



Prime Minister

An effective

critique of

Lord Lever - but

2 September 1982

We await the

Treasury's further

report, on Toronto,

for some more

positive ideas on

how to confront these

dangers.

MCS 2/9

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Dear Michael,

INTERNATIONAL BANKING: LORD LEVER'S MEMORANDUM

I understand that in the course of yesterday seminar on international banking the Prime Minister referred to Lord Lever's views. He recently circulated to the Treasury and others his Memorandum on "Deficit Finance - Bankers and Governments", which has I believe also reached the Prime Minister (copy ... attached). She may therefore like to see the attached note about it. Lord Lever delivered a lecture at Chatham House on rather similar lines a few week ago.

I am copying ^{the} letter and enclosure to Tim Allen at the Bank, and to Alan Walters.

Yours ever,

John Kerr

JO KERR
Principal Private Secretary

LORD LEVER'S MEMORANDUM: DEFICIT FINANCE - BANKERS & GOVERNMENTS

Lord Lever's Memorandum is in two parts: analysis and prescription. The analytical part is a critique of the functioning of the Eurodollar markets in recycling the OPEC surplus to governmental borrowers. The prescriptive part proposes first that central banks should act to prevent banking failures on lines close to those already agreed in Basle; and second that a committee of central banks and governments should determine the total value of liquidity needed and then apportion it between prospective borrowing countries.

2. The thrust of Lord Lever's approach is to substitute centralised decision taking for market operations, and to deplore the operation of the Euromarkets as free markets. But whatever view is taken about how the Euromarkets have operated, it can be said at once that the idea of substituting allocation by committee for allocation by the markets is a complete non-starter. There is no prospect of international agreement on either the total volume of liquidity or its allocation. The nearest approach to a single point of decision on world liquidity is in fact the decisions of the US authorities on the dollar money supply and US monetary policy.

The Euromarkets

3. Lord Lever sees the Eurodollar markets as a dangerous and unsatisfactory channel for the recycling of funds to deficit countries. He complains that lending was left to the "reflexes of the private banking system"; that it was a "soft option" for governments to encourage private bankers to recycle rather than using his committee system; and that it was a "fundamental weakness" of recycling through the Euromarkets that there were no central decisions about total liquidity and its allocation. He concludes that: "We have thus allowed to develop a vast unregulated cash mountain, restlessly moving between currencies to become a major source of parity instability".

.. There has been international debate about the rapid growth of the Euromarkets for a good many years. Chancellor Schmidt has shared some of Lord Lever's views about the character of these markets, and there was a time (1978) when he and US Secretary of the Treasury Miller pressed for a compulsory reserve requirement system in the Euromarkets by international agreement. The UK (Bank and Treasury) had doubts about the practicability and effectiveness of this proposal, and its implications for London as a financial centre. It was not pursued.

5. The Eurodollar markets developed because the compulsory reserve requirements of the Federal Reserve in the US drove a part of the US banking system (and dollar banking generally) offshore. The Eurodeutschemark market based on Luxembourg developed for a similar reason. It was cheaper for both borrower and lender to operate through the Euromarkets. Any system of controls is likely to create a market outside the control and then to complicate or undermine the control system. The UK has tried to avoid policy steps or forms of control which would encourage expansion of the (small) Eurosterling market.

6. The Eurodollar markets are an extension of the domestic US credit markets. It is US monetary policy which determines interest rates in the Eurodollar as in the domestic market. Funds move freely between the domestic and external markets in response to relative demand and to any movement in the (small) difference in interest rates. It is sometimes suggested that the Eurodollar market generates inflation through a multiplier effect in its lending. In fact a bank making an international loan is less able to count on securing deposits as a result of its own lending than a bank making a domestic loan. Like domestic banking markets, the growth of the Euromarkets is determined by the level of interest rates.

7. The Eurodollar markets also made recycling easier politically at a time when countries like Saudi Arabia and Kuwait would have been reluctant to deposit too much of their surpluses directly in

the United States. Their existence has also been of very great importance in the development and health of London as a financial centre.

8. It is not true to suggest that there are no restraints or controls in the Euromarkets. First, the operations of banks in the Euromarkets are subject to their own prudential requirements about capital ratios, which limit the scale of their lending wherever undertaken. Secondly in the US and the UK central bank supervision applies to the consolidated balance sheets of these banks, including overseas subsidiaries. The Bank of England have devoted much effort to extending consolidation (and corresponding central bank responsibility) to other G10 countries eg Germany. All G10 countries have however accepted that parent banks are responsible for their banking subsidiaries as well as branches abroad; and that this must be taken into account in the prudential regulation of parent banks - though this has not stopped the Italians arguing in the Ambrosiano case that the agreement did not apply to subsidiaries which are holding companies rather than registered banks.