not think that, for the group as a whole, the use of exchange controls would lead them very far, though it might be useful for a particular country.

Mr. Solomon said that restrictions could take various forms, and need not necessarily consist of exchange controls or restricting borrowers' access to the market.

Mr. Hay then raised the matter of interest rate policy. In his view, that was the fundamental question for the proposed standing committee.

Mr. Bouey said that, while they had concentrated their attention on the Euro-dollar market, in his opinion interest differentials were the most important factor that propelled funds through the market.

Dr. Emminger pointed out that there was no reference in the Chairman's paper to what might be called open-market policy for the Euro-dollar market. That might be more useful than exchange controls. He suggested that illustrative examples of the "ways and means" mentioned in Point 4 should be included in brackets.

* * *

The Chairman then said that he thought the discussion had been carried far enough to enable him to prepare a paper for submission to the Governors. So far as concerned the timetable, should they postpone everything until May or were some problems too urgent for that?

Mr. Morse asked what there was to prevent the standing committee being set up by the Governors at their present meeting. With reference to Point 1 in the Chairman's paper, he added that it was clear that some members of the group would like the Governors to agree at once on their being no net increase in the Euro-placements of their central banks pending the standing committee's study. While he could not commit his Governor on that matter, he wondered whether the Chairman could not put this suggestion to his fellow Governors.

Dr. Emminger agreed with Mr. Morse's suggestion and added that if the Chairman did not make that suggestion to the Governors his President would put forward some such idea.

The Chairman said that such a decision, which could have far-reaching implications, would not be easy to take. They could however try to settle the whole matter now and not leave it over until May.

Dott. Ossola then raised the question of the composition of the standing committee.

The Chairman gave it as his opinion that it should be of the same level as the ad hoc group, at any rate to begin with.

Dott. Ossola then said that, for the work of analysis, perhaps another sort of group would be better.

The Chairman replied that the standing committee would be free to delegate some problems to another group. But the committee as such should start on the same level as the present group.

Dr. Emminger very much agreed. Otherwise there would be perhaps six months of simply analytical study.

Following a short discussion on the desirability of avoiding publicity, the Chairman then closed the meeting by saying goodbye to the other members of the group in his capacity as their Chairman and by thanking them for the work they had done.

Annex I

Dr. J. Zijlstra

17th April 1971

BIS Working Group

The papers submitted to the working group since its meeting of 17th February 1971, and the record of this meeting, clearly indicate that the Euro-currency market can have an important impact both on the effectiveness of domestic monetary policies and on the working of the international monetary system. Although the papers show certain differences with respect to theoretical analysis and practical evaluation there seems to be enough common ground to list the following questions as those that may be considered to be the most relevant for consideration.

1. On the supply side of the market there seems to be broad agreement that the inflow of funds on account of deposits of central banks entrusted to Euro-banks has been an important expansionary (or inflationary) factor. The question therefore arises whether a study should be made of ways and means to reduce, to stop or, if this were considered appropriate, even to reverse this inflow.

2. There also seems to be broad agreement that even without the inflow from central banks the market can generate expansionary (inflationary) outflows. In this respect it may be worthwhile to concentrate on two specific questions:

(a) Would there be agreement that it is useful to distinguish between net outflows and gross outflows and that, from the point of view of the expansionary (inflationary) impact of the transactions, <u>gross</u> outflows are more relevant than net outflows?

(b) Would there also be broad agreement that among gross outflows the outflows to <u>non</u>-banks (lending to non-resident end-users) have to be distinguished from interbank outflows, the former, from the point of view of the expansionary (inflationary) impact of the transactions, being more relevant than the latter?

3. With respect to the gross outflow to non-banks, would there be broad agreement that it is unlikely that the monetary impact of these outflows is fully compensated by a reduction in domestic credit expansion in the receiving country (and possibly also in the lending country)?

Annex I -

4. If there is broad agreement with the propositions under 2. and 3. it would appear appropriate that - lacking adequate possibilities to cope with the expansionary (inflationary) effects of the Euro-currency market by the use of exchange control - a study should be made of ways and means (e.g. some form of liquidity requirement) to reduce the Euro-currency market's potential for generating expansionary (inflationary) outflows?

PARTICIPANTS

Chairman:	Dr. J. Zijlstra
Belgium:	M. G. Janson M. P. André
Canada:	Mr. G.K. Bouey
France:	M. M. Théron
Germany:	Dr. O. Emminger
Italy:	Dott. R. Ossola
Japan:	Mr. S. Inoue
Netherlands:	Professor G.A. Kessler
Sweden:	Mr. S. Joge
Switzerland:	Mr. A. Hay
United Kingdom:	Mr. C.J. Morse Mr. J.L. Sangster
United States:	Mr. C.A. Coombs Mr. R. Solomon
BIS:	Dr. M. Gilbert Mr. M.G. Dealtry

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 12, 1971

To Governor Daane

From A. B. Hersey

Subject: Relation of Project for BIS Withdrawal from Eurodollar Market to U.S. Balance of Payments Policy

CONFIDENTIAL (FR)

The fundamental objections to the Coombs project of selling special securities to the BIS as an inducement to the BIS to withdraw from the Eurodollar market are:

(1) tightening the Eurodollar market in this way will not be effective in defeating speculators on the mark;

(2) it is not in the U.S. interest to defeat European speculators on the mark, though we would be happy to see U.S. speculators out of the thing as far as possible.

Tightening the Eurodollar market in this way will not be effective in defeating mark speculation because:

(1) speculators can get financed elsewhere, including the United States;

(2) funds will always be obtainable in the Eurodollar market, no matter how tight it gets, because funds will be drawn in from other sources where interest rates are lower, including the United States.

U.S. balance of payments policy in a very short-run frame of reference has three conceivable strategies:

(1) exchange controls, IET on short-term capital, etc. (widely regarded as unworkable, and under present exchange market conditions probably counterproductive even if confined to moral suasion and "voluntary" programs);

(2) action on interest rates (see below);

(3) hands off, letting the markets force a revaluation of the DM as soon as possible -- giving the speculators their profits -- in the expectation that much of the speculative money coming out of the DM will move back to the United States.

The only actions on interest rates that make sense in this situation are actions that raise U.S. rates or reduce European rates. Raising Eurodollar rates makes no sense because it widens the spread favoring movements out of the United States.

It is not in the U.S. interest to defeat European speculators on the German mark, because:

(1) any revaluation of the German mark now, even if too small, is better than none;

(2) any revaluation of the German mark would put additional pressure on Japan to revalue the yen.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

FEDERAL RESERVE
BANK - NEW YORK

Office Correspondence

Date May 21, 1971

To Chairman Burns

From C. A. Coombs

Subject: Euro-dollar problem--
a possible action program.

CONFIDENTIAL

1. As of the moment we have the agreement of the European central banks to refrain from further placements of dollars in the Euro-dollar market, either directly or via the BIS. The question now arises whether we should push ahead from this base to bring about a gradual contraction of existing central bank placements in the Euro-dollar market on the grounds that such central bank dollar investments should, in the general interest, be placed in U.S. Government securities or deposited with the head offices of U.S. banks, thereby avoiding the possible recycling and double counting effects of placement of central bank reserves in the Euro-dollar market.

2. The earlier Exim Bank and Treasury issues of 3-month paper to the London branches of U.S. banks has served to mop up Euro-dollar debt owed by U.S. banks, which otherwise would have been repaid. This has been a useful but expensive operation for the U.S. Treasury and I would be inclined to the view that we

should not go appreciably further in this direction, but should not shrink from rolling over such paper at maturity until a more favorable opportunity for liquidating such issues comes along.

3. I continue to favor Treasury issuance of special securities to the BIS, designed to divert BIS placements of central bank funds from the Euro-dollar market to the U.S. Treasury. Such an operation would obviously be far less profitable to the BIS management than its current placements of funds in the Euro-dollar market. But if the deposit interest rate available to the European central banks under such an arrangement were reasonably attractive, I would hope that they would push the BIS management into acquiescence.

4. I have become increasingly impressed with the magnitude of funds available to the oil-producing countries for placement directly or indirectly in the Euro-dollar market. For example, I have heard that during the third week of April, oil company payments to the oil-producing countries amounted to no less than \$1.5 - \$2 billion. Moreover, as a result of the recent negotiations between the oil companies and the producing countries, the dollar receipts of the producing countries will

rise from $5 billion in 1970 to $15 billion in 1975. Imports by these countries, such as Libya, will probably lag far behind, thus increasing still further their already large reserves in dollars and sterling. Here, I think, the BIS could serve a useful purpose if it could solicit deposits from the central banks of the oil-producing countries for placement in CD's in the New York market. While the central banks of the oil-producing countries would probably be less appreciative than the European central banks of the risks of central bank placements in the Euro-dollar market, a concerted effort to persuade them by the BIS management, together with representatives of the U.S. and European central banks, might well succeed in channeling a goodly part of the dollar and sterling reserves of the oil-producing countries away from the Euro-dollar market into New York and sterling placements in London.

5. Such efforts to shift central bank funds from the Euro-dollar market into New York CD's would tend to maintain or widen the present spread between Euro-dollar and U.S. rates and thereby create the risk of generating new flows of short-term

private funds from the U.S. into the Euro-dollar market. Pending a closer convergence of U.S. and foreign interest rates, strong action to tighten up the OFDI and VFCR regulations and to extend the IET to short-term investments is essential. We can tolerate for a while either U.S. rates substantially below European levels or slack enforcement of short-term capital controls, but not both at the same time.

6. All European countries experiencing inflows of foreign money should be pressed to institute controls designed to reduce to zero the interest paid on such foreign deposits, or even to institute a penalty provision.

7. We should also press for the introduction of controls in each European country designed to limit, when appropriate, borrowing in the Euro-dollar market by their banks and business corporations. Such controls already exist in France and the United Kingdom and in various less stringent forms in certain other countries. In the absence of such controls, German industrial borrowing abroad alone accounts for $6 billion of the increase in the Bundesbank reserves during the past

year. The hard line being taken by Schiller is being financed by borrowed money.

8. The 20 percent reserve requirement on Euro-dollar borrowing by U.S. banks in excess of their bases no longer serves a useful purpose and should be eliminated. From time to time, New York banks may well find short-term Euro-dollar rates attractive enough to bid for Euro-dollar funds if the reserve requirement were eliminated.

9. At the April meeting of the BIS the question was raised whether central bank placements of dollars with their commercial banks on a swap basis should be included in the agreement to avoid placing new funds in the Euro-dollar market. (In such swap contracts, the commercial bank would normally place the funds acquired from its central banks in the Euro-dollar market.) It was agreed, however, that such operations should be exempted from the holding operation since certain central banks felt that they were an essential instrument of central bank credit policy. I think we should now move to prevent such central bank swaps with their commercial banks from injecting new

funds in the Euro-dollar market by generalizing to the extent necessary our recent operations with the Swiss National Bank, which enabled the National Bank to sell part of its dollar reserves to the Swiss commercial banks for placement via the BIS in the New York CD market.

10. Finally, I think we should intensively explore possibilities of instituting a uniform reserve requirement on commercial banks operating in the Euro-dollar market. I doubt that this could be accomplished effectively by Bank of England action, which O'Brien would probably sternly resist, to impose such reserve requirements on all banks conducting Euro-dollar operations in London. The best avenue would lie in uniform action by each major country to place such a reserve requirement checkrein on the Euro-dollar operations of its commercial banks, more particularly the operations of their foreign branches.

11. With a certain amount of negotiating effort, I should think we could get a general endorsement by the European central banks of points 1 - 9 outlined above. Point 10 is bound to stir up sharp controversy and I would not place much hope in early action in this area.

FEDERAL RESERVE
BANK - NEW YORK
May 21, 1971

Chairman Burns | Euro-dollar problem--

C. A. Coombs | a possible action program.

CONFIDENTIAL

1. As of the moment we have the agreement of the European central banks to refrain from further placements of dollars in the Euro-dollar market, either directly or via the BIS. The question now arises whether we should push ahead from this base to bring about a gradual contraction of existing central bank placements in the Euro-dollar market on the grounds that such central bank dollar investments should, in the general interest, be placed in U.S. Government securities or deposited with the head offices of U.S. banks, thereby avoiding the possible recycling and double counting effects of placement of central bank reserves in the Euro-dollar market.

2. The earlier Exim Bank and Treasury issues of 3-month paper to the London branches of U.S. banks has served to mop up Euro-dollar debt owed by U.S. banks, which otherwise would have been repaid. This has been a useful but expensive operation for the U.S. Treasury and I would be inclined to the view that we

should not go appreciably further in this direction, but should not shrink from rolling over such paper at maturity until a more favorable opportunity for liquidating such issues comes along.

3. I continue to favor Treasury issuance of special securities to the BIS, designed to divert BIS placements of central bank funds from the Euro-dollar market to the U.S. Treasury. Such an operation would obviously be far less profitable to the BIS management than its current placements of funds in the Euro-dollar market. But if the deposit interest rate available to the European central banks under such an arrangement were reasonably attractive, I would hope that they would push the BIS management into acquiescence.

