MULTINATIONAL BANKING AND REGULATION: AN ECONOMIST'S POINT OF VIEW

Pierre-Bruno RUFFINI *

1. Introduction

The regulation of multinational banking has received much attention recently, as evidenced by the contents of an official communiqué issued by the governors of the central banks in the Group of Ten countries and in Switzerland. Summarizing the primary concerns of official circles, the communiqué acknowledged that the increase in international banking transactions has been encouraged by differences in the regulation of national and international banks. Furthermore, the communiqué noted, the uncontrolled growth of international banking aggregates challenges concerned states to devise appropriate remedies which could include (both national and international) new or increased regulation [I].

This subject is interesting not only because of its current importance but because it serves to illustrate the need for economic analysis as a discipline to take into account the effects of regulation. As used in this article "regulation" will encompass the totality of measures – incentive and restrictive – which governments take to influence the behavior of economic institutions and to attain pre-defined economic goals. The specific legal forms of these measures will not be specified; suffice it to say they are many and rely on a variety of institutional mechanisms. Instead, emphasis will be placed on the interaction between national economic policies and the totality of the regulatory tools used for implementing these policies, remembering always that regulation is the direct operative form of policy.

In this economic analysis of the effects of regulation upon multinational banking, the existing body of rules will be examined in the context of their economic milieu. That is to say, this analysis will seek to determine the objectives of economic regulation (i.e. what events made it necessary and what are its ultimate goals?) and the efficiency of the regulation (i.e. has the

* Maitre-assistant de Sciences Economiques, University of Rouen.

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regulation attained its objectives?). In addition, this analysis will examine secondary or indirect effects of regulation, i.e. unexpected consequences which can be traced back to the regulation under study [2].

Multinational banking activity is an excellent subject for economic analysis, as the discipline has just been defined, because a multinational bank is above all merely a bank and, as such, is subjected to state regulation more often than any other economic institution. Furthermore, since an important, if not a major, portion of its activity occurs outside the economy of its home country, the existence of a multinational bank is a challenge to the home country's banking regulation system.

Banks are the most widely regulated economic institutions in all countries, first and foremost because money is the medium par excellence of banking activities. As far back in history as one may go, money has been both the symbol and the prerogative of sovereignty. Whatever its form, paper or precious metal, it has by convention always been a "good" which acquires such value as the dominant political power chooses to ascribe to it. In modern banking systems where the dominant forms of money are not only paper money but bank money created by the (commercial) banks themselves, state control is exerted by means of a regulatory hierarchy in which commercial banks are made dependent on the nation's central bank.

During the course of this century nations have been particularly concerned about regulating banking activities because of the Great Crash of 1929 and because of a trend toward increasing state intervention in economic life. In all Western countries the memory of the Great Crash and of the succession of bank failures which it occasioned stimulated the introduction or the re-enforcement of measures which would protect depositors and thus enhance the trustworthiness of money. Such measures, aimed at compelling banks to exercise some managerial prudence, focused upon bankers' professional qualifications, the definition of banks' fields of activity, compulsory compliance with certain balance sheet ratios, and the preservation of the competitive structure of banking markets [3]. Since the Second World War states have been giving increasing priority to monetary policy. As a result, no matter what devices are utilized (e.g. action on interest rates or action on the volume of loans), monetary policy and its correlative range of regulations have also greatly influenced the conditions for banking activity.

These state concerns may be summarized and analyzed as two trends in banking regulation: microeconomic and macroeconomic. In the former, the so-called "prudential" action of the state seeks to guarantee the good health of banks by compelling banks to adhere to sound banking standards, thereby eliminating the greater elements of risk. In the latter, the state seeks to ensure the good health of the economy by establishing monetary policy regulations to which the banks must adhere.

This distinction between micro- and macroeconomic concepts and goals is
theoretically applicable to analysis of multinational banking activity. However, and this is precisely what makes multinational banking so interesting as a subject for study, while multinational banking activity is not nearly so closely regulated as is domestic banking activity, it is the multinational side of the banks' activity that has undergone the most spectacular evolution in the last two decades through extension of the networks of the large United States, European, and Japanese banks, multiplication of off-shore centers, and skyrocketing Eurocurrency transactions. As a result of these developments, the multinational bank, defined as a bank that operates in more than one country and conducts activities on the Eurocurrency markets, has asserted itself as one of the most dynamic financial institutions on the world economic scene today.

This article will examine the extent to which this evolution has been caused or influenced by regulatory factors. First, it will study the history and theoretical underpinning of the relevant regulatory factors. Then, from a more practical point of view, it will examine the regulatory issues raised by multinational banking activity on the Eurocurrency market. The focus will remain on issues facing authorities in Western countries collectively rather than on the problems encountered by specific countries.

2. Effect of regulation on banks' multinational expansion

In general, it appears to be the case that the stiffer the banking regulations in a given country, the more likely it is that the banks located there will undertake foreign expansion [4]. Both microeconomic regulations, such as limitations on banks' field of activities, and macroeconomic regulations, such as limitations on capital outflows or credit growth, have this effect. These examples are discussed below.

2.1. Observations

2.1.1. Microeconomic regulation that limits the banks' field of activities

The effects of this type of regulation will be greatest where banking operations and systems are narrowly specialized and restricted to specific geographic areas. The United States and Japan illustrate this.

