PRINCETON STUDIES IN INTERNATIONAL FINANCE NO. 22

External Surpluses, Capital Flows, and Credit Policy in the European Economic Community, 1958 to 1967

Samuel I. Katz

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
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PRINCETON STUDIES IN INTERNATIONAL FINANCE

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EXTERNAL SURPLUSES, CAPITAL FLOWS, AND CREDIT POLICY IN THE EUROPEAN ECONOMIC COMMUNITY, 1958 TO 1967

I. INNOVATIONS IN THE TECHNOLOGY OF CENTRAL BANKING

After 1958, when European currencies became convertible, two economic developments—unexpectedly large balance-of-payments surpluses between 1958 and 1962 and the growth in international flows of private capital—threatened to undermine the effectiveness of actions by the central banks in meeting their goals of domestic stabilization in the countries of the European Economic Community. Because of these developments, the European banks were confronted with a conflict between the requirements for domestic and for international balance. Under these conditions, measures to restore domestic balance were likely to add to the external-payments surplus; on the other hand, policies that helped to reduce the external surpluses were likely to accelerate advances in domestic prices and costs.

The stubbornness of this policy dilemma, and the sudden spurt in exports between 1957 and 1958, led some Europeans to link their current-account surpluses to inflationary conditions elsewhere. In their view, the persistent creep in European prices and costs after 1958 came to be regarded as a manifestation of "imported inflation," attributable to the failure of important trading partners—in particular, the United States—to discipline adequately their international spending. The continuing payments deficits of the United States came to be regarded by some as the primary source of Europe's imported inflation.

It soon became evident that the payments surpluses had introduced important limitations on the employment of credit policy for domestic goals. The central banks' control over the credit base was seriously threatened by the liquidity created when the authorities were obliged to purchase incoming foreign currencies from the customers of the commercial banks. Efforts to sterilize these additions to internal liquidity through the traditional tools of monetary control (discount policy, uniform reserve requirements, and—on the restricted scale common to these countries—open-market operations) raised questions

about the capacities of European financial markets to absorb offsetting operations as well as about the powers and range of policy tools available to the central banks.

Equally important, the enhanced mobility of private capital meant that measures of general monetary restraint could in many cases be self-defeating. By helping to push domestic interest-rate levels above those in foreign centers, such measures merely created incentives for additional inflows of private capital—adding to the reserve accruals which the central banks were obliged to purchase.

Greater mobility of capital within Europe was inevitable after 1958 with convertibility attained, restrictions dismantled, and financial markets more closely integrated, both among the countries in the Common Market and between them and the rest of the world. But several other developments at that time added greatly to intercountry flows of capital. Because rates were often lower there than in domestic markets, the growth of the Euro-dollar market encouraged European exporters and importers to switch from domestic to foreign-currency credits for ordinary business financing, especially as the volume of their foreign trade expanded and their credit-worthiness improved. This willingness to borrow foreign currencies for domestic requirements was also stimulated by a growing rigidity in exchange-rate policy among the major industrial nations, both within the European Economic Community and among the Group of Ten. As changes in exchange-rate parities became less and less likely, European businessmen became increasingly prepared to borrow in foreign currencies—especially where the rate was cheaper—and even to maintain uncovered positions on the credits in order to save the cost of forward cover.

In this environment, the volume of flows of private capital expanded rapidly after 1958. More important perhaps, the threat of additional flows if the financial authorities raised domestic rates above those abroad became a major consideration in European decisions about the extent, the timing, and the particular instruments of credit restraint in each country. The broad range of capital flows which actually took place in Europe can be identified under five principal headings:[1]

(a) Short-term funds—responsive to interest differentials, both with and, on occasion, speculatively without forward exchange cover,

[1] These categories, though analytically distinct, may overlap in practice. For example, "commercial credits" could also be included in some cases under "precautionary and speculative flows."

(b) Commercial credits—obtained by European entrepreneurs in foreign currencies, either directly or through local institutions,
(c) Fixed-interest securities, equities, and convertible debentures—purchased privately, either in foreign currencies or in foreign centers or both,
(d) Precautionary and speculative flows—including "leads and lags" in foreign-trade financing, prompted either by interest differentials or by uncertainties about the stability of an exchange-rate parity,[2]
(e) Direct investment flows—financed in foreign (European or Euro-dollar) currencies.

