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*Monetary Policy*

# Euro-Currency Market as Recycling Medium

by Dr Helmut Mayer, Basle *

**During the past year the Euro-currency market played a very large role in bridging over the oil-induced payments imbalances. In the interest of international monetary stability this market should now move somewhat away from the centre of the stage and leave the main responsibility for the recycling of oil funds to the official financing mechanisms.**

The increases in crude oil prices imposed by the OPEC countries at the end of 1973 radically changed the size and structure of international payments flows virtually overnight. They transformed the western industrialised countries, which as a group had traditionally been countries with current-account payments surpluses and thus also capital exporters, into current-account deficit countries and capital importers. In addition, they widened the current-account deficits of the developing countries, thereby further increasing their dependence on capital imports to a dangerous degree. On the other side of the coin, a relatively small group of oil-exporting countries, which hitherto had accounted for only a tiny proportion of the world's gross national product, is now recording huge current-account surpluses; and they have, of course, no alternative but to invest their net receipts in the oil-importing countries.

In order to gain some idea of the extent of the changes, it may be recalled that, in very broad terms, before the oil price increase the industrialised countries and the oil-exporting countries both showed current-account surpluses of $ 5 bn, while the developing countries had a corresponding deficit of $ 10 bn. As a result of the oil price increases the oil-exporting countries' surplus grew elevenfold in 1974 to some $ 55 bn, the industrialised countries' current balance moved into deficit to the tune of $ 35 bn, while the developing countries' deficit expanded to $ 20 bn.

It need hardly be emphasised that the massive growth, to many times their former volume, of net international capital flows needed to finance these balances, together with the change in their direction, represent an enormous challenge to the viability and adaptability of the international financial markets, a challenge which, as we shall show later, they would be hard pressed to meet in the long term unless relieved and supplemented by other channels of financing. Though some of the more populous oil-exporting countries will within a relatively short time be able to utilise their additional oil revenue and interest receipts for investment purposes, so that the OPEC countries' combined current-account surplus will begin to shrink again in the next few years, there is little hope in the foreseeable future of a return to an international balance-of-payments structure like that existing before the oil price increases; the OECD has estimated that within a few years, even on the assumption that there is no change in the real price of oil, the OPEC countries' foreign claims will reach $ 250 bn at constant 1974 prices.

As soon as the oil price increase was introduced it was quite clear that the Euro-currency market, as the international credit medium par excellence, would have an important rôle to play in the financing of the newly-created payments imbalances. Its size, flexibility and frequently demonstrated adaptability all pointed in that direction. What is more, for the oil-exporting countries it offered the advantages of anonymity, political neutrality, freedom from taxes at source and, most important, the possibility of extremely liquid and yet highly remunerative investments. And from the point of view of the deficit countries there was the strong attraction of being able to take up large credits

* Bank for International Settlements.

at flexible rates of interest without political or economic strings and without the need for lengthy negotiations.

### Expectations Fulfilled

In 1974 the Euro-currency market did indeed fulfil in large measure the expectations placed in it. In broad figures it can be estimated that the oil-exporting countries placed some $ 23 bn of their current surplus of $ 55 bn in the Euro-currency market. By far the largest part of these investments took the form of direct deposits, while a much smaller proportion entered the market via trustee accounts in Switzerland or consisted of loan repayments. Over half of the direct deposits, or about $ 13 bn, were concentrated on London alone, and the major part was in dollars, though the other two currencies most used in the Euro-market, the Deutsche Mark and the Swiss franc, were also of some importance. By comparison, the share of their surpluses that the oil exporters placed directly in the importing countries' national banking systems or money-market paper may be estimated at about $ 18 bn; as much as $ 11 bn of this went to the United States and $ 5.5 bn (in sterling) to the United Kingdom.

All in all the proportion of OPEC surpluses invested at short term in 1974 can be put at about 75 p.c., of which over 40 p.c. was placed with the Euro-banks and 55–60 p.c. with banks as a whole. Of the other 25 p.c. of the total, about $ 10 bn went to direct credits to international institutions, such as the IMF and the World Bank, and to the public sector of individual oil-importing countries. Part of the remaining $ 4 bn was placed in real property and long-term portfolio investments. This figure also includes purchases of Euro-bonds. Since, however, the volume of issues reached only the extremely modest total of $ 2 bn in 1974 owing to the high level of short-term interest rates and the uncertainties associated with inflation and exchange rate fluctuations, the Euro-bond market, in sharp contrast to the Euro-currency market, cannot have played any significant part in the recycling of oil funds.

### Uses of the Funds

It is hard to identify precisely the uses of the funds invested by the OPEC countries in the Euro-currency market since they naturally merge with other funds coming into the market. While it is true that, making allowance for double-counting, the growth of the market in 1974 was due predominantly to oil funds, there were nevertheless considerable variations from one period to another. In the first quarter of the year, for example, the growth of Euro-market lending far outstripped the volume of new oil money entering the market, while in the third quarter credit expansion came to a halt though the inflow of oil funds continued. Thus, whereas in the first quarter a substantial proportion of the funds taken up in the market by the oil-importing countries stemmed from those same countries themselves, in the third quarter the new OPEC money served in part simply to replace funds withdrawn by the oil-importing countries.