United States banks are regulated primarily by state and federal branching laws and by the federal Glass-Steagall Act. The branching laws prohibit banks in one state from opening branch offices in other states and, to varying degrees, they limit branching within states. Unit banking statutes are the most restrictive since they simply disallow branching and only permit the opening of auxiliary windows that accept deposits and exchange currency. Statewide branch banking statutes are the most liberal since they permit banks to establish branches within the state either by merger or de novo. In between
these two extremes, the limited branch banking statutes allow branching to occur within a relatively small geographic area.

The Glass-Steagall Act [5] regulates the banking industry by classifying banks according to the nature of their activities. So-called commercial banks, the type we are concerned with in this article, are permitted only to receive deposits, make loans, and become involved in a few types of investment activities. On the other hand, so-called investment banks are permitted only to counsel companies in the capital market, analyze companies’ financial problems, and render managerial advice to such companies.

When U.S. banks turn to foreign countries all these restrictions disappear. The Federal Reserve Board freely permits the banks to establish branches abroad because it wants to maintain U.S. bank competitiveness in foreign markets. This practice has led to the opinion that “[i]n some instances foreign branching is a reaction against state regulations prohibiting the establishment of branch offices” [6]. Similarly, U.S. banks are permitted to conduct a greater diversity of activities abroad than within the United States. For example, they have been allowed (through subsidiaries and affiliates) to underwrite and deal in securities and thus to participate in the Eurobond market and in the nascent capital markets in some developing countries. In connection with their financial activities they have also been allowed to make limited equity investments in non-financial companies [7]. In addition to this freedom for foreign operations, U.S. banks have added opportunities for financial diversification through establishment of “Edge Act” or “Agreement” affiliates in the United States to handle international business [8].

With respect to the range of permitted activities for banks, the situation in Japan bears some resemblance to that in the United States. For instance, Japanese banks are not permitted to deal in securities. Moreover, banks are further specialized according to whether they engage in mainly short-term activities (city banks) or long-term financing activities (long-term credit banks or trust banks). Japanese banks have reacted to these limitations by progressively widening their foreign operations to include operations forbidden to them in Japan [9].

This activity abroad evolved in two stages. First, the city banks created consortium banks with brokerage companies (e.g. Banque Européenne de Tokyo established in Paris in 1968; Japan International Bank and Associated Japanese Bank (International) established in London in 1971) in order to enter into long-term financing in the international financial markets [10]. Subsequently, the banks and the brokerage companies started seeking joint expansion abroad. The commercial banks, desirous of engaging in brokerage activities such as issuing and underwriting Eurobond loans or serving as consultants for mergers and acquisitions, created common subsidiaries with British merchant banks (e.g. Sanwa Bank with Baring Brothers, Fuji Bank with Kleinwort Benson, Mitsui Bank with Hambros, Sumitomo Bank with White
Weld) or with other foreign commercial banks (e.g. Dai Ichi Kangyo Bank with Paribas) [11]. On the other hand, the Japanese brokerage companies desirous of entering the banking business established subsidiaries in such countries as The Netherlands, Great Britain, and France or in Hong Kong where the subsidiaries receive the legal status of banks [12].

Thus, in the United States and Japan domestic regulations caused the banks to look to foreign expansion so as to establish multipurpose institutions which operate simultaneously as commercial and investment banks.

2.1.2. Macroeconomic regulation that limits capital outflows or credit growth

Once again, the effects of this type of regulation can best be understood by examining two countries which have such regulation: the United States and Germany.

In order to reduce its balance of payments deficit during the period 1965 to 1974, the United States limited the growth of loans for foreign financing through the so-called Voluntary Foreign Credit Restraint program (VFCR) [13]. Quite spectacularly, the result was that foreign branches of U.S. banks replaced their head offices for the allotment of foreign loans. In 1964, just before the VFCR program was established, 42% of the international assets of U.S. banks were entered on the books of their foreign branches, the rest being held by central offices; in 1973, the share held by the foreign branches rose to almost 90%. At the same time, the number of U.S. banks with at least one branch abroad had risen from 11 to 129, and the total number of branches from 181 to 737 [14].

Domestic monetary policy also contributed to this foreign branching boom of U.S. banks. In fact, it has been said that the U.S. monetary policy had been "perhaps a more important factor at the basis of U.S. bank branching than the need to follow customers" [15]. Two of the measures introduced to control the growth of banking aggregates (minimum reserve requirements and levelling off of interest rates paid on term deposits) [16] did not apply, in fact, to the activities of foreign branches. By raising capital through foreign branches, parent banks circumvented the minimal reserve requirements [17].

Because they were not subject to Regulation Q, foreign branches could be highly competitive on the Eurodollar market and, therefore, attracted deposits which provided the parent office with the liquidity that domestic monetary policy limited. An examination of the period from 1966 to 1969 reveals that recourse to foreign branches was almost automatic as monetary restraint in the U.S. became more and more of a strain [18]. By the end of 1969, the loans made by foreign branches to U.S. banks amounted to $14 billion. Thus, the banks took advantage of the weaknesses of the credit squeeze system to circumvent it.

In Germany, recurrent trade account surpluses, the ever-pending question of the deutschmark revaluation and massive capital inflows presented many
threats to domestic monetary conditions in the late sixties and early seventies. In December 1968, the Bundesbank imposed several measures, including minimum reserve requirements on the growth of external liabilities of German banks.