4. I have become increasingly impressed with the magnitude of funds available to the oil-producing countries for placement directly or indirectly in the Euro-dollar market. For example, I have heard that during the third week of April, oil company payments to the oil-producing countries amounted to no less than \$1.5 - \$2 billion. Moreover, as a result of the recent negotiations between the oil companies and the producing countries, the dollar receipts of the producing countries will

rise from $5 billion in 1970 to $15 billion in 1975. Imports by these countries, such as Libya, will probably lag far behind, thus increasing still further their already large reserves in dollars and sterling. Here, I think, the BIS could serve a useful purpose if it could solicit deposits from the central banks of the oil-producing countries for placement in CD's in the New York market. While the central banks of the oil-producing countries would probably be less appreciative than the European central banks of the risks of central bank placements in the Euro-dollar market, a concerted effort to persuade them by the BIS management, together with representatives of the U.S. and European central banks, might well succeed in channeling a goodly part of the dollar and sterling reserves of the oil-producing countries away from the Euro-dollar market into New York and sterling placements in London.

5. Such efforts to shift central bank funds from the Euro-dollar market into New York CD's would tend to maintain or widen the present spread between Euro-dollar and U.S. rates and thereby create the risk of generating new flows of short-term

private funds from the U.S. into the Euro-dollar market. Pending a closer convergence of U.S. and foreign interest rates, strong action to tighten up the OFDI and VFCR regulations and to extend the IET to short-term investments is essential. We can tolerate for a while either U.S. rates substantially below European levels or slack enforcement of short-term capital controls, but not both at the same time.

6. All European countries experiencing inflows of foreign money should be pressed to institute controls designed to reduce to zero the interest paid on such foreign deposits, or even to institute a penalty provision.

7. We should also press for the introduction of controls in each European country designed to limit, when appropriate, borrowing in the Euro-dollar market by their banks and business corpoaations. Such controls already exist in France and the United Kingdom and in various less stringent forms in certain other countries. In the absence of such controls, German industrial borrowing abroad alone accounts for $6 billion of the increase in the Bundesbank reserves during the past

year. The hard line being taken by Schiller is being financed by borrowed money.

8. The 20 percent reserve requirement on Euro-dollar borrowing by U.S. banks in excess of their bases no longer serves a useful purpose and should be eliminated. From time to time, New York banks may well find short-term Euro-dollar rates attractive enough to bid for Euro-dollar funds if the reserve requirement were eliminated.

9. At the April meeting of the BIS the question was raised whether central bank placements of dollars with their commercial banks on a swap basis should be included in the agreement to avoid placing new funds in the Euro-dollar market. (In such swap contracts, the commercial bank would normally place the funds acquired from its central banks in the Euro-dollar market.) It was agreed, however, that such operations should be exempted from the holding operation since certain central banks felt that they were an essential instrument of central bank credit policy. I think we should now move to prevent such central bank swaps with their commercial banks from injecting new

funds in the Euro-dollar market by generalizing to the extent necessary our recent operations with the Swiss National Bank, which enabled the National Bank to sell part of its dollar reserves to the Swiss commercial banks for placement via the BIS in the New York CD market.

10. Finally, I think we should intensively explore possibilities of instituting a uniform reserve requirement on commercial banks operating in the Euro-dollar market. I doubt that this could be accomplished effectively by Bank of England action, which O'Brien would probably sternly resist, to impose such reserve requirements on all banks conducting Euro-dollar operations in London. The best avenue would lie in uniform action by each major country to place such a reserve requirement checkrein on the Euro-dollar operations of its commercial banks, more particularly the operations of their foreign branches.

11. With acertain amount of negotiating effort, I should think we could get a general endorsement by the European central banks of points 1 - 9 outlined above. Point 10 is bound to stir up sharp controversy and I would not place much hope in early action in this area.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date June 2, 1971

To

From Robert C. Holland

Subject: Dealing with the Euro-dollar market problem.

STRICTLY CONFIDENTIAL (FR)

Attached for your reference is a memorandum dated May 28, 1971 from Mr. Coombs combining in one document the ideas he has expressed regarding the possible establishment of a money-employed account in the Exchange Stabilization Fund to provide an alternate investment vehicle for dollars owned by leading central banks. This proposal is under review by Treasury officials, who would have the primary responsibility in proceeding with any such proposal.

Copies to: Gov. Robertson
Mitchell
Maisel
Brimmer
Sherrill

bc: Mrs. Mallardi (2) - for information

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date June 2, 1971

To

Subject: Dealing with the Euro-dollar market problem.

From Robert C. Holland

STRICTLY CONFIDENTIAL (FR)

Attached for your reference is a memorandum dated May 28, 1971 from Mr. Coombs combining in one document the ideas he has expressed regarding the possible establishment of a money-employed account in the Exchange Stabilization Fund to provide an alternate investment vehicle for dollars owned by leading central banks. This proposal is under review by Treasury officials, who would have the primary responsibility in proceeding with any such proposal.

Copies to: Gov. Robertson
Mitchell
Maisel
Brimmer
Sherrill

bc: Mrs. Mallardi (2) - for information

CONFIDENTIAL--F. R.

May 28, 1971

TO: Chairman Burns

FROM: C. A. Coombs

SUBJECT: Dealing with the Euro-dollar market problem

As you will recall, on May 14 I sent to Under Secretary Volcker and Governor Daane the following memorandum entitled "Euro-dollar Market Problem", which recommended the issue of a special Treasury security to the B. I. S. with the objective of diverting present deposits of G-10 central banks with the B. I. S. from the Euro-dollar to the U. S. market.

> "Re the Euro-dollar market, we face the problem of how to avoid the recycling effect and double counting of dollar reserves arising from BIS placement of central bank funds in the Euro-dollar market. The G-10 central banks have agreed to a holding operation under which they will not place additional funds with the BIS for deposit in the Euro-dollar market. The question now arises whether some withdrawal of BIS funds from the Euro-dollar market would not serve to keep Euro-dollar rates at a high enough level to exert pressure on speculative positions recently built up in German marks and other European currencies. This could conceivably be accomplished by a special Treasury issue to the BIS along the lines sketched out below.
>
> 1. The BIS has been offering central banks 3-month deposit facilities with a two-day call at rates roughly 1/4 percent below the New York 3-month CD rate, thus yielding the depositor central banks roughly 4 3/4 percent, as compared with Treasury bill rates ranging around 4 percent. The BIS has reportedly been placing such central bank funds in the Euro-dollar market, thus gaining for itself the spread between its deposit rate of 4 3/4 percent and the Euro-dollar rate.
>
> 2. The U. S. could take the position that central banks should normally place reserves in U. S. Treasury bills, thus avoiding recycling via the Euro-dollar market. To facilitate the transition back to such a normal procedure, the Treasury should issue to the BIS 2-year paper with a two-day call feature, available to both parties, at 5 percent, from which the BIS might take 1/8 percent as its commission, thus leaving 4 7/8 percent to its G-10 depositors. Macdonald of the BIS is asking 1/4 percent as the BIS commission.

3. Such an operation would create for the BIS two types of liquidity problems. First, individual central banks depositing funds with the BIS might encounter reserve drains necessitating the withdrawal of their deposits. This liquidity problem could probably be taken care of by the BIS itself, with the possible assistance of drawings on the BIS - Fed swap line at 5 percent.

4. The second, and potentially more difficult, liquidity problem is the risk that the central banks depositing with the BIS might generally become dissatisfied with a 2-year arrangement at 4 7/8 percent, if the broad spectrum of short-term rates, including the Treasury bill rate, should rise well above 4 7/8 percent before the 2-year term is up.

5. Macdonald of the BIS has suggested that this second liquidity problem could be solved by incorporating in the 2-year Treasury bill issue a provision for renegotiating the interest rate every six months. I have suggested instead, that the depositing central banks should be content with a guaranteed deposit rate of 4 7/8 percent for the entire 2-year period, unless the U. S. Treasury bill rate should rise so much above this level as to convert the whole operation into a losing proposition for the foreign central banks. If such a precipitous rise of the bill rate should in fact occur, perhaps the best way out would be for the U.S. Treasury itself to exercise the call feature, on the grounds that the 2-year issue was a transitional device designed to deal with a situation in which European central bank money was being diverted from its normal placements in U. S. Treasury bills. With the Treasury bill rate having moved to attractive levels, the European central banks could then be encouraged to shift from placements with the BIS into direct placements in the U. S. Treasury bill market."

As noted above, my preliminary discussions with Macdonald of the B. I. S. have suggested that we might run into a time-consuming bargaining encounter with the B. I. S. management over the question of the B. I. S. commission as well as over the issue of whether the rate on a special Treasury security should be variable during its lifetime. More generally, I sense that Macdonald will prove resistant to any scheme which locks his operations into U. S. Treasury decisions as to whether or not to issue special securities. We do, however, have the alternative of dealing directly with the G-10 central banks making deposits with the B. I. S., and with this in mind I sent off, on May 25, 1971, a cable to

Messrs. Volcker and Daane, through the Consulate in Munich, which ran as follows:

> "Regarding my earlier suggestion of a special Treasury issue to the BIS, which BIS management might resist on various grounds, it might be useful to have an alternative proposal available, namely, creation of a 'money employed' account at the Federal Reserve Bank of New York, as agent of the Stabilization Fund, which might offer time deposit facilities to G-10 central banks comparable to those provided by BIS. Basic feature of such an account would be a two-day call provision on 3-month deposits generally yielding slightly less than the 3-month bill in which such central bank deposits would normally be invested. As part of a special cooperative effort to shift to the U. S. market present central bank placements in the Euro-dollar market via the BIS, however, we might temporarily offer on such deposits a rate somewhat higher than the bill rate by investing part of the deposits in special Treasury issues of somewhat longer maturity. Liquidity of the money employed account could be readily assured by domestic and foreign trading desks of the Federal."

I should now like to spell out in somewhat more detail the above proposal for a money-employed account.

1. The Federal Reserve Bank of New York could offer to the G-10 central banks which now have dollars placed via the BIS in the Euro-dollar market, a time deposit account on a "money-employed" basis; that is, the deposit would be placed into a pooled account yielding a uniform interest rate, which would be higher than might be possible on an individual investment basis.

2. The Federal Reserve Bank of New York would offer this facility as fiscal agent for the U. S. Treasury, and the deposits would be placed on the books of the Exchange Stabilization Fund of the U. S. Treasury.

3. The foreign central bank dollars so pooled could be invested both in U. S. Treasury marketable securities of various maturities and in special nonmarketable securities, with an average maturity well in excess of three months. Thus, the yield on the overall account could be set higher than the 3-month bill rate, perhaps as much as 1/2 percent higher. [(See Appendix A for a sample portfolio.)]

4. Deposits in the account would have a two-day call feature, with relatively mild penalty provisions against exercising the right of call.

5. The prospective interest rate on such a "money employed" account, combined with the call provision, would make this facility comparable with deposit facilities now being offered by the BIS.

6. So long as the U. S. Treasury bill rate remains below the rate on the money-employed account, I think it probable that foreign central bank deposits in the money-employed account would prove relatively stable. Foreign central banks suffering reserve drains would clearly be inclined to cash in first their lowest yielding reserve assets.

7. Nevertheless, from time to time some central banks might find themselves compelled to draw on the money-employed account. I think, however, the liquidity of the account could be assured by any one of the following techniques, or by a combination of them:

(a) Investment of, say, 25 percent of the funds in the money employed account in 90-day Treasury bills with staggered maturities;

(b) Investment of another 25 to 50 percent of the funds in the money-employed account in special Treasury securities providing a call feature;

(c) Arrangements for direct purchases when advisable by the domestic Trading Desk of marketable securities held in the money-employed account;

(d) Spot purchases against forward sales by the foreign Trading Desk of the Federal of foreign currency balances now totaling $220 million on the books of the Stabilization Fund.

8. There remains the risk that a general upsweep of interest rates might call for periodic adjustments upward in the yield offered by the money-employed account. Such interest rate flexibility could be achieved by devoting, as suggested above, roughly 25 percent of the investments of the money-employed account to short-term Treasury bills.

9. The main risk I see in the money-employed account proposal is that it could be construed as a move to take the BIS completely out of business. I would think it would be possible, however, to reassure the BIS and its supervisory central banks on this score, more particularly since we should hardly be inclined to push a money-employed account facility so far as to undercut our own bill market to which the bulk of central bank dollar reserves should continue to flow. I can rather see useful possibilities of such a money-employed account being operated in parallel fashion with BIS operations with the general objective of regulating the Euro-dollar market in the interests of all of the central banks concerned.

APPENDIX A

SAMPLE PORTFOLIO
(Maximum maturity of 2 1/2 years)

Amount (in millions of dollars)	Securities	Yield*
$ 300	U.S. Treas. Bills due within 6 mos.	4.50
10	U.S. Treas. Bills due in 1 year	5.25
25	U.S. Treas. Notes and Bonds due in 1-2 yrs.	5.30
25	U.S. Treas. Notes and Bonds due in 2 - 2 1/2 yrs.	5.65
70	U.S. Govt. agencies due in 1-2 yrs.	5.90
70	U.S. Govt. agencies due in 2 - 2 1/2 yrs.	6.03
500	U.S. Treas. Special C of I -- 2 1/2 yrs.	5.63
$1,000		5.33 average yield

* Based on 5/26 prices.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DATE June 9, 1971

TO Chairman Burns

In connection with the discussion of Euro-dollars at luncheon on Monday, June 7, it occurred to me that you might be interested in the attached effort to jot down some tentative extra curricular thoughts on the subject.

Attachment.

F. S.

FREDERIC SOLOMON

ROUGH DRAFT FOR COMMENT
(Frederic Solomon-5-19-71)

1920s STOCK MARKET, 1970s EUROMARKET

From time to time significant new profit possibilities are discovered (or imagined). If there is an available supply of funds, the two can combine to produce a greatly increased flow of funds throughout the economy. The increased flow occurs when funds are placed in the newly profitable outlets, are disbursed to flow back through the economy, are drawn back into the profitable outlet by the high yields offered, and the process is repeated over and over again. The increased flow can continue until something interrupts it, such as disappointed expectations, or some other constraint on the flow at some point. (In some cases there can be an actual reversal of the flow, as when a speculative bubble bursts.)

