INTERNATIONAL MONETARY PROBLEMS

A conference sponsored by
American Enterprise Institute
for Public Policy Research

American Enterprise Institute for Public Policy Research
Washington, D. C.

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Library of Congress Catalog Card No. L.C. 78-186300

DISCUSSANTS ON PROFESSOR MACHLUP'S PAPER

Edward M. Bernstein

Professor Machlup has presented a noteworthy paper on the Eurodollar market, or the Eurodollar system as he prefers to call it. Although I have been writing on the Eurodollar market since 1963, I found his paper not only very informative but educational. He raises many new questions—questions that we should have asked ourselves many years ago. I like the way he answers them, but I am afraid I do not always agree with him.

I hold with Professor Machlup that the Eurodollar market did not arise out of the U.S. payments deficit and that it would have developed in much the same way if the United States had been in surplus. The greatest growth of the Eurodollar market was in 1968 and 1969 when the U.S. balance of payments was in surplus on an official reserve basis. The Eurodollar market has become the largest and most competitive international money market because it is a profitable market for depositors and a convenient market for borrowers.

The central question that Professor Machlup discusses is the extent to which the Eurodollar market creates credit and generates Eurodollar deposits. If the Eurodollar market were similar to a domestic banking system—note that Professor Machlup does call it a system—it would be possible to have a large expansion of Eurodollar deposits through credit creation on the basis of a primary deposit originating outside the Eurodollar market. In fact, the secondary expansion of deposits would be very much greater than in any national banking system because the reserve needs are very small or even nil. Incidentally, Professor Machlup does not regard this as the essential basis for the generation of Eurodollar deposits.

The question I raise is whether the Eurodollar market is a banking system in the same sense that the banks of the United States or other countries constitute a system. This seems to me the heart of the problem. A banking system is one that serves an economic system. The holding of deposits in banks in the various Federal Reserve districts is closely related to production, consumption and investment in these regions. It is precisely because payments are made in connection with transactions in the economic system that transfers of deposits will be almost entirely from one bank to another within the national banking system. The net leakages—the payments outside the national banking system—are relatively small even in countries with a large proportion of international trade relative to domestic output.

The Eurodollar market is not a banking system in this sense. The geographic distribution of Eurodollar deposits does not conform to the relative importance of countries in international trade and investment, nor to their relative output, nor to their domestic money supply. Of the $31 billion of Eurodollar deposits in London at the end of 1970, Switzerland held 22.2 percent, Canada 9.5 percent, the United States 9.3 percent, Italy 8.4 percent, France 5.0 percent, Germany 2.5 percent, and Japan 1.2 percent. I emphasize this point not in order to deny that Eurodollars are part of the cash balances of some depositors, but to show that they are not held to finance transactions in a relatively self-contained economic system. In short, the use of Eurodollars for payments to nonholders of Eurodollars is very large relative to the payments to other Eurodollar depositors.

We can see this in Professor Machlup's useful subdivisions of the Eurodollar system: a money market in which banks lend and borrow liquid balances which they regard as cash reserves; a credit market in which corporations lend to banks and borrow from banks; and a deposit system in which nonbanks hold part of their cash balances. In my opinion, the third subdivision is the essential part of a banking system. It is also by far the smallest part of the Eurodollar market. The operations of the first and second subdivisions are inconsistent with the creation of Eurodollar deposits through loans as they are solely concerned with taking funds from national banking systems to deposit them in the Eurodollar market and then borrowing the funds from the Eurodollar market to return them to national banking systems.

That is why loans of Eurodollars do not generate Eurodollar deposits in the ordinary meaning of the term. The borrowers do not want Eurodollars to hold in their own Eurodollar balances or to pay other Eurodollar depositors. About 53 percent of all Eurodollar borrowing in the London market at the end of 1969 (33 percent at the end of 1970) was by U.S. residents and nearly all of that was by U.S. banks. These funds were taken out of the Eurodollar market to be used for extending bank credit in the United States. Where the funds were borrowed by corporations—U.S., Japanese, German or Italian—they were mainly converted into local currency by selling the dollars in the exchange market where they were probably acquired by central banks. This is a leakage that would ordinarily be regarded as terminating the further expansion of Eurodollar deposits.

Professor Machlup, however, does not regard it as necessary for Eurodollar borrowings to be paid to other Eurodollar depositors in order to result in an expansion of Eurodollar deposits. It is sufficient if the Eurodollars are lent to banks which expand their own loans in their national currencies. As he explains, these loans will generate a feedback of funds as Eurodollar deposits. This is so, but I do not regard it as of decisive importance. Without prior Eurodollar loans, an expansion of bank credit in any country would result in some flow of funds for deposit in the Eurodollar market. It is equally true that the expansion of bank credit will result in an accumulation of other liquid assets—in the United States, deposits in savings and loan associations and holdings of commercial and finance company paper. If that is what Professor Machlup means by the creation of Eurodollar deposits, no one can deny that it happens and that it is important; but it is not the concept I regard as underlying the generation of deposits through expansion of bank credit.