As was the case in the United States, German banks circumvented the control regulations by taking advantage of their imperfections. A typical approach to circumventing these controls was that German banks would transfer loan business vis-à-vis German residents to the books of their foreign branches. As a result, German (non-bank) residents would incur liabilities to the foreign branches of German banks, and since neither these foreign branches (which legally are classified as nonresidents) nor domestic nonbank customers were subject to the minimum reserve requirements, German banks were able to circumvent the control without any loss of business [19].

German banks established themselves abroad in great numbers. Luxemburg, the neighboring tax-haven, naturally became their favorite center. The aggregate balance sheets of Luxemburg-based branches and subsidiaries of the major German banks rose from two billion to six billion deutschemarks from the beginning of 1971 to the beginning of 1972; almost half of this increase represented an increase in the number of claims on German non-bank residents [20].

Thus, as illustrated by the United States and Germany, domestic regulation reflecting monetary policy led to foreign expansion of banks seeking to operate without domestic restrictions.

2.2. Discussion

The various examples that have been discussed share a common factor. The national regulatory systems, whose effect has been to stimulate multinational expansion of banks, have a dual nature; they are much more permissive for the banks' activities abroad than they are for their domestic operations. This difference of treatment provides an incentive for going abroad.

Besides the differences existing within the national systems of banking regulations (between the measures that apply to domestic activities and those that apply to foreign operations), there are differences between the various national systems, which also affect a bank's decision regarding multinational expansion.

Some countries, for instance, have severely regulated the establishment of foreign institutions on their territory (Canada, Japan, Australia) whereas others have maintained a liberal stance by granting foreign banks overwhelming advantages [21]. Therefore, a bank wishing to establish itself outside its country may prefer one foreign financial center to another, depending on the extent of the bank's desire to minimize regulatory constraints [22]. It should be noted, however, that with choice of location, the influence of regulation is felt
in the ultimate phase of the process of multinational expansion (in deciding where foreign offices should be opened) and not, as was the case above, in its early stage (deciding whether there are reasons for operating from foreign offices). Yet, in practice, this distinction loses much of its clarity.

Examination of bank transactions on the Eurocurrency markets helps to explain what role regulatory factors really play in the decision of a bank to undertake multinational expansion. The Eurodollar market (which represents approximately four-fifths of all Eurocurrency business) provides an informative example. It is well known that a certain number of institutional conditions and regulatory measures have determined the evolution of this market. Tradition has it that the first Eurodollars appeared in 1957, during the cold war period, at a time when the fear that the United States would place an embargo on Soviet dollar holdings caused their holders to transfer them to London banks. The restrictions that British monetary authorities placed the same year on the international use of the pound sterling led the London banks to develop international lending by using the U.S. currency. In 1958, the return to external convertibility of the major European currencies created the conditions for the international mobility of capital.

During the sixties, the growth of Eurodollar transactions and the increase in the number of U.S. bank branches and subsidiaries in Europe resulted from the measures, described above, taken by the U.S. monetary authorities for domestic credit restraint and capital outflow limitation.

While it seems that the Eurodollar market owes much of its development to the restrictive and discriminatory measures taken by national (and mostly U.S.) monetary authorities, is it possible to say, however, as it is often suggested, that the Eurodollar market is "explained" by these various events, or even that it would never have been created without them?

There is no denying that Eurocurrency transactions can be conducted only insofar as national regulations permit. In particular, a sufficient degree of international capital flow must exist, together with some freedom of exchange, so that some currencies (in practice the dollar, and to a lesser extent the deutschmark and the Swiss franc) may be held by non-residents. There is no denying, also, that Eurocurrency transactions began to take place because of disparities between regulations applying to domestic bank transactions and foreign bank transactions. It is no wonder, finally, that the banks try to evade regulations: the rise in Eurocurrency transactions illustrates the tendency of markets to elude official control. The fact that Eurocurrency markets are essentially unregulated [23] is their main characteristic, contrasting with domestic banking conditions. In other words, it is impossible to ignore regulation if we are to understand the Eurocurrency phenomenon. However, this explanation is far from comprehensive if it is limited to an analysis of the influence of the regulation variable. This may even conceal other, more fundamental considerations.
Using the example of the Eurodollar again, it is evident that the phenomenon is non-reversible: when the VFCR program was discontinued in 1974, the contraction of the Eurodollar market, that many had predicted, did not occur [24]. The wave of rapid creation of U.S. branches in Europe from 1965 to 1973 was not followed by a counter-wave of the disappearance of those same branches from 1974 onwards, as the hastiness of their appearance might have led one to suppose. Rather, by that time, the banks had reorganized the distribution of international loans: branches, less called upon to finance the central offices than during the monetary restrictions of the sixties, shifted their activities toward Eurodollar international financing more than before [25].

The fact that the Eurodollar market outlived the repeal of the measures that had signalled its genesis is evidence that its justification goes far beyond the circumstances of its creation. That is to say, the non-reversibility of the Eurodollar phenomenon indicates that the process is more than the mere result of regulatory constraints applied here and there to control the banks' activity. To understand the phenomenon, one must look to see what world economy functions are being fulfilled by Eurocurrency banking transactions. From this viewpoint, the justification of these transactions becomes simple: they exist primarily because they are useful. They present many advantages which suit the very specific demands made upon them.

The advantages of Eurocurrency markets can be briefly summarized under the following three headings.