As the flow continues there are a number of effects. An immediate inflationary effect is reflected in the increased prices that result from the increased demand in the area where the flow is most sharply focussed, that is, in the newly profitable area. A stockpiling or blance sheet effect follows when there is a build-up of obligations that reflect the flow that has occurred. Since the capacity or willingness of the total economy to hold obligations usually will not increase as rapidly as the increased flow generates extra obligations, there usually is a displacement effect when the new obligations generated in the newly profitable area tend to crowd out other obligations.

Banks usually play a prominent role in the process, although they may act largely as agents or arrangers, without the resulting obligations appearing on their own balance sheets.

The process outlined above appears most frequently, but not exclusively, in speculative activities such as trading in land or securities. The stock market of the 1920s is an outstanding example. However, as indicated below, there are striking similarities in the Euromarket of the 1970s.

1920s STOCK MARKET	1970s EUROMARKET
NEW PROFIT POSSIBILITY	
Several factors contributed to suddenly increased attractiveness of investment in common stocks, among them, the campaigns that sold war bonds in World War I, the profitability of the auto industry, and publicity regarding common stock profits. Rises in common stock prices attracted new funds and made "street loans" highly profitable.	Several factors contributed to the increased attractiveness of loans in the Euromarket, among them, the profitability of American businesses entering the cartelized European markets, and investments by American businesses seeking to establish themselves inside the tariff walls of the common market. Later, credit restraint in the United States led many large U.S. businesses to finance themselves directly or indirectly through the Euromarket, even for their U.S. activities.

IMMEDIATE INFLATIONARY EFFECT

The principle initial impact was on stocks and street loans. Since the supply of the former was rather inelastic, prices soared. The high yield and presumed safety of street loans attracted large amounts into them from around the world.

Since the Euro-borrowers used the funds to finance their activities, the impact probably was spread widely throughout the economies of the European countries and also the U.S. This may have been a significant but little noted cause of world-wide inflationary pressures.

STOCKPILING (BALANCE SHEET) EFFECT

The volume of street loans increased greatly, reaching an estimated $11 billion.

The volume of Eurodollars increased greatly, reaching an estimated $50 billion. There also were large amounts of Eurobonds.

ROLE OF BANKS

Very few of the street loans were made directly by the banks and appeared on their balance sheets. However, virtually all the others were made by the banks acting as agents for nonbank lenders.

By definition, none of the borrowings were made directly by domestic offices of U.S. banks, and none appeared on their domestic balance sheets. However, the U.S. banks borrowed and loaned large amounts of Eurodollars at their foreign branches, and later had their foreign branches borrow Eurodollars for the head offices. Non-U.S.

banks also borrowed and loaned Eurodollars.

DISPLACEMENT EFFECT

Street loans tended to displace other forms of investment, causing reduced demand for such other investments. Farmers charged that credit was being denied them (i.e., there was reduced demand for their obligations) and that funds were being drained from agriculture.

Eurodollars tended to displace what they most resembled and considerably out-yielded, namely, State-side dollar obligations (U.S. dollars). Reduced demand for U.S. dollars caused dollar weakness and gold drain.

REMEDIAL EFFORTS

General monetary restraint and "direct pressure" were both tried, with little effect. Securities Exchange Act of 1934 placed margin requirements on stock market loans, thus restraining the flow by limiting the demand for borrowed funds to enter the area.

Problem seems to remain even though many remedies have been tried, including general monetary restraint, VFCR, IET, restraint on transfers of funds abroad by U.S. corporations, currency swap arrangements, and reserve requirements on Eurodollars transferred to head office. Current efforts to issue special EX-IM and Treasury securities probably will, in a static sense and at some cost to the U.S., absorb some of the Eurodollars generated by past operations of the process.

However, there is a serious question whether such special securities can restrain the dynamic process by which additional Eurodollars are created, and whether such securities may not even contribute to further expansion of the process.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date June 23, 1971

To Chairman Burns

Subject:

From A. B. Hersey

aBH

Attached is a memorandum by Miss Logue reporting on testimony on the Eurodollar market given yesterday by Messrs. Gilbert, Klopstock and de Vries.

Attachments.

Cc: Governor Brimmer
Governor Daane
Governor Mitchell

June 23, 1971.

To: Mr. Hersey

From: Ruth Logue

Report on Hearings before the Reuss Subcommittee on International Exchange and Payments, Tuesday, June 22, 1971, Afternoon Session.

Congressmen present:

Henry S. Reuss (D-Wis.), Chairman
William B. Widnall (R-N.J.) After 3:00 PM

Witnesses:

Milton Gilbert, Economic Adviser, Bank for International Settlements
Fred H. Klopstock, Manager, International Research, FRB of NY
Rimmer de Vries, Vice President, Morgan Guaranty Trust Company

Topic: The Size, Functioning and Economic Significance of the Euro-dollar Market

Dr. Milton Gilbert described the Euro-dollar market as arising in part from effort of banks to avoid various domestic monetary controls, and he called for multilateral supervision of the market. Among the factors causing the large increase in official Euro-currency holdings in 1970-71, he mentioned a shift in the relative composition of reserve holdings from dollars to Deutsche Mark.

Fred H. Klopstock praised the Euro-dollar market as "a funnel through which temporarily unemployed funds in virtually all parts of the world are quickly and efficiently transmitted to banks in major financial centers, and through them, to borrowers in need of loan accommodation". Mr. Klopstock dismissed fears that the dollar balances held in the Euro-dollar market represent a potential claim on the United States, saying that only the small fraction of total deposits employed in the United States constituted a claim on United States reserves. He was also of the opinion that only a small part of the proceeds of Euro-dollar credit is redeposited in the market, and therefore the multiplier effect must be quite small. Mr. Klopstock said the market was already subject to national controls. While he thought central bank coordination of policies with respect to the Euro-currency market would increase, he doubted that a system of supranational control could be effective.

Mr. Klopstock also touched on the rapid growth of medium-term lending of Euro-dollars, and he mentioned the concern of some bankers about the easing of Euro-dollar lending criteria.

Rimmer de Vries attributed the growth of the Euro-dollar market mainly to interest differentials. He also praised the market for its efficiency in gathering liquidity, but looked more favorably on the idea of imposing restrictions. De Vries thought the Euro-dollar market tended to magnify the short-term capital outflow from this country during the recent crisis. He mentioned that this outflow had been broadly based, and emphasized that foreign-related entities, i.e., U.S. agencies and branches of foreign banks, and U.S. subsidiaries of foreign companies had been as active in bringing about the outflow as U.S. banks and corporations.

Chairman Reuss summarized the statements by saying he gathered that the three thought (1) the Euro-dollar market a good thing, that it equilibrates interest rates; (2) that U.S. controls increased the scope of the market; (3) that the Euro-currency deposits of central banks were not in a major way responsible for the May crisis, and (4) that the June 14 statement of Zijlstra was constructive.

Rimmer de Vries agreed with (1) and (2), but not with (3). He said European central bankers had complained of the U.S. following a passive policy, but there was a long history of European central banks following a passive policy. Their tight money had attracted funds to Europe. He thought the depositing of funds in the Euro-dollar market "a magnificent error" on their part.

Fred Klopstock said that the equilibration of interest rates had not been successful, but it had facilitated the evening out of supplies of funds. He agreed with (3) but said we need a greater degree of cooperation on monetary policy.

Milton Gilbert thought the fact that the market made banks act more competitively good. He attributed the disparity of interest rates to the effectiveness of controls.

Chairman Reuss asked the panel to comment on his proposal to close the gold window, and have a period of temporary float for the dollar while the IMF worked out a new alignment of currencies.

De Vries thought the Reuss program too drastic.

Reuss asked what the panel would do in view of the undervaluation of the yen: (1) Nothing; (2) quotas and embargos on trade; (3) the Reuss plan. Gilbert praised Reuss' plan as being the first to take account of economic realities; it was not Gilbert's policy, but is economics. Reuss asked for his program. Gilbert said he didn't like floating; it would create a severe monetary crisis. He asked to speak off the record, and then told Reuss that the IMF Executive Directors didn't have the power to realign rates over the week-end; it could be done only by negotiations among governments.

Representative Widnall asked de Vries about the participation of U.S. banks in the flow of funds to Europe in the week of May 12 (quoting Governor Brimmer). De Vries replied that he couldn't explain the outflow by looking at American banks. Widnall said that we have to understand more fully the passage of funds through the banks. De Vries said we need to know more about short-term capital movements, that the Subcommittee should bear on the Federal Reserve and the Treasury to gather and publish more data on short-term capital movements -- that they now collect more than they publish.

Representative Widnall asked Mr. Klopstock about the deterioration in the quality of credit he had spoken of on p. 12 of his statement. Klopstock said there was a need for medium-term credit in the world, but there had been some worsening of credit quality at the margin. Rep. Widnall asked if borrowing short and lending long were a trend. Klopstock said yes, there were basic pressures to provide term loans. Widnall asked it it weren't true that each liquidity crisis had been caused by same phenomenon -- lending long; borrowing short. He asked if there weren't measures to control this. Milton Gilbert replied that the banks in the Euro-dollar market were the very best banks, that it was inconceivable that they would get in trouble because the authorities wouldn't let them. He said liquidity crises were not always a matter of lending long and borrowing short. Klopstock mentioned the huge pool of Euro-dollar funds as a safety factor, and De Vries said there were very few demand deposits in the Euro-dollar market.

Widnall then asked the panel if they agreed with Houthakker that the U.S. balance of payments was not in such bad shape. Klopstock was hopeful, citing the rise in receipts from direct investments and price rises abroad. Gilbert thought it was worse than the officials say it is.

The three statements are attached.

Statement before the Subcommittee on
International Exchange and Payments of the
Joint Economic Committee, U.S. Congress
on June 22, 1971

by Dr. Milton Gilbert
Economic Adviser and Head of the
Monetary and Economic Department

Bank for International Settlements
Basle, Switzerland

The essence of the Euro-currency market is financial intermediation by commercial banks in foreign currency. And, the market itself may be defined as the group of banks outside the United States which actively bid for foreign currency deposits in order to off-lend the funds to other banks or to final borrowers. The market is very well-organized, very competitive and has an excellent communications network.

The BIS statistics of the size of the Euro-currency market cover the outstanding amount of foreign currency credits channeled through the commercial banks of eight reporting European countries, namely, the United Kingdom, Belgium, France, Germany, Italy, the Netherlands, Sweden and Switzerland. Our measure of the market's size is thus based only on those credit flows which on their way from the original suppliers to the ultimate users pass at some stage through the banks of the reporting European countries. The banks of other countries are not really excluded, as they come into the picture as suppliers of funds to or receivers of funds from the reporting European banks. This limitation of the statistics to the banks of the European Group of Ten countries is partly dictated by the availability of information, but is also largely justified by the dominant role of these banks as Euro-currency intermediaries - including of course the European branches of US banks. Thus, while we have data for Japanese and Canadian banks, the Japanese banks are not included as Euro-dollar intermediaries, since we regard them only as end-users of Euro-funds which they obtain from the market. The Canadian banks are left out because we believe it more useful for analytical purposes to group them together with the banks in the United States, thereby showing them as suppliers of funds to or takers of funds from the reporting European banks. No figures are available for the bookkeeping offices of US banks in the Bahamas or similar outposts, but, in any case, these branches are really part of the US banking system, rather than independent foreign currency intermediaries.

In our estimates we seek to eliminate the double-counting which arises from interbank deposits within the reporting area. On the other hand, to the extent that the reporting banks create Euro-dollars by switching out of domestic or third-currency funds, or employ Euro-dollars for conversion into domestic or third currencies, they are themselves considered as suppliers or users respectively of Euro-currency funds. Moreover, we try to adjust the banks' assets and liabilities vis-à-vis the United States for amounts unrelated to the Euro-dollar market.

The size of the Euro-currency market at the end of 1970 may be put at $57 billion, and at about $60 billion at the present time. The dollar component is estimated at $46 billion, and perhaps $47 billion on these two dates.

I may make a few remarks on the meaning of these figures. Firstly, contrary to what is often thought, these dollars do not represent a corresponding potential liability of the United States. In fact, the US international financial position is in general affected only insofar as US bank and non-bank residents have borrowed from or lent to the market. After the large repayments made by US banks to the market in 1970-71, probably not much more than 20 per cent. of the Euro-banks' dollar assets by now represent claims on the United States. The remaining 80 per cent. mainly reflect capital flows between third countries. The fact that these credit transactions happened to be denominated in dollars, at least on part of their way, does not really make them different from other capital flows that occur outside the United States. I may add that the "potential" claims on US reserves are indicated by the private and official liabilities to foreigners reported by the US banking system - which have no fixed relation with the Euro-market.

Secondly, it follows from the above, paradoxical though it may sound, that the economic significance of the market does not derive from the fact that the credit flows are largely denominated in dollars, but from the effect the market has on the international mobility of short-term funds. The Euro-dollar is, in a way, only the device which has helped to bring about this increased international mobility of short-term capital. For example, by accepting deposits and extending loans in dollars, banks outside the United States have been able to avoid exchange controls, reserve requirements, or interest restraints that they would have encountered if they had tried to do the same thing in domestic currency. Similarly, by moving to London, US banks have been able to do international business which might otherwise have been ruled out by the US balance-of-payments restraint program, the Regulation Q ceilings, or reserve requirements.