Despite these limitations it may be of interest to take a look at the composition of the new publicly announced Euro-market credit facilities in 1974. The total of these exclusively medium and long-term facilities, almost all of which carry flexible interest rates, amounted to some $ 28 bn (about 70 p.c. of which was granted in the first six months of the year alone). Of this total $ 0.7 bn went to OPEC countries themselves (the previous year they had taken up over $ 3.0 bn), $ 1.3 bn to eastern-bloc countries and $ 1.5 bn to American firms. Of the remaining $ 24.5 bn, $ 7.2 bn was taken up by developing countries and $ 12.7 bn went to EC member countries, with the other OECD countries receiving $ 4.6 bn. The largest single borrowing countries were the United Kingdom with $ 6.2 bn, France with $ 3.1 bn and Italy with $ 2.2 bn; all the loans granted to Italian borrowers and the bulk of those to French and British borrowers were provided in the first half of the year. It must, however, be stressed that all the figures just quoted refer only to credit facilities and not necessarily to credits actually drawn. Moreover, they are all gross figures, i.e. they do not take account of repayments of credits taken up before 1974. Bearing these two factors in mind, the real net growth of lending by the market was probably not over $ 20 bn.

Conventional short-term Euro-currency credits do not seem to have been of great significance in financing the oil deficits. On the other hand, in a number of cases interbank credits played an important rôle. This applies in particular to Japan, where in the first nine months of 1974 the banks' foreign position turned round from net claims of $ 2.9 bn to indebtedness of $ 5.8 bn; a large part of this net $ 8.7 bn inflow of funds came from the Euro-currency market.

Although the sizeable contribution made in 1974 by the Euro-currency market to bridging the balance-of-payments difficulties stemming from the oil price rise was extremely welcome and undoubtedly exerted a stabilising influence on the international monetary system, it is nevertheless by no means certain that it would be a desirable thing for it to continue to play such a central rôle in the recycling of oil funds, or even that it is prepared to do so. There are indeed a number of factors, both micro- und macro-economic, that would seem to urge caution on this score and which have, after a period of euphoria in the first half of 1974, already led to a marked slow-down in the expansion of the market.

### Dangers to the Euro-banks

From the point of view of the state of health of the Euro-banks themselves, the following are the main reasons why a more modest rôle for the Euro-currency market in the future seems both desirable and likely:

□ After a prolonged period of extremely rapid growth in a climate of inflation, exchange rate speculation, keen competition among the banks and liberal maturity transformation, the market has reached a point where a breathing space can do nothing but good. In many countries inflation has led to a dangerous erosion of the private business sector's capital base, and the hazards arising from this situation are further intensified by the pronounced recessionary tendencies in the world economy at the present time. This has increased the credit risk for the Euro-banks and first-class potential borrowers have diminished in number.

Although they actually had nothing to do with Euro-currency business, the huge losses incurred by individual banks themselves on their foreign exchange dealings contributed to something of a crisis of confidence in the Euro-market in the summer of 1974 which hit the smaller banks particularly hard. The resulting sharp rise in the rates that these banks had to pay for borrowed funds brought them into a tight profit squeeze, and this experience will certainly tend to put a break on the future growth of their lendings. In addition, the combination of rapid balance-sheet growth and narrow profit margins has led to a general deterioration in the banks' capital base, which, in conjunction with the crisis on the share markets and the consequent difficulty of raising equity capital, is already seriously impeding the expansion of Euro-lending business.

□ The balance-of-payments consequences of the higher oil prices have weakened the international financial position of most of the oil-importing countries and thereby, viewed from the standpoint of the Euro-banks, naturally also undermined their credit-worthiness. The future worsening of the relationship between these countries' official reserves and their rapidly growing foreign indebtedness will further exacerbate the problem, particularly since many of them have little prospect in the foreseeable future of ever being able to repay their debts and indeed will probably be able to meet the interest service only by means of further borrowing. Although macro-economically unavoidable, therefore, the financing of the oil-induced payments deficits scarcely fulfils the qualitative requirements normally demanded of bank credit. It is consequently doubtful whether the Euro-banks will be willing to increase their lending to those oil-importing countries that really need it – that is to say, those with the largest balance-of-payments deficits. All these considerations apply of course not only to lending to the public sector to cover balance-of-payments deficits but also to credits to private firms in those countries for the financing of investments. In that case the international insolvency risk of the country in question has added to it the individual business risk.

□ The recycling of the oil funds exposes the individual Euro-banks to the danger of excessive dependence on a small number of large depositors, viz. the governments of the oil-exporting countries. A sudden withdrawal of these deposits could place a bank in serious liquidity difficulties. The risk is further heightened by the fact that up to now the oil-exporting countries have shown a distinct preference for liquidity and have kept their deposits in the Euro-currency market predominantly in very short-term form, whereas the deficit countries' financing needs are of a very long-term nature.