(a) **Scale**: banking syndicates can coordinate loans of over a billion dollars on these markets, far more than would be possible on any national capital market.

(b) **Adaptability**: this results simultaneously from the almost complete absence of state controls (e.g. tax exemption and a guaranteed anonymity), the fast completion of transactions (e.g. by telephone or telex between banks belonging to an exclusive circle), and finally, the perfect adaptation of the range of their services to the sophisticated needs of their multinational corporate customers (e.g. multicurrency contracts, etc.).

(c) **Rates**: depositors benefit from the creditor rates, which are higher than those obtainable on national markets for the same currencies; borrowers are also offered rates which tend to be more advantageous than those available on national markets. The economies of scale allowed by the volume of the markets, the absence of regulation which would press heavily on the banks' charges, and the keen competition between banks explain the rate advantages for both deposits and loans.

Taking such advantages into account, it is not surprising that these markets should have become the necessary financial interchange for all the large projects of international finance over the past few years. The primary function of multinational banks, when they operate on the Eurocurrency markets, consists in gathering, transforming, and redistributing liquidities on the world
scale: the Eurocurrency markets may be considered a huge network of bank offices covering all economic areas, through which surplus deposits made by agents in one part of the globe are drained and then directed elsewhere towards agents with financial shortages, by a series of successive loans and redeposits from bank to bank and financial center to financial center (bank-to-bank transactions). Financial Euroloans, i.e. middle- and long-term multicurrency loans, are the tools par excellence of this function of international financing.

This fact cannot be understood outside its general context, that of the opening of economies, the interdependence of markets and national systems of production, and the internationalization of the strategies of economic agents. From this point of view, the internationalization of financial channels (and especially the appearance, with Eurocurrency transactions, of an international financial market) both reflects and determines the internationalization movement in the commercial and industrial fields; the multinational bank is itself the “financial counterpart” of the multinational firm [26]. Whether its financing activities are turned towards international industrial projects (participation in syndicated Euroloans to multinational firms) or towards the financing of disequilibria in the balances of payments (recycling oil surplus capital towards countries with balance of payments deficits), the multinational bank matches and supports every aspect of the movement towards economic internationalization.

Therefore, the main justification for the existence of Eurocurrency markets and, more generally, for the multinationalization of banks, is to be found in the specific financial needs of an economy on its way to reaching a world dimension.

When reconsidering the original problem, these developments shed light on the role played by regulatory factors in the expansion of the banks' multinational activity. Such multinational activity cannot be viewed merely as the result of a wish to escape a too constraining body of regulation. Rather, to find the essential reason for the banks’ creation of foreign branches and subsidiaries as well as the true justification for Eurocurrency markets, it is necessary to refer to larger economic trends: the expansion of world trade in goods and direct investment by multinational firms. Some will say that had the Eurocurrency markets not existed, they should have been invented. This kind of statement does more than pay homage to the economic role of Euromarkets. It reveals that the true causes for their existence lie in the flows of capital transfers in the economic society – in this case, the demand for the financial services of a world economy in the making – and not in institutional or regulatory history. In light of these circumstances, the influence of regulatory factors appears to exert itself on the form of multinational expansion, on its rhythm, its extent, and its direction, but not on its very essence.

Quite probably, if the obstacles created in some countries by way of
regulation had not existed, or had taken other forms, the geography of international banking flows, or the map of international banking centers, would have been different. Just as probably, the chronology of the development of international banking would have been altered too. But this development would not have been greatly affected. Regulatory factors act as catalysts; they can encourage the appearance of multinational banking, but cannot essentially create the phenomenon. Perhaps they even conceal its true nature [27].

3. The regulatory challenge of multinational banking: Should the Eurocurrency market be subject to control?

As in the above analysis, the Eurocurrency market provides a context for examination of the question whether regulations should be enacted to control multinational banking. The current debate on this point is receiving considerable attention among official circles at the Bank for International Settlements (BIS), where the bank-monitoring agencies of the Group of Ten countries and of Switzerland have top civil servants as permanent representatives while the central bankers of their countries hold regular meetings in Basle to discuss their points of view. Although the debate on the control of Eurocurrency markets has not reached a conclusion yet, it has shed light on the main data and issues being considered. The discussion of this issue requires both an analysis of the arguments in favor of regulation of the Eurocurrency markets and an exposition of what has actually been undertaken. These are discussed below.

3.1. Arguments in support of regulation of Eurocurrency transactions

The distinction between micro- and macroeconomic concepts applies to arguments supporting regulation of Eurocurrency banking.

3.1.1. The microeconomic arguments

The specific risks of Eurocurrency business are generally advanced to demonstrate the need for prudential regulation.

These risks result from the original pattern of the “Eurocurrency system”, in which the banks are interrelated to a very large extent. The extent of this interrelationship is reflected in the fact that most Eurocurrency transactions are bank-to-bank transactions. This means that there is a high proportion of double counting which should be netted out when the net size of the Eurocurrency market is calculated from the gross size estimate. In fact, bank-to-bank transactions represent roughly two-thirds of the total number of Eurocurrency transactions.
Indeed, such a high degree of integration is beneficial, in that it improves the multinational banks' efficiency in collecting and redistributing capital on the world scale. The "interbank chain" is the series of links through which banks balance the money surpluses of one geographic area with the borrowing needs of another. The great importance of bank-to-bank transactions reflects the fact that liquidities are shifted from one bank balance sheet to another, and from one financial center to another, to achieve optimal capital allocation on the world scene.