The large and rapid growth of Eurodollar deposits has been adduced as indirect evidence that it was self-generated through the expansion of credit. As Professor Machlup has said, the growth of Eurodollar deposits at a compound rate of 37 percent a year from December 1964 to December 1969, with a 73 percent increase in 1969, is nothing less than spectacular. It is not, however, unique. In the United States, outstanding commercial and finance company paper increased at a compound rate of over 30 percent from 1964 to 1969 and increased by 55 percent in 1969. Nobody would claim that this remarkable, if not spectacular growth, is due to the capacity of the commercial and finance company paper market to generate a multiple expansion of credit.

In fact, both the Eurodollar market and the commercial and finance company paper market expanded rapidly for the same reason. In a period of very tight bank credit in the United States, borrowers had to resort to other credit markets, and those with sufficient credit-standing sold their own paper. At the same time, with banks restricted from paying competitive interest rates on time deposits, those with short-term funds to invest were attracted to the higher rates in the commercial and finance company paper market. In fact, all credit markets grew relative to deposit institutions. The commercial and finance company paper market grew very rapidly and the Eurodollar market grew even more rapidly because they paid higher interest rates on a liquid investment and they lent these funds to banks and corporations that could not meet all their borrowing needs elsewhere.

This brings me to an ancillary point, whether Eurodollar deposits are cash balances in the same sense as deposits in domestic banks. In my younger days I argued that all bank deposits are money, but that some perform more of the money function than others. The degree to which different bank deposits acted as money could be measured by their velocity. I know now that this is only a half-truth. In any case, I agree with Professor Machlup that we cannot distinguish money and quasi-money by saying that the latter acts as a substitute for money by facilitating an increase in its velocity. By any meaningful definition, it is certainly true that there is more money in the world with the Eurodollar market than there would have been without it. Eurodollar deposits of nonbanks are money, but not in the same degree as domestic deposits.

There is a spectrum of money that varies from the highly visible to the barely visible according to the liquidity of the asset. In this spectrum, demand deposits are most visible. Time deposits in commercial banks and deposits in thrift institutions are another part of the spectrum, almost as visible as demand deposits. Large CDs, bankers' acceptances and commercial and finance company paper, all readily marketable, are less visibly money. Eurodollars cover almost the entire money spectrum. At the end of June 1971, about 17.7 percent of the more than $30 billion of Eurodollar deposits in the branches of U.S. banks were overnight or call deposits. Of the rest, 30.5 percent matured in the first calendar month, 31.5 percent in the following three calendar months, and 20.3 percent in still later periods. If we note the great importance of banks as lenders and borrowers in the Eurodollar market, I would say that most nonbank depositors regard their Eurodollar deposits as about in the same position in the money spectrum as large CDs. Incidentally, the Federal Reserve now publishes data on three definitions of the money supply, all three excluding large CDs.

The Eurodollar market is not just an interesting analytical problem for economists. It is an important practical problem for the monetary authorities. The massive movements of funds to and from the Eurodollar market have made it more difficult to implement national monetary policy. The obvious solution is to have international cooperation to control the Eurodollar market, with the Bank for International Settlements acting as the agent for the central banks. It would be a pity if the operations of such a large and useful international money market were to be hampered by imposing restrictions. As Professor Machlup says, it would be better to remove the artificial obstacles that have caused massive movements of Eurodollars by ending the limitations on the interest rates that U.S. banks can pay in bidding for funds. My own preference would be to let the Eurodollar market remain free to compete for deposits and loans from corporations. I believe, however, that the international monetary operations of banks, in this country and abroad, through the Eurodollar market or through national markets, should be subject to central bank control, not for balance of payments reasons but for monetary policy reasons.

Carl H. Stem

Let me commend Professor Machlup for his paper. It includes very comprehensive analysis of the creation—of Eurodollars, that is—and has great value as a synthesizing piece. He has constructed an analytical framework which, I believe, is quite useful in analyzing the Eurodollar system. In fact, it resembles in many respects the work on Eurodollars which I began in 1967 under the inquisitive guidance of Professor Haberler.[1]

I will focus my attention first on Professor Machlup's analysis of the creation—or expansion—of Eurodollars and Eurodollar credit. Then I will turn to the matter of controlling Eurodollar banking.

[1] Carl H. Stem, *The Eurodollar System: An Analysis of Its Credit Function and Impact on the International Financial Position of the United States,* an unpublished Ph.D. dissertation submitted to Harvard University, December 1968.