The increased international mobility of capital resulting from the Euro-dollar market has of course important policy consequences. For one thing, it magnifies the force of international interest rate differentials and thus limits national autonomy with respect to monetary policy. This holds true even for the United States, but to a much greater extent for other countries. It is partly a matter of relative size. Although the Euro-market is quite large by absolute standards, it is relatively small in relation to the total US credit supply, and thus the US monetary authorities can fairly easily neutralize the domestic monetary effects of Euro-dollar inflows or outflows. The same cannot be said of smaller countries where the amount that might be obtained from the Euro-currency market is very large in relation to the domestic credit supply.

In addition, because of the status of the dollar as an international reserve currency, capital flows into or out of the United States do not have an immediate and direct effect on the nation's official reserves, as is the case with other countries.

All this implies that the Euro-dollar market tends to increase the degree to which the slant of US monetary policy is imposed on the rest of the world; while other countries, even if their monetary policies were all to move in the same direction, would not have the same effect on the United States.

Another point to be made regarding the significance of the Euro-currency market is that, although the market has increased the international mobility of short-term funds, it would be very unrealistic to assume that none of the credit flows effected through the market would have occurred without the facilities of the market. For example, given the international constellation of interest rates and the Regulation Q ceilings, there would in any case have been a substantial flow of short-term funds to the United States in 1969 and a reversal of this flow, with a substantial inflow into Germany, in 1970-71. It appears evident, however, that the Euro-currency market facilitated these flows. In a way, of course, the Euro-currency market is just one aspect of a much broader development towards greater international interdependence and reduced national autonomy.

A related point is that the large volume of Euro-currency credit outstanding cannot be regarded as adding that amount to the world supply of credit to non-banks. To some extent, naturally, this is so; but part of it is only a substitute for credits in domestic currency, or merely entails a reallocation of credit, and some of it might even have caused a reduction in the world supply of credit to non-banks. The actual impact of the Euro-currency market on the world supply of credit will depend, above all, on the direction of the Euro-credit flows. If the Euro-market contributes, as it did in 1969, to a capital flow to the United States, its overall impact will tend to be a contractive one, since the tightening effect of such flows on the rest of the world is likely to be larger than the expansionary impact on the United States. Conversely, when, as in 1970-71, the Euro-market accentuated capital outflows from the United States, its overall impact on the world supply of credit to non-banks tends to be an expansionary one. To the extent that the Euro-currency market adds to capital flows between third countries, the situation is less clear. In the absence of exchange rate speculation and high rates of inflation these capital flows will, however, in general respond to differences in the degree of credit tightness, and their overall impact is likely to be expansionary because money will move from countries with easy monetary conditions to countries with a tight monetary situation.

I have been asked to what extent dollars have been "recycled" by official monetary institutions back into the Euro-dollar market. I am not sure of the meaning of "recycled" in this connection and I doubt that it is a measurable concept. In any case, I believe a more straightforward question is the magnitude of total placements in the market by official institutions - whatever their source.

Precise statistics in this matter are not available, but I have made estimates which I believe give the approximate order of magnitude. I estimate the total placement of funds in the market as of the end of April 1971 at roughly $10 billion. This was mostly dollars but included other currencies as well. The Group of Ten central banks, Switzerland and the BIS accounted for $3.7 billion, while $6.3 billion (obtained as a residual) was accounted for by other countries around the world. These figures may be compared with the net size of the Euro-market which we estimate to be at present of the order of $60 billion - $47 billion in dollars and $13 billion (equivalent) in other currencies.

More important than the present total of official placements in the market has been the increase in their volume over the past year and a half or so. I estimate the official funds in the market as of early 1970 at about $3 billion, which means that the increase over this period was about $7 billion. This is quite a large increase for a 16-to-17-month period and is what has caused concern in official circles. Of this total increase, about $2.5 billion may be attributed to the Group of Ten, Switzerland and the BIS, and about $4.5 billion to the rest of the world. By comparison, the expansion of the net Euro-market over the same period was about $16 billion.

One may explain the large increase in official Euro-currency holdings by three factors:

(1) At the end of 1969 a sizable volume of official funds that would normally be in the Euro-market was being held in US banks because, with such funds exempted from Regulation Q ceilings, higher interest rates were paid on them in the United States than in the Euro-market. When US interest rates declined in 1970-71, the funds moved back naturally to the Euro-market.

(2) A second, more important factor, besides the shift of funds, was the huge increase in foreign exchange reserves. From the beginning of 1970 to the end of May 1971 this increase was probably about $20 billion and it certainly accounted for the bulk of the new official placements in the Euro-market.

(3) A third factor, I believe, was a shift in the relative composition of reserve holdings from dollars to Deutsche Mark. This tended to increase official funds in the market because a much larger proportion of D-Mark reserves than of dollar reserves are held in the Euro-market. Total D-Mark deposits in the Euro-market rose by about $4.6 billion (equivalent) in 1970 and the first quarter of 1971, and the figure certainly increased significantly in April and May. However, I have no way of estimating the amount of official funds there may have been in this increase - though I believe they were a factor.

The rapid expansion of the Euro-currency market and of the volume of official funds placed in the market has crystallized the view in official circles that the market should be subject to multilateral supervision. I myself have been of this opinion for the last five years or so, as it was clear to me that the rapid growth of the market would continue and that it should be brought under official consideration at an early stage.

In his speech at the Annual General Meeting of the Bank for International Settlements on June 14, 1971, the Chairman of the

Board of Directors, Dr. J. Zijlstra, made the following statement:

> "... it is becoming increasingly clear that the Euro-currency market needs guidance and supervision. The group of Governors meeting regularly in Basle decided to set up a study group under my chairmanship to analyse the problem and to work out terms of reference for a standing group which might suggest policies to be adopted by the Governors. I am confident that the Governors will be able to bring the Euro-currency market into better harmony with the proper functioning of the international monetary system. I may say, in fact, that we have already decided for the time being not to place additional official funds in the market and even to withdraw funds when such action is prudent in the light of market conditions."

This study of the Euro-currency market in all its ramifications has only recently been initiated and it is, therefore, too early to say how any multilateral supervision over it may be exercised. Legal powers among the countries differ considerably, as do their interests in the market as a functioning institution. I may add that whatever may be done within the Basle group of central banks will not necessarily influence the large number of other central banks in the world.

However, even at this stage we can put the problem of joint supervision of the Euro-market into a logical framework. If one thinks of direct controls, there seem to be three possibilities for acting upon the market:

(1) Control over the foreign currency positions of commercial banks vis-à-vis non-residents. Such control may be over either the gross or the net foreign currency positions of banks vis-à-vis non-residents. In its net form, this instrument is used from time to time by all the principal European countries - and, indeed, by many other countries as well. For example, a central bank may direct its commercial banks to maintain a balanced position in foreign currencies vis-à-vis non-residents, so that the domestic credit market is not affected either by net borrowing from, or net lending to, abroad in this form. At other times, the banks might be permitted, or indeed encouraged, to have an unbalanced position in foreign currency vis-à-vis non-residents - when that suited the

central bank, for reasons either of monetary policy or reserve policy.

Control over the gross foreign currency positions of commercial banks has, up till now at any rate, been much rarer. Indeed, the only example I can think of among the major countries is the guidelines on foreign lending by banks in the United States. In the countries where the Euro-currency banks are located it could only be introduced simultaneously and in the same way in all of them, as an act of international co-operation. Moreover, there would be the likelihood that such measures would push the Euro-currency market to other countries without controls.

(2) Control over outflows of resident-owned non-bank funds which may go to the Euro-currency market. This instrument is available to any countries that have some sort of exchange control apparatus. It is in fact currently used, to a greater or lesser extent, by many of the countries of the Basle group. As examples, I may cite (a) the controls, under the balance-of-payments program, over US corporations' holdings of liquid assets abroad, and (b) the general control in the United Kingdom over outflows of resident funds, except through what is known as the investment dollar market, where a very substantial premium has to be paid to obtain foreign exchange.

(3) Control over non-bank residents' borrowing from abroad, including from the Euro-currency market. This is also an exchange control power which is widely available in European countries. And in fact during the past year both France and the United Kingdom have acted to restrain business from borrowing in foreign currency from abroad when there were ceilings on borrowing from banks at home. The main European country where this control does not exist is Germany. Had the German authorities had such power last year, they would have been able to limit the heavy foreign borrowing in the Euro-currency market by German corporations in the months before the recent exchange crisis.

On the general subject of controls, I may say that some authorities are skeptical about their efficiency, particularly when they are used over long periods of time. And no country believes that it is able entirely to insulate itself from the rest of the world through direct controls. Furthermore, many believe that the aim of controls should be to alleviate specific problems without losing the benefits of the Euro-currency market. These include the stimulus that it has given to banking competition, both international and domestic; the efficiency with which the market handles large transactions; and the advantages which result from the internationalization of available liquidity.

A second line of thought for managing the Euro-currency market, which would avoid using direct controls, is to put banking in domestic currencies on an equal footing with banking in foreign currencies. One of the main reasons for the existence of the Euro-market is the relative absence of regulations on Euro-banks' foreign currency operations, coupled with the regulations that govern banks' domestic currency operations - both in the United States and elsewhere. An obvious example of this is that the deposit rates of US banks are subject to Regulation Q, whereas those of Euro-dollar banks are not. Thus, if the provision of Regulation Q that prohibits the payment of interest on deposits made for periods of up to thirty days were abolished, US banks would be able to compete more effectively for funds with Euro-banks. (Because many foreign branches of American banks have been established just to avoid such limitations, it has been said that the United States is exporting its banking system.) Similarly, foreign currency deposits with European banks are in general not subject to the reserve requirements that apply to their deposits in domestic currency, thereby giving a competitive edge to banks' foreign currency operations over their operations in domestic currencies.

I would like to say, finally, that a very important factor in keeping the expansion of the Euro-currency market in check would be a fundamental readjustment of the United States' balance-of-payments deficit. While it is possible to imagine there being a Euro-currency market without this persistent deficit, I believe the deficit has been a major force which explains the dynamic expansion of the market.

For release on delivery

Statement by

Fred H. Klopstock

Manager, International Research Department

Federal Reserve Bank of New York

before the

Subcommittee on International Exchange and Payments

of the

Joint Economic Committee

June 22, 1971

It is a pleasure and a privilege to appear before this distinguished Committee which has made such an important contribution to the public's understanding of the international financial mechanism. Your committee has already added substantially to our knowledge of the subject under review this afternoon by commissioning the intensive study of the Eurodollar market that was prepared by Ira O. Scott, Jr. who was at that time Professor of Finance and Dean of the Arthur T. Roth School of Business Administration at the C.W. Post Center of Long Island University. This highly informative study, which your parent committee published last year, provides a full description of the Eurodollar market, how it operates, its structure and the policy questions its existence has raised. Therefore, with your permission, I will skip over the history of the market and its functioning, and instead will focus on some problem areas of the market that have recently surfaced. I would like to comment in particular on those aspects of the market that continue to puzzle and worry the international financial community. In this context I plan to comment briefly on the implications of the phenomenal growth of the Eurodollar market for the international position of the dollar, and on some proposals for the supervision and control of the market.

There is no doubt in my mind that the Eurodollar market has made a major contribution to the financing of economic growth in this past decade. Perhaps its outstanding merit is that it has enabled banks outside the U.S.--including the overseas branches of U.S. banks--to draw huge amounts of balances originating in many parts of the world into the financing of international trade transactions and the operations of large private and public corporations. The market has become a funnel through which temporarily unemployed funds in virtually all parts of the world are quickly and efficiently transmitted to banks in major financial centers and, through them, to borrowers in need of loan accommodation. It has added immensely to the ability of banks in Europe, Canada and even in the United States through their overseas branches to provide financing of their customers at advantageous rates. The Eurodollar market has been an efficient transmission belt for the movement of vast amounts of funds from low interest to high interest rate countries and has made a major contribution to evening out surpluses and shortages in national money markets.

It is nevertheless true that many central bankers and other members of the international financial community have become increasingly disenchanted with the market. Many close observers of the market are appalled by its huge dimensions, and fearful of its proven ability to set into motion capital flows that are capable of undermining domestic monetary policies. While not disregarding the market's valuable contributions to the financing of world trade they increasingly have come to look upon the huge capital movements associated with it as a major source of domestic and international monetary instability.

The market is also often severely criticized because it has financed speculative attacks on currencies that are vulnerable and speculative flows into countries whose currencies are candidates for revaluation. In view of the market's gigantic size and the destabilizing capital flows which it has financed, a prominent central banker recently referred to the Eurodollar market as a "monster". Other European central bankers have suggested that much of the Eurodollar market's explosive growth is due to multiple credit creation within the market and that this uncontrolled credit expansion has been an important factor in furthering world inflation.

Several central bankers, notably Governor Carli of the Bank of Italy, have called for control of the Eurodollar market. Federal Reserve Board Chairman Arthur Burns has warned against the practice of central banks' recycling their reserve gains into the market. The market has increasingly become a source of medium-term loans to borrowers in many corners of the world, but these loans are almost entirely financed with short-term money, often under terms and conditions that have caused a number of prominent commercial bankers to raise questions about the quality of credit in the market.

There is thus a great deal of evidence that many leaders of the international financial community are deeply worried over recent developments in the market. I believe some of this concern is justified, but it is also true that the central bank community is making a major cooperative effort to prevent the market from undermining international monetary stability and at the same time to retain and strengthen the market's valuable role in the financing of a large variety of the world's credit needs.