However necessary it may be, this interrelationship of banks entails some risks. The banks that hold a relay position between other banks in the international process of capital flow do not know the original source and the final use of the money they handle. Such a situation may prevent a sound appraisal of the risks involved. There is also a danger that disequilibria may be passed from bank to bank in a chain reaction, if an accident (important losses or even bank failure) happened to appear at one point in the system. In view of this possibility, commentators have often compared the Eurocurrency system to a "paper pyramid" [28].

Specifically, the events which would be likely to start off such a chain reaction could result from the following risks:

- rate-related risk: because of extreme fluctuations in interest rates, banks might be compelled to borrow funds at rates higher than their lending rates;
- maturity-related risk: a bank may finance medium- or long-term Eurocredits with short-term resources;
- liquidity risk: a bank may find it difficult to raise on the market the funds necessary for the revolving foreign currency loans it has undertaken to make;
- the risk of failure to repay: lending banks which are owed large sums by developing countries with uncertain abilities to repay (such as Zaire, Peru, North Korea, etc.) face country risks;
- exchange risk: as banks doing Eurocurrency business operate on the foreign exchange markets on a regular basis, they may suffer foreign exchange losses.

The unsettled state of the international economic environment through the seventies (floating currencies, steep increases in oil prices, recessionary trends), as well as the narrowing margin of bank rates caused by very sharp competition, have intensified these various risks. The banks have tried to cope with this situation by including special clauses in their loan contracts (e.g. clauses for periodic revision of debtor rates, market "drying out" clauses) or by a wider use of syndicated Eurocredits, which allow risk-sharing. Moreover, national authorities have tended to restrain open exchange positions.

The international financing system remains unstable, however, as was demonstrated in 1974 by the serious difficulties banks encountered with
respect to exchange losses. Now, it is feared that the failure to repay some over-indebted state borrower might provoke a financial crisis. It is because those risks are now almost unanimously recognized that the question of prudential control of Eurocurrency multinational banking is raised more systematically than in the past.

3.1.2. The macroeconomic arguments

The argument for macroeconomic regulation of Eurocurrency markets is based on the notions that the Eurocurrency markets (a) interfere with national monetary policies and (b) add to world inflation.

The argument that the Eurocurrency markets interfere with national monetary policies is most valid for the United States and Germany. When a policy of monetary restraint is implemented in either of these countries, it may be thwarted, as was seen earlier, because residents can obtain on the Euromarkets the financial resources that are restricted domestically. Such circumvention is possible because capital flows are not limited, in principle, in the United States and in Germany and because U.S. and German currencies are held in great quantities by non-resident banks, from which they can easily be borrowed.

The validity of the second notion, that the Eurocurrency markets have inflationary effects, has not been determined. Besides the disagreement among economists over the existence and scope of a Eurocurrency multiplier, the professionals (bankers, legislators) also differ as to the role Eurocurrency transactions play in the continuous rise in prices.

It is not disputed, however, that Eurocurrency supply grows at the rate of 20–25% a year, which represents a far steeper rate of increase than that in the various national monetary aggregates. It has also been established that many states borrow under Eurocredits, which they use to finance their balance of payments deficits. This enables them to postpone the deeper actions necessary to reorganize their domestic financial situations.

Although these arguments tend to show the inflationary character of Eurocurrency banking, it is often pointed out that the rapid growth of Eurocurrency supply has no significance in itself. Rather, one must analyze the use of Eurocredits, not their rhythm of allocation. This is because when Eurocurrency loans contribute to increasing industrial productivity, they do not necessarily generate inflation. It has also been said that the banks' recycling of OPEC surpluses has had an “anti-deflationary, not an inflationary effect” [29] by allowing oil-importing countries to pay their energy bills without cuts in their real resources. Finally, it can be argued that, if an inflationary effect exists, it should be ascribed to international financing as a whole, and not to Eurocurrency financing alone. Indeed, one commentator has stated that “there is a choice of two things: either foreign capital inflows are useful, and the fact they are channeled through Euromarkets is of secondary importance; or else they are harmful, and in this case, general restrictive measures must be devised that should be applicable to all capital inflows from whatever source” [30].
3.1.3. Discussion

As long as the real impact of Eurocurrency banking on inflation rates is not quantified, it is doubtless difficult to decide whether the micro- or the macroeconomic arguments are more persuasive. However, it is not absolutely necessary to believe in the inflationary effect of Euromarkets to support the idea of a macroeconomic control of these markets. At a time when supervision of monetary supply has gained great importance in Western countries, Eurocurrency business, the fastest growing category of transactions, paradoxically remains to a very large extent outside the scope of this monitoring. Although the principle of extending monetary control to Eurocurrency banking seems a logical part of an irreversible trend, there are many grounds for disagreement as to its application.

Before looking at the application of monetary controls to the Euromarket, it is important to note that there is a fundamental ambiguity in the very idea of regulation of Eurocurrency transactions. Indeed, the question arises whether, by their nature, Eurocurrency transactions are compatible with the idea of regulation. It will be recalled that, originally, Eurocurrency business took advantage of the regulatory disequilibrium between domestic and foreign bank transactions, the latter being subjected to little or no regulation. This situation can be briefly summarized by saying that the difference between a dollar and a Eurodollar is that the latter is unregulated. The permissiveness of national banking regulations concerning Eurocurrency transactions made their development possible, but it does not explain the essence of Eurocurrency transactions, as was demonstrated earlier.