### General Economic Problems

Closely bound up with these risks for the individual banks, severe problems of a more general kind could also arise if the Euro-currency market were to continue to play a leading rôle in the recycling of oil funds. It is true that a sudden withdrawal of OPEC assets, resulting in a general liquidity crisis in the Euro-market, is not very probable even though they are being held in short-term form; the OPEC countries have no alternatives for placement of the funds in the short run. But there could be a real risk to international monetary stability if these funds are shifted around within the market. For the Euro-market provides an investor with the means of switching his assets from one currency into another without having to change banks. It should, however, be stressed here that the OPEC countries appear to be aware of the potential consequences of their actions, that they have so far acted in a very responsible way and that there has been no evidence of any sudden switching around of assets. Nevertheless, given the size of their current surpluses, severe pressures could result simply from the OPEC countries changing the currency composition of their new investments. The strains that the foreign exchange markets came under towards the end of 1974 and early this year may serve as an illustration of this.

Exchange rate stability could likewise be jeopardised if the Euro-banks themselves were to change their own distribution of the oil funds – if, for example, because of confidence factors they attempted to withdraw their credits from a country. A sudden withdrawal of this kind would, of course, also intensify the risk of the country's external insolvency and – if a major country or several countries were involved – the risk of a serious crisis of confidence in the Euro-market. And given the far-reaching identity or association between the Euro-banks and banks operating in the national markets, such a crisis would probably not be confined to the Euro-currency market alone. On top of the losses sustained by banks in foreign exchange transactions, the fear of one or more major debtor countries becoming insolvent was in fact one of the main reasons for the "mini-crisis of confidence" in the summer of 1974 referred to above, and it was only after the central banks' meeting in Basle in September had issued a press communiqué confirming their willingness to come to the aid of the markets in case of need that a measure of confidence returned to the Euro-currency market.

It remains finally to be stressed that from a global point of view the Euro-banks' rôle in the recycling of oil funds cannot be regarded anymore as a very useful contribution so long as, for understandable reasons, they are no longer willing to increase their commitment towards the deficit countries. For this would mean that they would redirect the oil funds to the strong-currency countries among the oil importers, which in any case have no need of them. These countries would then find themselves faced with the necessity of choosing between two things: a) a perhaps excessive rise in their currency's exchange rate, or b) absorption of the funds by way of intervention on the foreign exchange market with a resultant inflation of the domestic money supply that might be difficult to neutralise. If these countries were obliged to opt for alternative b), which is quite probable in view of the exchange rate consequences to which they would otherwise be exposed, the task of redirecting the inflowing funds to the weak-currency oil-importing countries would then also fall upon them. All that the intermediary rôle of the Euro-currency market would then have achieved would be to transfer the credit risk from the OPEC countries to other strong-currency countries.

The Euro-banks themselves and their depositors, and the various governments and monetary authorities, all seem to be aware of the recycling problems just described and began some time ago to act accordingly. Already in the second half of 1974 the willingness of the Euro-banks to accept oil funds, particularly on a short-term basis, was somewhat reduced; at the same time the banks have become more selective in their new credit-granting and, especially as regards the term of lending, more cautious. The degree of maturity transformation has consequently declined, while interest margins have risen to a level which should enable the banks to improve their capital base. As already mentioned, after the first four months of 1974 the growth of the market temporarily came to a halt and a marked contraction was prevented only by the continued inflow of oil money. Although a further, moderate expansion was observable in the last few months of the year, there was hardly any rise at all in lending to the major balance-of-payments deficit countries in the second half of 1974 and the main weight of new lending was on the financing of such projects as the development of oilfields in the North Sea.

**Desirable Development**

At the same time measures were undertaken in the official sector to assist those countries hardest hit by balance-of-payments deficits, and this of course has also removed some of the burden from the private capital markets and done much to reduce the danger of a debtor country becoming internationally insolvent, which in 1974 hung over the Euro-market like the sword of Damocles. In this context mention should be made of the $ 6 bn IMF oil facility for 1975 together with the $ 1.5 bn carried over from the previous year, the planned increase of 32.5 p.c. in IMF quotas and the doubling of OPEC countries' share of quotas, the $ 3 bn EC facility, and the $ 25 bn solidarity fund of OECD countries ("Kissinger plan"). Moreover, the OPEC countries have turned out to be quite generous in granting direct aid to the developing countries and seem to be quite willing to extend intergovernmental loans to the industrial countries on a bilateral basis.

This certainly does not mean that all dangers have been eliminated and all problems solved, particularly in view of the somewhat menacing developments in the world economy at the present time, but things are at least moving in the right direction. While the very large rôle played by the Euro-currency market in 1974 in bridging over the oil-induced payments imbalances was a welcome contribution to international monetary stability, it will be no less welcome in the interest of that stability if the Euro-currency market now moves somewhat away from the centre of the stage and leaves the main responsibility for the recycling of oil funds to the official financing mechanisms.