With your permission, I will now briefly comment on several of the market's aspects that have raised concern and uncertainties here and abroad. First a few words about the recent growth of the market and the fact that the market's net size now surpasses foreign liquid dollar holdings in the United States.

Linkage of Market's Size to Foreign Dollar Balances in the U.S.

During the past three years, the Eurodollar market has grown by leaps and bounds; this growth continued in 1970, contrary to expectations. Many observers had felt that the market would shrink as United States banks and corporations repaid their heavy Eurodollar borrowings incurred during the tight money era in 1969. However, huge borrowings by corporations in Germany in response to tight money market conditions in that country and by banks in Italy absorbed the Eurodollars set free by U.S. repayments. Heavy medium-term borrowings by multinational corporations and public and semi-public institutions in the less developed countries also added significantly to the demand for Eurodollar loan facilities. Most of the added supplies in the Eurodollar market may be attributed to the rapidly growing placements by central banks, primarily those in the less developed countries, but also by several Western European countries that in the past had stayed away from the market.

After making allowance for double counting arising from interbank deposits within the Eurodollar area, dollar deposits in banks outside the United States now exceed $50 billion, $46 billion of this huge amount represents dollar deposits in eight European countries which make up the core of the Eurodollar system and regularly report their dollar liabilities to the Bank for International Settlements. It is on the basis of these reports, that the BIS computes the net size of the market which reflects commercial bank liabilities of these eight countries vis-a-vis monetary institutions, commercial banks and non-banks outside the area and vis-a-vis central banks and non-bank residents inside the area. But my $50 billion plus estimate also includes sizable amounts of similar net dollar liabilities of banks in several countries outside Europe that have become increasingly important participants in the Eurodollar market, notably banks in Canada, Japan and Nassau.

At more than $50 billion, the Eurodollar market far exceeds foreign liquid dollar holdings in the United States, which at the end of 1970 amounted to $43 billion. The market has grown much more rapidly than the dollar accruals to foreign accounts resulting from our balance-of-payments deficit. Some members of the financial community have expressed puzzlement over these facts and concern about their implications for the dollar's international position. They have expressed fear that dollar balances held in the Eurodollar market represent a potential claim on the United States and, therefore, on our diminishing monetary reserves. These fears are not well founded. Only those Eurodollar deposits that Eurodollar banks have employed in the United States or that they retain in U.S. banks for reserve and transactions purposes constitute a claim on United States reserves.

Presently such balances represent no more than a small fraction of total deposits employed in the market. Eurodollar deposits that are not passed on to United States banks or borrowers in the United States give rise to claims only on the banks abroad in which they are lodged. In the event of withdrawal of these deposits, the banks would have to either acquire dollars in the foreign exchange market or fall back upon maturing Eurodollar deposits and loans, most of which are obligations of foreign banks and corporations.

To many observers it appears puzzling that the market's size exceeds foreign liquid dollar holdings in the United States, especially since each Eurodollar deposit involves a transfer of foreign dollar deposits from one account in a United States bank to another. But upon further reflection the excess of Eurodollar deposits over U.S. liquid liabilities need not evoke surprise. The size of the market is not limited by outstanding foreign dollar holdings. It is primarily determined by the cash holdings denominated both in domestic currencies and in dollars that a large variety of investors throughout the world wish to place in the market. The explanation of the discrepancy between foreign liquid holdings in the U.S. and net holdings in the Eurodollar market is that one and the same foreign-held dollar balance can be repeatedly employed for making Eurodollar deposits. Dollar balances acquired by investors for placement in the market to the extent that they are not employed in the United States are almost instantaneously returned to the foreign exchange market as the dollar-accepting banks, or borrowers from these banks, or those to whom they make payments, convert these dollar balances into third currencies in foreign exchange markets. Some or all of these balances may be acquired by central banks. These same dollar balances, after passing through the hands of several holders--possibly in several countries--as a result of a series of transactions outside the Eurodollar system, may again become vehicles for Eurodollar deposits as investors desirous of making additional deposits reacquire them in the foreign exchange market. The repeated utilization of some part of the existing stock of foreign dollar balances associated with the recurrent reinjections of the same dollars into the market that had previously been ejected from it also explains why the increase in the size of the market during recent years far exceeds the dollar balances obtained by foreigners as a result of our balance-of-payments deficit.

It is, of course, true that certain Eurodollar placements, primarily those by United States residents, add to our liquid liabilities. Some Eurodollar deposits, notably those that are borrowed by U.S. banks or are invested by the overseas branches in U.S. Treasury or Export-Import Bank securities, as well as reserve and transaction balances of Euro-banks, are reflected in our liquid liabilities. Some portion of foreign-held dollar balances--actually no more than a small portion--performs a vehicle role in the placing of Eurodollar deposits. But the great bulk of Eurodollar deposits does not affect our short-term liabilities and the growth rates of the two magnitudes are therefore to a large extent independent of each other.

Multiple Credit Creation in the Eurodollar Market

Several central bankers as well as some prominent members of the academic profession have attributed the enormous expansion of the market to the process of multiple credit creation. They have suggested that the Eurodollar system functions in the same way as the U.S. banking system where, as borrowers disburse loan proceeds, the recipients have virtually no choice but to redeposit them in the same or another American bank. This bank, as a result of the attendant reserve gains, may find itself in a position to make additional loans and investments.

Those who believe that this phenomenon is also a characteristic of the Eurodollar market claim that a very substantial amount of Eurodollar deposits represents balances that can be traced directly to Eurodollar loan proceeds. In fact, concern over multiple credit creation in the market has caused some of its close observers to support recommendations that Eurodollar borrowing be made subject to reserve requirements. I have argued elsewhere that at least until the end of 1969 multiple credit creation has played no more than a minimal role in the expansion of the Eurodollar market. This argument is supported by the fact that the market experienced its most impressive rate of growth in the late 1960's when most new Eurodollar deposits were pulled out of the market by U.S. banks and corporations that borrowed heavily in it. These funds were used in the United States and thus could not serve as a base for multiple credit expansion in the Eurodollar market. In 1970, the credit multiplier tended to increase inasmuch as several central banks during the year acquired sizable dollar balances that originated in the Eurodollar market and redeposited them in the market. But even now the great bulk of Eurodollar borrowings is either paid to U.S. residents or converted in foreign exchange markets into local and third-country currencies and not returned to the market by those who acquire these balances. Altogether, the available evidence on worldwide uses of Eurodollars suggests that only a small part of the proceeds of Eurodollar credit is redeposited in the market, and in my view the multiplier remains only a fraction of the figures that have recently been publicized.

Central Bank Participation in the Market

Another question widely discussed by Eurodollar market participants is the placement by official monetary institutions of part of their dollar holdings in the Eurodollar market. In any appraisal of central bank participation in the Eurodollar market, a sharp distinction should be drawn between (a) dollar balances recycled by Western European central banks that deposit part of their dollar gains either directly in European banks or in the Bank for International Settlements, and (b) deposits in European banks by monetary authorities throughout the world, notably in lesser developed countries and also in Eastern Europe. According to the Bank for International Settlements, during the past year central bank deposits in the Eurodollar market have increased by approximately $7 billion. A large portion of these deposits was placed by European central banks, but a very substantial part originated in less-developed countries. Many central banks in these countries, dependent as they are on the income from their exchange reserves, found it difficult to resist the relatively attractive yields available in the Eurodollar market.

Undoubtedly, as Federal Reserve Board Chairman Arthur Burns recently pointed out in Munich, central banks as they place funds in the Eurodollar market have aggravated their own problems. Such deposits have added to the explosive growth of monetary reserves in Europe, flooded European economies with unwanted liquidity, expanded money supplies and thus contributed to inflationary pressures. The process through which this occurs is simple. Typically, a sizable part of the central bank deposits placed in Eurobanks is used for loans to European borrowers. These borrowers or those to whom they make payments tend to convert all or virtually all of their dollar borrowings into local currencies. As the borrowers sell dollar balances to their commercial banks, their domestic currency deposits and thus their nations' money supply increase. The commercial banks--by selling all or part of the resulting dollar accruals to their central bank--are in turn in a position to add to their reserve balances and consequently to their lending capacity. In this process, the central banks, in their capacity as residual buyers of dollars in the foreign exchange market, in effect reacquire the balances that they had placed in the Eurodollar market. According to press reports, the major European central banks are presently reviewing the investment of their monetary reserves with a view toward limiting their placements in the Eurodollar market. They are reported to be ready to withdraw balances from the market, if market conditions permit them to do so.

Incidentally, central bank deposits in the Eurodollar market are solely an obligation of the banks in which they are deposited. Taken together, they are not a reserve liability of the United States and do not affect our balance of payments.

Control of the Market

The phenomenal growth of the market together with its credit creation potential, and its ability to mobilize massive amounts of funds that may flow quickly from country to country and thus undermine domestic monetary policies, have given rise to demands for a comprehensive system of international control of the market. These demands have gained in strength in recent weeks as Eurodollar balances, as has happened often in the past, have again been used on a large scale to feed speculative movements into currencies that have become candidates for revaluation, notably the Deutsche mark.

In appraising demands for international control of the market it should be kept in mind that presently the market is already subject to a large measure of national controls. For many years, central banks have used a variety of devices to regulate the flow of Eurodollars out of and into their countries. Moreover, for many years, central bankers have exchanged views on their Eurodollar market policies and on occasion have taken concerted action to coordinate their regulatory activities in this area. At times, notably at year-ends, central banks have rechannelled substantial deposits into the market either directly or through the Bank for International Settlements, with a view to smoothing out temporary disturbances in the market when such action did not conflict with basic monetary policy objectives then being pursued.

Central banks are likely to strengthen their existing controls and supervision of the market. As a matter of fact the central bank governors meeting regularly in Basle have set up a study group to analyze the problem and to work out terms of reference for a standing group which might suggest policies to be adopted by the governors. There is thus every reason to expect that central bank coordination and cooperation with respect to policies affecting the Eurodollar market will become more intensive in the months and years ahead. For instance, central banks could intensify cooperation so as to avoid that national controls work at cross-purposes. They might well make even greater efforts than in the past to coordinate their monetary policies with a view to reducing the emergence of large scale capital movements that do not serve their purpose. But it is difficult to visualize any system of supranational control of the Eurodollar market. In my personal view, central control on a worldwide scale is not a practical proposition. There is no international institution extant that can effectively control the vast supplies in the market or restrict the worldwide demand for Eurodollars. International control of the market would, moreover, call for comprehensive foreign exchange regulations that many countries are unwilling to adopt. The obstacles to control by an international institution also stem for divergencies in national objectives of the countries whose banks play a major role in the market. Hopefully, central bank cooperation involving primarily coordination of national controls will serve to reduce, if not eliminate, Eurodollar flows that tend to undermine international monetary stability.

Medium-Term Lending and the Worsening of Credit Quality

Another recent development in the Eurodollar market is the rapid growth of medium-term lending of Eurodollars. During the last year or two, the overseas branches and affiliates of American banks, as well as other major banks in London and elsewhere in Europe, have been heavily engaged in extending 5 to 8 year roll-over Eurodollar loans, usually to large commercial and semi-public corporations, with the lending rate periodically adjusted in line with the interbank rate for three or six-months Eurodollars. Typically, the banks managing such loan arrangements syndicate them, placing varying portions with a number of other banks and retaining in some cases only a small portion on their own books. Borrowers of medium-term loans reside in many countries throughout the world. In order to serve this rapidly growing market for Eurodollar term loans, several groups of United States and European banks have established a large number of jointly owned international banks.

In meeting the deep-seated need for medium-term finance, the balance sheets of many banks operating in the Eurodollar market have become less self-liquidating. Of course, the fact that interest rates for these loans are periodically readjusted in line with prevailing Eurodollar interbank rates eliminates the risk that rates in the market will run against the lender. This risk has been passed on to the borrower who hopefully is always in a position to assume it. The fact that the Eurodollar market, despite its dependence on purchased as distinct from hard-core demand deposit money, has become so large a source for meeting the world's medium-term credit needs should not be overlooked in any assessment of its overall position.

Quite apart from the growing maturity gap, many thoughtful bankers have become increasingly concerned over the disregard in Eurodollar banking of the strict lending standards that have long been in vogue in term lending in the United States. Elaborate term loan agreements with a number of appropriately protective covenants such as the obligation of the borrower to maintain his working capital at minimum levels are much less common in Eurodollar banking than in the United States. Few Eurodollar term loans include amortization arrangements that provide for the tailoring of maturities in line with prospective cash flows. Single-payment revolving loans stretching over five years are not uncommon. It is probably true that as rapid an expansion in the number of borrowers as occurred during the last two years has brought into the market some second class names not deserving of unsecured loan facilities.

It is encouraging that prominent bankers have publicly drawn attention to the easing of Eurodollar lending criteria. Still and all I do not believe that there has been any fundamental deterioration of credit quality in the market. The market continues to be dominated by the biggest and strongest banks in Western Europe and generally these banks remain highly selective as to the borrowers to whom they extent loan facilities.

Conclusion

In concluding my remarks, I should like to reemphasize the important contribution of the Eurodollar market to the growth of the international economy and the expansion of world trade. It would be most unfortunate if the widespread demand for control of this market should give rise to restrictions on international capital movements that would regulate it out of existence or impair its functioning as an efficient medium for allocating credit on a worldwide scale. Meanwhile, the obvious ill-effects of the market and some undesirable deposit and loan practices that have recently emerged are receiving the intense attention of the central banking community and there is every reason to expect timely action to maintain the fundamental soundness of the Eurodollar system.