Thus, it seems possible that the effort to submit Eurobanking to the same regulations as domestic banking might destroy the uniqueness of the Euromarkets by removing one of their essential advantages over domestic markets. By following this line of reasoning to its ultimate consequence, one might conclude that there is a danger of provoking an eventual disappearance of Euromarkets.

Obviously, these prospects should be avoided, because Euromarkets have attained a leading role in international financial mechanisms, and also because no alternative can be found within the framework of any national market. In particular, nations would be ill-advised to alter drastically a mechanism which allows them to make up their foreign payments deficits easily. However, the questions raised above illustrate the dilemma of regulation of Eurocurrency markets; regulation is desirable, but it must not be applied in such a way as to destroy the dynamics of the markets. This dilemma is solved in practice because monetary regulatory constraints, similar to those applied to domestic money markets, are rejected and prudential regulation, which is less ambitious in scope, receives priority.
3.2. Attempts to establish regulation of Eurocurrency banking

Contrary to what is generally said, it is not absolutely true that Eurocurrency transactions are unregulated. Some prudential measures — regulation, or simply monitoring — have already been taken in various countries. However, no macroeconomic regulation exists yet. The establishment of such regulation would be a dramatic innovation, whereas the establishment of prudential regulations would result from the generalized and coordinated application of as yet undeveloped initiatives in a number of countries. As shall be seen, the obstacles to be overcome differ according to the goals of the regulation.

Two preliminary observations must be made before discussing the establishment of Euromarket regulation. First, attempts to establish regulation are made through the coordination of national regulatory authorities. The countries concerned try to reach an agreement, by consensus, on the objectives and the means to be used, each country being responsible for carrying them into effect with respect to the banks within its jurisdiction [31]. As no nation is willing to surrender part of its sovereignty to a kind of “central bank of central banks”, no attention has been seriously devoted to the notion of international control effected by a supranational body endowed with adequate powers.

The second observation concerns the geographic application of the regulatory measures being considered. To be effective, regulation must be enforced by all the countries where banks doing Eurobusiness are domiciled. Should this not be the case, the countries that decide to regulate Eurocurrency business would see their efforts thwarted by the presence of safe havens in other financial centers which would attract transactions seeking to avoid the control “penalty”.

3.2.1. The establishment of macroeconomic control: A controversial initiative

It should be remembered that the macroeconomic approach to Euromarket regulation is based on the idea that these markets are growing too fast. In conformity with the monetarist tradition, the theory of macroeconomic regulation is founded on the notion that a standard of growth should be imposed upon all monetary aggregates. A widely held idea of dubious theoretical justification states that Eurocurrency liabilities should increase at the same pace as domestic liabilities. To achieve the “domestication” of the foreign component of each nation’s monetary supply, it was therefore only natural to apply to it the regulatory devices which aimed at limiting the growth of the domestic component.

To stem the increase in volume of Eurocurrencies, regulatory action may bear — at least in theory — either (1) on “the source” of Eurocurrencies, by affecting the appearance or creation of Eurocurrencies, or (2) on the banks’ use of Eurocurrencies, by exercising a moderating effect on credit allocation.

To analyze the first kind of intervention, it is necessary to describe briefly
the mechanism of Euromoney creation, using the Eurodollar as an example. Every time an economic agent transfers dollar holdings to a bank domiciled outside the United States, there is, by definition, a creation of Eurodollars. In the credit-expansion process, which may be triggered afterwards, the Eurodollars are called primary because they feed the process in its original stage. They are distinguished from induced Eurodollars, which result from the redeposit, with Eurobanks, of a fraction of distributed Eurodollars. The goal of the first type of regulation is to deal with the problem at its origin, by intervening in the conversion of dollars into Eurodollars (and more generally, the conversion of currencies into Euromoney), that is, by acting on the creation of primary Eurodollars.

To achieve this one first might resort to foreign exchange control. By restricting capital outflows, foreign exchange controls limit the currency holdings in the hands of non-residents, which is the very basis of Euromoney creation. The efficiency of this measure is undisputed, yet its application is very sensitive. Limiting the volume of Euromoney through exchange controls would affect the dollar, and to a lesser extent the deutschmark, but these two currencies, in addition to being the preferred media of Eurobusiness, are used for the settlement of most international transactions. Therefore, an attempt to limit the holding of these currencies by non-residents might obstruct the normal flow of exchanges between nations, and, in particular, further disturb international trade relations. Moreover, it would run counter to the trend towards greater freedom in international capital flows, which has been developing since the end of the Second World War. It is not surprising, therefore, that this solution has not been given serious thought.

Another solution aims at reducing the direct participation of central banks in Euromoney creation by curtailing their investments of currency reserves on the Euromoney markets. Instead of Euromoney investments, the central banks could choose other forms of investment, and set the example. The central banks of the Group of Ten countries and of Switzerland led the way in 1971, when they decided to discontinue the investment of their exchange reserves on the Euromarkets. They reaffirmed this determination at the end of 1978. Such a measure has been termed "symbolic", however, for the central banks that have adopted it hold Euromoney reserves amounting to about 10 billion dollars, whereas the Euromoney reserves of the central banks which do not apply it amount to approximately 100 billion dollars [32]. Thus, this is not an effective method for limiting the growth of Euromoney transactions.