Statement of Rimmer de Vries, Vice President, Morgan Guaranty Trust Company of New York, to the Subcommittee on International Exchange and Payments of the Joint Economic Committee, U.S. Congress, Tuesday, June 22, 1971.

1. The Euro-dollar market has been making the headlines recently. During the recent international monetary crisis, leading commentators accused the Euro-dollar market of being the villain of the piece. Bankers, too, having difficulty in believing that some $5 billion had moved out of the United States in the two weeks ended May 12, accused the Euro-dollar market of having brought about massive movements of funds and the crisis. The impression was created that Euro-bankers were manufacturing Euro-dollars, a kind of counterfeit U.S. dollar, offering them to the central banks of Germany, Japan and other countries, which in turn handed them to the Federal Reserve to be invested in U.S. money market instruments. As a result, U.S. liabilities to official foreigners rose, thereby aggravating the official-settlements balance of payments deficit. Although these views are obviously incorrect, they do point at the need to clarify the characteristics and the role of the Euro-dollar market, to review its benefits and short-comings and to examine whether any action is needed to curb the market. The views I express today are my own and not necessarily those of Morgan Guaranty Trust Company.

2. A Euro-dollar is a dollar-denominated deposit in a bank outside the United States. Likewise, a Euro-mark is a mark deposited in a bank outside Germany and a Euro-Swiss franc is a Swiss franc deposited in a bank outside Switzerland. Any convertible currency can exist in Euro form. Euro-deposits, therefore, are not confined to dollars. In fact, a growing proportion of the Euro-market is denominated in German marks, Swiss francs and other strong currencies. The distinguishing characteristics of a Euro-currency is that the currency of denomination is foreign to the country of the bank which accepts the deposit.

The depositor himself does not have to be a foreigner: residents can and do deposit non-native currencies in their local banks. A British resident can deposit dollars in his British bank and a Swiss resident can deposit German marks in his Swiss bank. Moreover, Euro-deposits are not restricted to European banks: a sizeable share of Euro-deposits are placed in non-European banks. This worldwide market for foreign-currency deposits is called the Euro-dollar market or more appropriately the Euro-currency market. This market is broader in scope than measured by the statistics compiled by the Bank for International Settlements. At the end of March of this year, the size of this market -- with interbank deposits netted out -- exceeded $62 billion, of which over $50 billion consisted of Euro-dollars.

3. The Euro-currency market can best be characterized as an international money market. Many misunderstandings, plausible as they may be, are created if the market is looked upon as a super-banking structure. The market is an extension of, and has added an international layer to, the money markets in the United States, Britain, Continental Europe, Canada, and other countries. Banks -- and to a much lesser extent corporations and individuals -- from around the world deposit a portion of their liquid assets in this market. Although there may have been a variety of reasons for making such deposits through the history of the market, at present the overriding reason is that it is attractive to do so from an interest rate point of view. Deposit rates in the Euro-market are frequently higher than in the domestic money markets, even on a hedged basis. At the end of April this was true for many European countries, the United States and Canada. Government regulations (e.g. Regulation Q in the United States) and monetary

policies are among the main factors causing the discrepancy between Euro and domestic deposit rates.

The same reasoning applies to the demand side of the market. The demand for short-term and medium-term credit in the Euro-market has been enhanced by the fact that lending rates are frequently lower than those prevailing in the domestic credit markets. At the end of April, the commercial bank rates to prime borrowers of Japan and all Continental European countries, except Switzerland, were higher than Euro-dollar lending rates.

Moreover, borrowers frequently seek credit abroad, normally in the Euro-market, because of the lack of availability of funds in the domestic market. Many local markets are too narrow to accommodate adequately the demand for funds by their own residents. Furthermore, the monetary authorities regulate -- often by imposing quantitative limits -- domestic bank credit expressed in their national currency, but frequently do not regulate bank credit denominated in foreign currencies. The authorities also often shy away from imposing controls on the activities of nonbanks. Finally, they normally encourage foreign borrowing by their nationals to finance their foreign operations; the OFDI controls in the United States are a notable example.

Nevertheless, the key to understanding the rapid growth of the Euro-market is the ability of Euro-banks to offer attractive interest rates, both as regards deposits and loans. This reinforced their practice of operating with much smaller margins between deposit and lending rates than is customary in domestic markets. The larger the interest-rate differentials between national markets, the larger will be the flows through the Euro-market.

4. It is important to keep in mind that the Euro-market is not a stateless entity located outside the jurisdiction of the governments of this globe. Every participant in the market, depositor or borrower as well as the bank intermediary, is a resident of some country and thus falls under the actual or potential control or supervision of its monetary authorities. By the same token, it is wrong to call the Euro-market a completely free market. Many central banks and governments do regulate the deposit and lending activities of their residents in the Euro-market.

5. Another important point to be made is that there is no relationship between the level or change in U.S. liquid liabilities to foreigners to the size of the Euro-dollar market. It is perfectly possible for the size of the Euro-dollar market to rise sharply while U.S. liquid liabilities to foreigners rise only modestly or even decline. The main reason for these possible divergent developments is that U.S. liquid liabilities to foreigners -- and accordingly the liquidity U.S. balance of payments -- is affected only if one of the participants in the Euro transaction is a U.S.resident. Even though a Euro-dollar transfer has to go through the books of a U.S. banks, a U.S. resident does not necessarily have to be one of the participants, i.e, depositor or borrower. In fact -- except when U.S. commercial banks were heavy takers of Euro-dollars such as during 1968-70 -- U.S. residents play a relatively minor role in the many daily Euro-dollar transactions. Most Euro-transactions take place between residents of two foreign countries. In this case, there occurs merely a transfer of ownership of U.S. liquid liabilities from one foreigner to another, which affect the balances of payments of the two countries, but not that of the United States. Moreover, the deposit and lending rates structure of a particular country and that of the Euro-market may be such that some residents of that country deposit funds in the Euro-market while other residents of the same countries borrow in the

Euro-market. In this case no country's overall balance of payments and credit base is affected and yet the Euro-market's size has risen.

6. This leads me to say a few words about the creation of Euro-dollars, particularly multiple credit creation. It is true that all financial claims are created by the borrower or issuer. The U.S. Treasury creates Treasury bills, General Motors Acceptance Corporation creates commercial paper, savings banks create passbook savings accounts and Euro-dollar banks create Euro-dollar liabilities. The important point, however, is not whether claims are created, but whether or not these created claims are money. It is here that we have our doubts. Payments normally are not made in Euro-dollars as such, but only in U.S. dollars, marks, francs, guilders or other national currencies. This is also the reason why the so-called leakage in the Euro-market is so large: recipients of a Euro-dollar credit normally convert the proceeds thereof immediately into some national currency or to the United States to make payments. Demand deposits constitute only a very small portion in the Euro-market, and Euro-banks function primarily as intermediaries, seeking fixed-term deposits after they are assured of making a loan. The market facilitates more efficient use of existing national bank reserves and money supplies. Thus, while the market by itself does not tend to increase the world money supply, it does increase its velocity.

7. One major exception to this analysis is when a central bank deposits funds in the Euro-market. In that case, additional bank reserves are created. The country of the central bank that makes the Euro-deposit does not experience a short-term capital outflow but the country receiving the Euro-credit registers an inflow and an increase in its credit base. Euro-deposits by central banks of free world countries are not a new phenomenon. They

occurred already in the mid-1960s when they amounted to between $1 to $2 billion. Such deposits gradually rose to between $3 and $4 billion at the end of 1969. However, there was a very large increase in 1970 -- particularly in the latter part of last year -- when the amount of central bank deposits in the Euro-market increased by almost $7 billion and reached a total of about $11 billion. The principal reason for the sharp increase during 1970 was the large divergence between rates available in the U.S. money market and those available in the Euro-market. Although there was also a large difference in 1969, U.S. banks then were able to offer foreign monetary institutions interest rates competitive with those quoted for Euro-dollars, because U.S. deposits from such institutions are exempt from Regulation Q ceilings. The recent sharp increase has clearly been a destablizing factor in the past year, as it seriously interfered with the anti-inflationary efforts of many countries. A statistical appendix to this statement contains additional information explaining the estimate mentioned here about central bank deposits in the Euro-market.

8. Let me now turn to the recent international monetary crisis. This country's balance of payments deficit on an official settlements basis was over $5 billion in the first quarter of this year, and so far during the second quarter it has amounted to nearly $9 billion, raising the total for the year to date to about $14 billion. During the two weeks April 28-May 12 this deficit amounted to approximately $5 billion, which was also just about equal to the central bank reserve increases of Europe and Japan.

The outflow during these two weeks was very broadly based. Banks, corporations, and individuals -- in each case both foreign all participated in the movement of funds. It cannot be emphasized sufficiently that foreign-related entities, i.e. U.S. agencies and branches of foreign banks, U.S. subsidiaries of foreign companies, foreign banks and companies themselves, and foreign investors were all just as -- if not more -- active in bringing about this outflow as U.S. corporations, banks and individuals.

My guess is that about two-thirds of this $5 billion outflow was moved directly out of the United States to foreign countries as a reaction to the exchange-rate uncertainties, much of which through leads and lags in international payments. U.S. residents with short-term commitments in strong currencies accelerated their payments to avoid large payments at a later date, while foreigners delayed making dollar payments. The remaining one-third moved out during these two weeks because of the widening discrepancy between Euro- and U.S. interest rates. U.S. bank liabilities to foreign branches fell about $500 million in the two weeks ended May 12, probably because of this interest-rate discrepancy. U.S. agencies and branches of foreign banks -- whose assets in the United States exceed $10 billion, a large part of which is held in liquid instruments -- probably also moved very large sums of money abroad because of the large interest-rate differential. Some of the $500 million increase in loans to foreign banks and corporations reported by the weekly reporting large U.S. commercial banks no doubt was due to the relatively low lending rates prevailing in the United States.

It should be added, however, that the sharp rise in Euro-dollar rates and the resulting large differential during the heat of the crisis was brought about by heavy borrowing in the Euro-dollar market for the purpose of converting the proceeds into marks, francs, guilders, etc. In the absence of this large interest-rate discrepancy, the outflow from the United States probably would not have been as large. Therefore, one must admit that the Euro-dollar market tended to magnify the short-term capital outflow from this country, although these would have been very large even in the market's absence. Nevertheless, as the London *Times* recently pointed out, to blame the Euro-dollar market for the recent international monetary crisis is as primitive as the medieval practice of executing the bringer of bad news.

9. In examining the question whether controls should be applied to the Euro-dollar market, it should first of all be stressed that this market has contributed significantly to the enormous growth of world trade and investment over the past decade. It has been highly efficient in gathering liquidity from all corners of the world and channeling credit to banks, corporations and individuals at relatively attractive rates. Moreover, the balances of payments of all countries -- not least the United States -- at one time or another have benefitted by the market. Furthermore, while the market has enhanced the movement of short-term funds, it has not been the underlying cause of these flows.

Nevertheless, a country suffering from an excessive outflow to, or inflow from, the Euro-market can impose restrictions on its residents' deposit and lending activity in the Euro-market in order to dampen such flows. This seems to be the most sensible course of action and most countries, including the United States, have adopted some restrictions. A notable exception has been Germany, which in retrospect, was probably ill-advised not to have taken more drastic action against the recent, excessive Euro-dollar borrowing activity of its residents.

In addition, short-term capital flows through the Euro-market can be curbed if the central banks refrain from placing their funds in the market. At times, it may also be desirable for them to siphon off some liquidity through direct borrowing in the market.

Finally, the authorities could impose reserve requirements against Euro-liabilities. This would strike at the raison d'etre of the market, because it would tend to widen the margins between borrowing and lending rates. Although this could seriously harm the market, it is doubtful whether such reserve requirements could be applied effectively. A great many nations would have to act in tandem and set the same obligatory rate. Without such uniform action, the chances are great that the market, which tends to be mobile, will simply shift elsewhere.

More important than trimming the edges of the Euro-market will be to get at the root cause of the massive short-term capital movements. This is the lack of confidence that prevails in the world stemming from the high rates of inflation, the exchange-rate rigidity of the Bretton Woods system which was predicated on a world with relatively stable prices, and the large underlying balance-of-payments deficit of the United States. Restoring price stability and giving IMF member countries greater flexibility in exchange-rate management, assuring smoother parity changes, should be high on the agenda of the world monetary authorities. The recommendations of last year's IMF report on exchange rates should be re-examined promptly and with sympathy.

Furthermore, considering that our present-day world is highly integrated and interdependent, monetary authorities should formulate their policies not purely from a domestic point of view. They should develop maximum international monetary cooperation so that their policies will be a stabilizing rather than a destablizing force in the international monetary system. However, greater coordination of monetary policies will require intensified use of fiscal policy and the development of income policies.

Finally, with the underlying balance-of-payments deficit having averaged about $3 billion during the past five years and certainly exceeding that level this year, the United States should take serious steps aimed at wiping out this large deficit.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

file re: Norman Bernard.

Date July 19, 1971

To Chairman Burns

From Robert F. Gemmill RFG.

Subject: Letter from Mr. Casey transmitting information on Euro-dollar transactions

CONFIDENTIAL (FR)

The transactions by Occidental Petroleum referred to in the documents sent by Mr. Casey appear to represent covered interest arbitrage -- primarily involving borrowings from and deposits in banks in Germany (including German branches of U.S. banks). The documents do not indicate whether the arbitrage possibilities arise from temporary excesses of deposit rates over borrowing rates in a particular currency (e.g. Euro-dollar rates or, perhaps, mark rates) or from arbitraging between currencies (e.g. switching from dollars into marks), but if more than one currency is involved it seems fair to assume that the transactions would be hedged against foreign exchange risk through a forward contract, since the transactions are repeatedly described as "risk-free." The banks involved are virtually all "prime names" and default risk appears miniscule.