The second kind of intervention attempts to restrain the growth of Euromoney transactions by limiting the banks' relending capacity. The measure that obviously comes to mind in this respect is the proposal advanced by the United States in May 1979 for minimum reserve requirements on the banks' Euromoney liabilities. This proposal, which has since been rejected by most countries, would have required the banks to counterbalance their Euromoney
liabilities by unremunerated deposits with the central bank of the country of the currency concerned. Quite simply, the point was to apply to Eurocurrency banking liabilities a method of control which had demonstrated its worth within the U.S. economic system.

According to its advocates – the United States and Germany – such a regulation would have been effective in two ways. On one hand, the banks, whose liquidities would have been reduced because of the minimum reserve requirements, would have had a limited capacity to make Euroloans. On the other hand, this measure would have introduced additional banking costs and reduced the comparative advantage of Eurocurrency markets over national money markets, thus causing Euroloans to become less attractive.

This second point stirred the most resolute opposition to the U.S. proposal. First, countries such as Great Britain and Switzerland, which derive important revenues from their role as international financial centers, very soon realized the threat to their economies posed by a regulation which would only lead to a reduction in Eurobusiness. Also, many people voiced the fear that the minimum reserve requirements would deal a very severe blow to Euromarkets, a result to be avoided for reasons already mentioned.

Finally, the decisive argument was that, were the measure to be applied, it would only be enforced by the countries which abide by international agreements on these questions. Consequently, the market would shift to unrestricted financial centers. This argument may also be used against other regulatory proposals under study, such as a proposal, which has prudential as well as macroeconomic origins, to limit the volume of Euroloans to a multiple of the banks' capital stock.

3.2.2. The gradual establishment of microeconomic control, i.e. prudential supervision

Although there are divergent opinions among nations on the necessity for macroeconomic control of Euromarkets, there is agreement on the advisability of prudential action. This is where reflection has been carried furthest and where the main results have been obtained. This situation puts the focus on supervision rather than regulation of Eurocurrency banking. After rejection of the proposals for macroeconomic control, cooperating states are now turning to the search for a tighter official monitoring of international banking and, in particular, for a better assessment of related risks. Less spectacular though they be, prudential initiatives are still held, by nations such as Great Britain and Switzerland, to be more advisable for the control of Eurocurrency transactions than macroeconomic regulation.

Concern with the need for prudence has predominated since 1974, when for the first time the international banking community faced the problem of the recycling of massive OPEC surpluses. The task was so huge that many doubted whether the international banking system would be able to cope with it without
damage to the economy. The result of this concern was an effort to ensure safe banking transactions.

Since 1974, The Standing Committee on Banking Regulations and Supervisory Practices (the so-called “Cooke Committee” at the Bank for International Settlements) has been the forum for discussion of, and cooperation on, banking prudence. In order to prevent the situation where a foreign branch or affiliate of a bank might evade supervision through a reciprocal renunciation of jurisdiction by the authorities of both the home and host countries, it has been decided that the solvency of the banking corporation’s activities should fall under the overall responsibility of the competent agency of the country where the parent bank is domiciled [33]. In view of this responsibility, each central bank must have a comprehensive command of the data on the total amount of foreign and domestic banking in the nation. In this connection, the countries, almost unanimously, agree on the need to generalize the use of consolidated balance sheets which treat the parent bank, its branches and affiliates as one financial institution. Some progress has already been made in this direction. Although balance sheet consolidation is not yet a general accounting practice in France and Germany, it has been instituted in The Netherlands. Since 1977, Switzerland has required that banks give consolidated information to the supervisory boards, but publication of consolidated data is not compulsory. In these countries the obligation to observe a ratio between capital stock and domestic transactions has an expanded effect through consolidated balance sheets.

The second most discussed issue of banking prudence is that a better assessment of bank lending to so-called risk countries is necessary. The collection of data on international banking has been broadened recently to include this kind of information. Since June 1974, the Bank for International Settlements requires that reporting area banks provide a country-by-country breakdown, for all currencies together, of their foreign assets and liabilities. Since the end of 1977, banks also communicate the breakdown according to dates of maturity of their foreign lending to countries that do not belong to the reporting area. These measures should ensure detailed knowledge of country risks, which have appeared so dangerous these past few years, as was seen before.

Although there is no cooperation in this field as yet, joint reflection has resulted in a general awareness which has already given rise to precise guidelines in a few countries. At the end of 1978, the three U.S. bodies that supervise banking transactions adopted a uniform procedure for the examination and evaluation of country risks faced by U.S. banks lending on the international market. These bodies are also commissioned to encourage banks to diversify their lending to sovereign customers. In Germany, at the beginning of October 1980, the Bundesbank required banks to provide detailed statements of loans made by their parent banks and by the foreign affiliates to
twelve specific developing countries whose indebtedness was deemed high.

From these measures as a whole we can expect that international banking will be made less secretive and that the authorities' monitoring should be all the easier. This concern for a better supervision, and the beginning of its implementation, can be ascribed to cooperation between central banks. With regard to the initial goals – possible regulation of the growth of Eurobanking – this result may seem limited. Its importance should not be underestimated, though. The larger objective of regulating Euromarkets for macroeconomic reasons did not materialize because, besides the technical difficulties involved, the various nations proved that they did not have the same needs with respect to regulation. Given their disagreement regarding the advantages and disadvantages of Eurocurrency banking, a majority of the relevant leading economies have decided to renounce the mandatory rule implied by a macroeconomically-inspired regulation. Cooperation on the prudential issues raised by the recent developments in multinational banking, and the subsequent awareness this cooperation has produced, are less spectacular, no doubt, but it is probably the most efficient means of achieving an adequate regulatory response.