Based on the available information, there is no reason to believe that these transactions involved speculation, or had a significant effect on the U.S. balance of payments.

We have been in touch with Mr. Ralph C. Hocker (Associate Director, Division of Corporation Finance, SEC) as requested by Mr. Casey, and have passed on our interpretation of the documents. Mr. Hocker intends to ask Occidental if any foreign currency borrowings of deposits were involved and will inform us of the answer.

CONFIDENTIAL (FR) December 20, 1971

TO: Board of Governors

FROM: Division of International Finance

SUBJECT: Rate of reserve requirement on Euro-dollar borrowings

The Board may wish to consider a reduction in the rate of reserve requirement on Euro-dollar borrowing from foreign branches, and on foreign branch loans to U.S. residents, from its present level of 20 per cent to 5 per cent -- the rate currently applicable to time deposits and to commercial paper issued by bank holding companies where the funds are used by the parent bank.

1. The main consideration favoring a reduction at the present time is the value of such an action as a gesture of international cooperation; the U.S. monetary authorities would be seen to be showing concern about the volume of dollars held abroad. By acting, the Board would make it easier for U.S. banks and U.S. nonbanks to borrow Euro-dollars from foreign branches. Reflows of funds from foreign countries may add to the supply of Euro-dollars and tend to depress Euro-dollar rates; increased borrowing by U.S. banks and nonbanks would tend to absorb the supply of Euro-dollars. But it is unlikely that any substantial volume of Euro-dollars would be absorbed by U.S. banks' borrowings -- rather than by foreign banks' borrowings -- unless or until interest rates in European money markets fall below U.S. rates. And unless European rates fall below U.S. ~~notes~~ rates, it is likely that the absorption of Euro-dollars resulting from a reduced rate of requirement would, at best, be a relatively short-term phenomenon, and/or concentrated in funds of a particular maturity attractive to U.S. banks.

2. There are two principal arguments against reducing the rate of requirement at the present time.

a) A reduction in the rate of requirement on Euro-dollar borrowing to 5 per cent would reduce the relative benefit to a bank of a reserve-free base. Banks that have been preserving these bases at some net cost might feel that the potential value of these bases had been reduced arbitrarily -- and this could create a problem of bank relations for the Board. The bank relations problem today would be much less significant quantitatively than it would have been last summer, when reserve-free bases were roughly twice as large as the estimate for the computation period that ends on December 22. Moreover, many banks appear to have made a decision to allow their bases to run off completely, and in the past three weeks gross liabilities to foreign branches have declined by $2 billion.

From the standpoint of Board Euro-dollar policy, it would be desirable to continue to allow banks to make decisions regarding retention of bases on the same ground rules that have existed for the past year, and to adopt a policy action that would change conditions only after an overall review of Euro-dollar policy, which is scheduled for next month.

b) A reduction in the requirement to 5 per cent might have a greater effect on foreign branch loans to U.S. residents than on head office borrowings through branches so long as the margin between deposit and lending rates in the Euro-dollar market was less than the margin between the Euro-dollar borrowing rate and the domestic lending rate (adjusted for any compensating balance requirements). Before the Board took an action that would encourage expanded foreign branch lending in the U.S. it would be advisable to have reviewed Euro-dollar policy generally. One consequence of establishing regulations that encourage foreign branch loans to U.S. residents would be a reduction in the amount of information on bank lending to U.S. nonbanks, and a delay in receipt of such information. (Information on foreign branch loans to U.S. residents is currently collected on the monthly foreign branch reports, which are available about 6 weeks after the report date, but these include no information on type of loan, etc.)

3. It may be noted that, if the Board did not act to reduce the 20 per cent requirement, U.S. banks could bid for foreign money but only through issuing CD's (for maturities of 30 days or more) at their head offices.

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

DATE: February 23, 1972

TO: MRS. MALLARDI

FROM: ROBERT C. HOLLAND

Following up the Chairman's interest in Fred Solomon's memo to him of last fall, attached is a draft copy of that memo that I have elicited from Fred. I told him the Chairman had been interested, and had been talking with me about the subject.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DATE February 23, 1972

TO Mr. Holland

As mentioned on the telephone.

F. S.

FREDERIC SOLOMON

ROUGH DRAFT FOR COMMENT
(Frederic Solomon-5-19-71)

1920s STOCK MARKET, 1970s EUROMARKET

From time to time significant new profit possibilities are discovered (or imagined). If there is an available supply of funds, the two can combine to produce a greatly increased flow of funds throughout the economy. The increased flow occurs when funds are placed in the newly profitable outlets, are disbursed to flow back through the economy, are drawn back into the profitable outlet by the high yields offered, and the process is repeated over and over again. The increased flow can continue until something interrupts it, such as disappointed expectations, or some other constraint on the flow at some point. (In some cases there can be an actual reversal of the flow, as when a speculative bubble bursts.)

As the flow continues there are a number of effects. An immediate inflationary effect is reflected in the increased prices that result from the increased demand in the area where the flow is most sharply focussed, that is, in the newly profitable area. A stockpiling or blance sheet effect follows when there is a build-up of obligations that reflect the flow that has occurred. Since the capacity or willingness of the total economy to hold obligations usually will not increase as rapidly as the increased flow generates extra obligations, there usually is a displacement effect when the new obligations generated in the newly profitable area tend to crowd out other obligations.

Banks usually play a prominent role in the process, although they may act largely as agents or arrangers, without the resulting obligations appearing on their own balance sheets.

The process outlined above appears most frequently, but not exclusively, in speculative activities such as trading in land or securities. The stock market of the 1920s is an outstanding example. However, as indicated below, there are striking similarities in the Euromarket of the 1970s.

1920s STOCK MARKET	1970s EUROMARKET
NEW PROFIT POSSIBILITY	
Several factors contributed to suddenly increased attractiveness of investment in common stocks, among them, the campaigns that sold war bonds in World War I, the profitability of the auto industry, and publicity regarding common stock profits. Rises in common stock prices attracted new funds and made "street loans" highly profitable.	Several factors contributed to the increased attractiveness of loans in the Euromarket, among them, the profitability of American businesses entering the cartelized European markets, and investments by American businesses seeking to establish themselves inside the tariff walls of the common market. Later, credit restraint in the United States led many large U.S. businesses to finance themselves directly or indirectly through the Euromarket, even for their U.S. activities.

IMMEDIATE INFLATIONARY EFFECT

The principle initial impact was on stocks and street loans. Since the supply of the former was rather inelastic, prices soared. The high yield and presumed safety of street loans attracted large amounts into them from around the world.

Since the Euro-borrowers used the funds to finance their activities, the impact probably was spread widely throughout the economies of the European countries and also the U.S. This may have been a significant but little noted cause of world-wide inflationary pressures.

STOCKPILING (BALANCE SHEET) EFFECT

The volume of street loans increased greatly, reaching an estimated $11 billion.

The volume of Eurodollars increased greatly, reaching an estimated $50 billion. There also were large amounts of Eurobonds.

ROLE OF BANKS

Very few of the street loans were made directly by the banks and appeared on their balance sheets. However, virtually all the others were made by the banks acting as agents for nonbank lenders.

By definition, none of the borrowings were made directly by domestic offices of U.S. banks, and none appeared on their domestic balance sheets. However, the U.S. banks borrowed and loaned large amounts of Eurodollars at their foreign branches, and later had their foreign branches borrow Eurodollars for the head offices. Non-U.S.

banks also borrowed and loaned Eurodollars.

DISPLACEMENT EFFECT

Street loans tended to displace other forms of investment, causing reduced demand for such other investments. Farmers charged that credit was being denied them (i.e., there was reduced demand for their obligations) and that funds were being drained from agriculture.

Eurodollars tended to displace what they most resembled and considerably out-yielded, namely, State-side dollar obligations (U.S. dollars). Reduced demand for U.S. dollars caused dollar weakness and gold drain.

REMEDIAL EFFORTS

General monetary restraint and "direct pressure" were both tried, with little effect. Securities Exchange Act of 1934 placed margin requirements on stock market loans, thus restraining the flow by limiting the demand for borrowed funds to enter the area.

Problem seems to remain even though many remedies have been tried, including general monetary restraint, VFCR, IET, restraint on transfers of funds abroad by U.S. corporations, currency swap arrangements, and reserve requirements on Eurodollars transferred to head office. Current efforts to issue special EX-IM and Treasury securities probably will, in a static sense and at some cost to the U.S., absorb some of the Eurodollars generated by past operations of the process.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date July 11, 1972

To Mr. R. Solomon

From A. B. Hersey
ABH

Subject: Effects of U.S. Banks' Borrowing from Eurodollar Market upon Member Bank Reserves and U.S. Interest Rates

CONFIDENTIAL (FR)

The following analysis relates to questions raised by Governor Mitchell at the May 23 meeting of the F.O.M.C. about the importance of Eurodollar interest rates as a factor influencing the relationship to be expected, in an inter-meeting period, between member bank reserve growth and the Federal funds rate.

When the overnight Eurodollar interest rate is below the Federal funds rate -- as it has been in recent months -- it might at first glance seem very likely that the Federal funds rate would be pulled down from what it would otherwise be, given a particular rate of reserve growth. A movement of funds from banks in the Eurodollar market to U.S. commercial banks might occur as a result of U.S. banks' borrowing from their branches abroad (who bid in the Eurodollar market for interbank and other deposits), or it might occur as a result of lending by foreign banks to their branches or agencies in this country. If there were a substantial cumulative flow of overnight funds in these ways from the Eurodollar market, the balance of supply and demand in the Federal funds market would be altered. A particular member bank borrowing overnight Eurodollars would have less need to borrow Federal funds; a foreign bank agency in New York receiving funds from its head office abroad might be contributing an addition to the supply of overnight interbank loans ("Federal funds sales") in New York.

In neither case would there have to be any alteration in the rate of reserve growth, which would be determined by Federal Reserve operations.[1/]

Apart from the interest rate effects directly ascribable to the inflows, it is possible that interest rates in U.S. markets may be influenced in a more general way by changes in conditions abroad that lie behind such inflows. It is possible, for example, that participants in U.S. financial markets may be influenced by their knowledge of interest rate declines abroad in formulating their own demand or supply schedules.

Two different sorts of factors limit the extent to which the Federal funds rate is pulled down by a change in demand and supply conditions attributable to U.S. banks' borrowing from the Eurodollar market. (1) There are institutional and regulatory factors (to be described below) that limit the magnitude of the flow of funds from the Eurodollar market. (2) The transmission of funds necessarily calls into action other market forces that tend to counterbalance, in part, whatever downward pressure the inflow tends to exert on the Federal funds rate. The next section deals with these counterbalancing forces.

1/ If the inflow involved purchases of dollars by holders of other currencies who were induced to place deposits in Eurodollars, foreign central banks might experience a drain of dollar reserves. If this took the form of a decline in foreign central bank deposits at the Federal Reserve or the form of gold sales to the U.S. Treasury to replenish those deposits (producing then a rise in Federal Reserve gold certificate holdings), additions to member bank reserves would be generated. But the Desk would take that into account and would modify its open market operations accordingly, buying less or selling more in order to offset the expansive effect of these foreign operations on member bank reserves.

Counterbalancing forces

Whenever a bank operating in the Eurodollar market obtains dollar funds from any source and lends them to a U.S. member bank -- this may be a U.S. bank branch advancing funds to its parent, or a foreign bank lending in the United States through a New York agency or branch -- the settlement of the double transaction necessarily involves a decline in some pre-existing foreign private or official asset in the United States.[1/] (For convenience of expression, we speak in absolute terms of a "decline" in assets, but we mean changes relative to what would have occurred in the absence of the particular borrowing transactions being considered.) Conceivably but improbably, the person (or institution) placing funds in the Eurodollar market is reducing his own pre-existing assets in the United States; this is improbable at a time when interest rate differences are tending to attract short-term investors' funds to the United States, not away from it. More probably, he is reducing his pre-existing assets elsewhere and buying dollars in the foreign exchange market. If so, the sellers of dollars in the foreign exchange market are reducing their assets in the United States. Again, it is improbable -- given the assumed interest rate differences -- that

1/ Alternatively, there might be a decline in foreign official gold holdings or other monetary reserve assets through sale to the U.S. Treasury, or there might be a rise in some foreign liability to the United States such as would result from an inter-central-bank swap drawing. In such cases, in order to offset the resultant increase in member bank reserves, Federal Reserve open market sales of securities would be increased (or purchases reduced).

foreign commercial banks are the ones who are reducing their dollar balances; as they sell dollars in the exchange market, they replenish their holdings by buying from their central banks. The central banks then have to replenish their working balances (these days) by reducing their holdings of U.S. Treasury bills or (in other days) by selling gold. (As it happened, the inflow in April and May, with the underlying balance of payments still heavily in deficit, served to check foreign reserve gains, and so was accompanied by a cessation of the previously large foreign central bank purchases of Treasury bills.)

We have been looking so far at the international ("balance of payments") part of the settlement process. At this point in the analysis it can be seen that while downward pressure is being put on the Federal funds rate upward pressure is being put on the Treasury bill rate. The analysis can now be carried further, to look at the domestic clearing part of the settlement process.

Suppose first that the Treasury bills being sold by foreign central banks are being bought by someone other than a member bank. As payment is made for the bills, the member bank at which the buyer of the bills has his deposit account loses reserves to the member bank at which the foreign central bank has its account. But simultaneously that bank is losing reserves, and as a result of the chain of foreign exchange and Eurodollar transactions that are taking place, the reserves go ultimately to the member bank that is borrowing, let us say, from the New York agency of the foreign bank that is drawing funds from the Eurodollar market. Thus, intimately linked with the foreign bank agency's adding to the supply of interbank loans, there is an additional demand for funds in the Treasury bill market, and when someone comes forward to buy the bills offered, a member bank somewhere becomes shorter of reserves (through no choice of its own) than it otherwise would have been, and very probably enters the Federal funds market as a borrower (or as less of a seller). Thereby equilibrium of supply and demand is established, and the decline in the Federal funds rate is minimized. Similarly, the buyer of Treasury bills -- who conceivably is influenced by his knowledge of a change in conditions in foreign financial markets, and in any case finds the Treasury bill rate attractive -- minimizes the rise in the Treasury bill rate by coming forward to buy. The process is the same whether foreign central banks are now selling Treasury bills, or have ceased being heavy buyers.

Suppose, alternatively, that no investor comes forward to buy the Treasury bills and that they are bought by a dealer who finances the purchase not by reducing a deposit balance but by borrowing. Some member bank with funds to spare lends, by its own choice, to the dealer (perhaps at a rate that has risen along with the Treasury bill rate) instead of lending Federal funds, or perhaps it buys Treasury bills itself. In this case the equilibrating reaction in the Federal funds market may perhaps not be as strong as in the first case (where a member bank was forced to borrow) but still something is happening to blunt the downward pressure on the Federal funds rate as well as the upward pressure on the Treasury bill rate.

These two examples of what may happen in connection with an inflow of overnight Eurodollar borrowings are only instances of a very general proposition that private capital inflows to the United States add neither to member bank reserves in the aggregate nor to the net supply of total credit to the domestic economy, since their effects in these respects are offset by the effects of the accompanying increase in Treasury bill sales (or decrease in Treasury bill purchases) by foreign central banks -- or by the Federal Reserve, in the case of gold settlements in the balance of payments.[1/] Nevertheless, private capital inflows are likely to have differential effects on different sectors of U.S. financial markets, tending to raise Treasury bill rates and depress other rates. But again, these differential effects on rates may turn out to be small, because of the action of equilibrating forces in the domestic markets.

Institutional and regulatory limits

The extent to which the Federal funds rate is pulled down by U.S. banks' borrowing from the Eurodollar market is limited not only by these equilibrating forces, but also by institutional and regulatory factors that limit the size of the inflow. One of these factors which is especially important at present is the 20 per cent marginal reserve

---

1/ See the preceding footnotes.

requirement against member banks' liabilities to their foreign branches. Under the market conditions of recent months member banks have found it advantageous to maintain average Eurodollar borrowings equal to their reserve-free bases, but not to increase their average borrowings over a 4-week computation period appreciably above that level. Typically they have borrowed more heavily in the first two weeks of a period, and then reduced their borrowings in order to avoid the cost of the reserve requirement.

Such influence as the Eurodollar market has had on the Federal funds market in recent months has been transmitted primarily through the operations of foreign banks with agencies or branches in this country. Here another institutional factor comes into play: the limits set by bank management on the employment of resources in particular fields do not permit an endless flow. At a time, as in recent months, when relatively easy money conditions in European national markets have been tending to hold down rates in the very short end of the Eurodollar market below corresponding rates in the United States, there has been a strong incentive to shift funds to the U.S. market. In fact, up to a certain point, the willingness of the foreign banks to lend here may be strong enough to have a clearly observable effect on U.S. money market rates despite the existence of the equilibrating forces described above. But the capital resources of these banks are finite, and the rule against putting too many eggs in one basket further limits the amount of funds that will be transferred to the United States. Thus, even though a gap may persist between the Federal funds rate and overnight money rates abroad, as it has in recent months, the inflow may come to an end fairly soon -- as indeed happened in May.

According to weekly balance of payments data maintained by the Federal Reserve Bank of New York, foreign agencies and branches in New York increased their liabilities to their head offices and branches abroad by $2.3 billion between Wednesday, December 29, 1971, and Wednesday, May 17, 1972. In the following four weeks there was a decline of about $300 million. The increase was especially sharp in the six weeks from March 29 to May 10, when it exceeded $1 billion. (Month-end balance sheet data indicate an even larger increase within the month of April.) Such information as is available indicates that an important part of this increase in the resources made available to the foreign agencies and branches was employed in interbank lending, including "Federal funds sales."

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date September 26, 1973

To Board of Governors

From Ralph C. Bryant RCB

Subject:

CONFIDENTIAL (FR)

This memorandum describes the various data we have for liabilities of U.S. banks to their foreign branches, notes some problems in interpreting them, and discusses recent developments. I thought you might find it of interest.

The most recent figures we have suggest that Eurodollar borrowings from branches, after rising somewhat in July and August, are now back down roughly to the average levels observed in May (see Table 1).

Attachment.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date September 24, 1973

To Mr. Robert Gemmill

From R. H. Mills, Jr.

Subject: Liabilities to Foreign Branches: Data Comparisons and Recent Developments

CONFIDENTIAL (FR)

We have three series of data relating directly to U.S. banks' liabilities to their foreign branches.[1/] The purpose of this memo is to point out the basic differences among them and to offer explanations as to why they have moved differently in recent weeks.

A. Net vs. gross liabilities

The liabilities data used for the calculation of the required reserve deposits under Regulations M and D are on a net basis, i.e., gross liabilities less head office claims on branches. The net liabilities figures are reported to us separately in connection with the imposition of the reserve requirement and are daily averages for the 4-week computation period; we do not have them for any shorter periods. Nor do we have the gross liabilities figures from which these net liabilities are derived. (Table 2 at the end of this memo shows the net liabilities series for 1973 to date).

B. Differences between the series on gross liabilities.

The two series on gross liabilities differ as to coverage of institutions, coverage of transactions, and frequency. One of these is

---

1/ In addition, the data on assets and liabilities of foreign branches include a series for branch claims on head offices.

the familiar "Wednesday series", which covers all banks with foreign branches and which pertains to liabilities as of Wednesdays only. This is the series that appears in Chart 3 included each week in the blue folder distributed at the Board meetings in connection with the Economic and Financial Review. The other series is the 51-bank daily series, collected in connection with the analysis of banks' reserve position, relating to the liabilities to foreign branches of 51 banks from which we receive data on a daily basis. We use these figures to compute 7-day weekly averages (with Friday figures given a weight of three days in calculating these averages). The liabilities reported by these 51 banks are nearly 100 per cent of the total liabilities to foreign branches of all U.S. banks.

In addition to the differences in institutional coverage and frequency just noted, these two series also differ in two other respects. The "Wednesday series" has balance of payment coverage and does not cover branches in Puerto Rico, the Virgin Islands, or on military bases abroad. In addition, it does not include the so-called RP's of Chase Manhattan Bank. These are commitments to buy back asset items, "foreign customers' liability under acceptances", which Chase Manhattan has sold, under repurchase agreement, to foreign branches (to reduce its foreign assets subject to the VFCR ceilings) and for which it has debited its branches' claims on head office.[2/] In contrast, when the Chase Manhattan

2/ The Wednesday series is adjusted for, i.e., includes, branch participations in domestic head office loans.

reports its net liabilities to branches for reserve requirement purposes, and when it reports its gross liabilities for the 51-bank daily series, it does count these RP's as a liability to foreign branches, adding them to its other such liabilities. These differences explain the anomaly -- see Table 1 -- which shows the daily gross liabilities to branches of 51 banks consistently much larger than the liabilities reported once a week by all banks that are the basis of our "Wednesday series".

C. Recent developments

The attached Table 1 compares the two gross liabilities series for the weeks since May 16, the day on which the Board announced that the required reserve ratio on foreign borrowings was reduced from 20 per cent to 8 per cent effective in the 4-week computation period May 10-June 6 and that reserve-free bases would be phased out by 10 per cent per computation period beginning in July.

The comparison shows three general differences that may be noted here. First, for reasons already mentioned, the 51-bank daily series is consistently greater than the "Wednesday series". Second, the "Wednesday series" figures, and the data in the daily series with which they are directly comparable -- which are Thursday figures, because of a difference in reporting procedure -- do not change from week to week by equal proportions.[3/] Third, not unexpectedly, the weekly averages of the daily figures do not show the same relative week-to-week movements as the figures for one day alone, as can be seen by comparing the first two columns of Table 1.

In recent weeks the divergences between the two series for gross liabilities have been particularly marked. For example, between August 1 and August 29 the "Wednesday series" shows a rise of $575 million, while the 51-bank daily figures show the weekly average declining by $44 million between the week of August 1 and the week ending August 29. One reason for this difference is that once-a-week figures do not move the same way as do weekly averages of daily figures; this is well illustrated by the fact that, while the 51-bank weekly average shows a drop between the week of August 1 and the week of August 29, the data for the Thursdays that immediately follow those weeks show a rise over the same span of time. The other reason why the movements of the "Wednesday series" and the 51-bank daily series diverged so sharply in August seems to be that in this period Chase Manhattan was reducing its RP's, while the sum of its liabilities to branches excluding RP liabilities, and other banks' liabilities to branches, was increasing.[4/]

3/ In the daily series liabilities are dated to correspond with the day when they provide the borrower with Federal funds, i.e., one day after they are entered on the balance sheet.

4/ This conclusion is supported by the figures for Chase Manhattan's reported liabilities to branches, which declined between these dates by much more for the purposes of the daily series than for "Wednesday series".

This would seem to be the reason why the 51-bank daily series for August 30 exceeded the comparable "Wednesday series" figure (for August 29) by only $290 million, whereas the gap between the two series had been $721 million on the basis of the comparison between the data for August 2 and August 1. (On earlier dates the gaps were still larger).

Table 2 compares the net liabilities for the 4-week computation periods in 1973 with the averages, for the same periods, of the daily figures for the gross liabilities of the 51 banks. Although the 51 banks do not include every single bank with liabilities to foreign branches, the omissions are of little importance. The Federal Reserve Bank of New York informs me that the 51-bank data cover 95-100 per cent (and probably closer to 100 per cent) of liabilities to foreign branches of all U.S. banks. Consequently, the differences between the two series in Table 2 give a good idea of the magnitude of head office claims on branches. While these claims do change from period to period there has been no marked tendency upward or downward this year, and the two series do move in roughly parallel fashion.

D. Conclusion and Recommendation

Because the "Wednesday series" does not count Chase Manhattan RP's as liabilities to foreign branches, that series understates the extent to which U.S. banks have borrowed abroad through their branches. And when the amount of these RP's changes, we get a distorted view of the movement of liabilities to branches. If, for example, Chase Manhattan winds up an RP, its liabilities to branches as reported in the "Wednesday series" increase, but this is a statistical change rather than a real increase in available funds. It seems that in August the "Wednesday series", by not correcting for such transactions, was recording some purely statistical increases in U.S. banks' liabilities to foreign branches.

This problem will disappear when and if these Chase Manhattan RP's are all wound up, and their amount seems to have been declining rapidly since mid-August. However, there are still good grounds for preferring the 51-bank daily series to the "Wednesday series" as a measure of gross liabilities to branches. The daily series has the advantage that weekly averages give a truer picture of the trend, over relatively short periods such as a few months, than the picture given by once-a-week figures. I recommend that we substitute weekly average figures, based on the daily series, for the "Wednesday series" where -- as in the chart distributed for the money market review -- the figures are used to assess their implications for domestic monetary conditions.

Table 1. U.S. Banks' Gross Liabilities to Foreign Branches: Comparisons of the Alternative Series
(in millions of dollars)

Wednesday	51 banks with foreign branches Daily series: average for week ending Wednesday (1)	51 banks with foreign branches Daily series: Thursday figure only 1/ (2)	All banks with foreign branches "Wednesday series": Wednesday only (3)	Col. 2 - Col. 3
May 16	2,225	2,758	1,721	1,037
23	2,440	2,492	1,492	1,000
30	2,464	2,156	1,351	805
June 6	2,172	1,934	940	994
13	2,054	2,251	1,266	985
20	2,252	2,310	1,242	1,068
27	2,332	2,417	1,521	896
July 4	2,230	2,701	1,758	943
11	2,535	2,514	1,637	877
18	2,628	2,734	2,032	702
25	2,688	2,769	2,086	681
Aug. 1	2,734	2,939	2,218	721
8	2,414	2,914	2,270	644
15	3,051	2,482	1,894	588
22	2,594	2,915	2,440	475
29	2,690	3,083	2,793	290
Sept. 5	2,193	1,704	1,503	201
12	2,007	2,088	1,935	153
19	2,349	2.076	1,792	284

1/ Thursday following the Wednesday indicated. These Thursday figures are directly comparable with the "Wednesday series" data.

Table 2. Gross and Net Liabilities to Branches in 1973
(averages of daily figures; in millions of dollars)

4-week computation period ending	Gross[1/]	Net[2/]	Difference
January 17	2,331	1,835	496
February 14	2,395	1,776	619
March 14	2,272	1,619	653
April 11	2,403	1,567	836
May 9	2,228	1,570	658
June 6	2,325	1,378	587
July 4	2,217	1,769	448
August 1	2,645	2,143 est.	502
August 29	2,685	n.a.	n.a.

1/ 4-week averages of the daily figures from the 51-bank series.
2/ Data for 4-week computation periods collected in connection with Regulation M and D reserve requirements.