4. Conclusion

In the course of this article the analysis of multinational banking has involved national economic regulations in two different ways. On the one hand, it appeared that national regulatory systems affect the process of multinational expansion of banks even though this phenomenon cannot be accounted for solely by regulatory influence. On the other hand, it appeared that the development of multinational banking, and especially the growth of Eurocurrency transactions, calls for regulatory action by the states. Faced with the international expansion of bank structures, and the emergence of international money markets, the states have understood that their only course is to take international action. This has taken the form of international cooperation. Analyzing the world economic problems of the seventies as a whole, the MacCracken report recently explained that “[t]o a significant extent the difficulties of the last five years can be attributed to the fact that while the economies of the developed and developing world have become so highly synchronised and inter-dependent, the responsibility for economic policy remains firmly in the hands of independent national entities” [34]. Recent developments have shown that multinational banking is one field where national entities have undertaken together to give their intervention the appropriate form for this advanced stage of economic internationalization.
Notes


[2] A good example of secondary effects of regulation is seen in “Regulation Q”, 12 C.F.R. pt. 217 (1981), which was instituted as a means to direct domestic monetary policy, but produced its most spectacular effects on the international monetary scene in the sixties.

Economic analysis has been used successfully to systematically evaluate the secondary effects of international commercial regulation. For example, a new customs regulation, such as a tariff decrease, has been shown to create commercial traffic (i.e. create new commercial flows) and to divert commercial traffic (i.e. one partner in the exchange is replaced by another). See J. Viner, The Customs Union Issue (1950).

[3] In France, the landmark dates in banking regulation are: 1941 (compulsory affiliation of banks to a professional association, the Comité Permanent des Banques); 1945 (nationalization of the Banque de France and of the four major credit institutions); and 1966 (extension of the range of authorized activities to deposit and commercial banks).

[4] A similar analysis has been developed to explain the multinational expansion of industrial firms. One commentator has stated: “One widely held view in the United States is that firms expand through horizontal integration abroad because they are forbidden by our antitrust laws to do so at home.” C.P. Kindelberger, American Business Abroad – Six Lectures on Direct Investment 62 (1969).


[12] Id.

[13] The VFCR Program was part of an array of regulations that also included the Interest Equalization Tax (1963) and the Foreign Direct Investment Program (1965).


[16] The minimum reserve requirements are contained in Regulation D, 12 C.F.R. pt. 204 (1981). The interest rate ceilings are contained in Regulation Q, supra note 2.

[17] However, beginning in September 1969, minimum reserve requirements were imposed on U.S. banks for capital borrowed from their foreign branches. Regulation M, 12 C.F.R. §213.7 (1970) (added by 34 Fed. Reg. 13,409 (1969); removed by 44 Fed. Reg. 36,012 (1979) (revising and combining regulations regarding international banking operations)).


[21] The “tax havens” such as Luxemburg and the Bahamas, where foreign banks are subject to little supervision, no taxes, etc. are examples of countries that have taken the liberal stance. See MacCarthy, Les places bancaires "off-shore": avantages et coûts, Finances et développement, Déc. 1979.
In effect, regulatory constraints, such as the obligation to maintain unremunerated reserves, taxation, administrative costs, etc. amount to extra costs and charges which reduce profits.

See section 3.2 below.

Similarly, the Eurobond market survived despite the repeal of the Interest Equalization Tax which, since 1963, many believed was the reason for that market's existence.

In 1976, the role of central offices had returned to its 1969 level (26.8%), even though it had been only 20% in 1973.


This point is emphasized by Brimmer and Dahl, who state: The expansion of their overseas activities by banks headquartered in the United States is one of the most important developments in international finance during the last decade. For a number of years the motivations behind this growth were obscured by the restrictions on capital outflows, imposed by the U.S. Government in the mid-1960's as a part of a program to improve the nation's balance of payments. However, even before the capital restrictions were terminated in January 1974, it was becoming increasingly clear to some observers that a basic transformation had occurred in the character of U.S. banking.

Brimmer and Dahl, *supra* note 7, at 341.


La concertation internationale et le marché des euro-monnaies, presentation delivered at the Conference on Euro-credits, Université de Dijon, at 16 (October 9–11, 1980).


For a general survey of this issue, see the Record of Proceedings of the International Conference of Banking Supervisors, in London (July 5 and 6, 1979).

See Larre, *supra* note 30.


Pierre-Bruno Ruffini (b. 1949) is Maitre-assistant de Sciences Economiques at the University of Rouen, Mont St. Aignan, France. He is diplômé de l'Institut d'Études Politiques de Paris (1975), and Docteur d'Etat ès Sciences Economiques, Université de Paris X – Nanterre (1979). From 1973 to 1980 he was an Assistant de Sciences Economiques. His doctoral thesis, entitled Banques multinationales et système bancaire transnational, was one of the three best theses on multinationals at the 1982 I.R.M. Competition, and is presently being edited by Presses Universitaires de France, Paris.