EXTERNAL LIQUIDITY AND DOMESTIC CREDIT POLICY

Given this enhanced mobility of capital, the central banks of the European Economic Community could not hope to make credit restraint effective in a period of payments surpluses unless they could devise ways to sterilize the excess domestic liquidity created by those surpluses without at the same time provoking unwanted inflows of private capital. Some economists had maintained that these two objectives could not be reconciled in a system of fixed exchange rates; that, in a period of continuing payments surpluses, "The Central Bank is bound to lose control of the money supply, and therefore over the level of total spending."[3]

Even if the central bank could "for a time at least, prevent the secondary deposit expansion by the commercial banks," Lutz was convinced that the banking system was bound to acquire "sufficient cash to support the *primary* deposit expansion which derives directly from the sales to them of foreign exchange by their customers." Scott and Schmidt were more optimistic: "Both the potential primary and secondary expansions . . . could be prevented through open market sales," a conclusion subsequently challenged, in part on technical

[2] Precautionary and speculative flows of funds directly related to the timing and locale of foreign-trade financing in Europe are described—and indications of the volume of the flows in Europe during the 1950s are roughly suggested—in my papers, "Leads and Lags in Sterling Payments," *Review of Economics and Statistics*, Vol. XXXV (February 1953) and *Sterling Speculation and European Convertibility: 1955-1958*, Essays in International Finance No. 37 (Princeton, N.J.: International Finance Section, 1961); and in Paul Einzig, "What Are Leads and Lags?" *Banca Nazionale del Lavoro Quarterly Review*, No. 83 (December 1967), pp. 376-389.

[3] Friedrich A. Lutz, *International Payments and Monetary Policy in the World Today*, Wicksell Lectures, 1961 (Stockholm: Almquist and Wiksell, 1961), p. 37.

grounds, by Oppenheimer and Lutz.[4] Lutz was convinced that the central bank's task was hopeless: "Reserve requirements will reach their maximum level, the stock of open-market paper will run out and the consequently unhindered expansion in commercial bank liquidity will render the official rediscount rate ineffective."[5]

The early experiences within the Common Market seemed to support a pessimistic judgment. The German central bank raised reserve requirements five times between mid-1959 and mid-1960, but this aggressive tactic failed to restore the Bundesbank's control over the internal credit base. On the contrary, disequilibrating inflows of capital, provoked by the tight monetary policy, finally forced the German authorities to change that policy late in 1960; ultimately, the DM was revalued in early 1961. Similarly, inflows of capital into the Netherlands convinced Roosa that "tight money has not . . . been the sole and satisfactory answer" and led him to conclude that "the days of simple reliance upon monetary policy . . . may possibly be gone forever."[6]

But these misgivings proved, in the end, to be exaggerated. The European monetary authorities were not prepared to abdicate their primary responsibility to promote domestic economic objectives. They accepted the limitations on their freedom of action imposed by the system of fixed exchange rates and proceeded to develop—gradually and even on occasion through a disorderly process of trial and error—policy instruments that would enable them to regain control over internal credit availabilities. As a result, monetary policy bore the major burden for domestic stabilization in these countries between 1958 and 1967, frequently with only limited support from fiscal policy.

ELEMENTS OF A NEW MONETARY TECHNOLOGY

But this transformation did not come easily. The central banks could reestablish a firm hand over key domestic financial indicators only after they had learned to supplement, or to replace, the traditional policy instruments with new tools or novel adaptations of older ones.

[4] Ira O. Scott and Wilson E. Schmidt, "Imported Inflation and Monetary Policy," *Banca Nazionale del Lavoro Quarterly Review*, No. 71 (December 1964), p. 395. See also Peter M. Oppenheimer, "Imported Inflation and Monetary Policy: A Comment" and the rejoinder by Scott and Schmidt in *ibid.*, No. 73 (June 1965), pp. 191-200.

[5] Friedrich A. Lutz, "World Inflation and Domestic Monetary Stability," *ibid.*, p. 114.

[6] Quoted in Scott and Schmidt, *op.cit.*, pp. 3, 4.

Their willingness to experiment and to accept innovation was a recognition of the need to broaden the scope, and to speed up the effectiveness, of credit action. The authorities recognized that, because the dependence of domestic banks upon the central bank was much reduced after 1958, new ways had to be found to force them once again to seek central-bank accommodation or, alternatively, to limit directly their new credits. Partly because of continuing excess demand and tight labor markets in their economies, European central banks also sought to speed up the response of the banking system to monetary action: in particular, they wanted in a period of restraint to achieve a prompt slowdown in the rate of loan expansion. Finally, they often sought new policy instruments in order to achieve a more selective impact than could be achieved through general measures of restraint.

The additional policy tools which the European central banks developed make the period from 1958 to 1967 a creative chapter in the continuing evolution of the art of central banking. The process through which these new instruments emerged can best be understood against the background of the experience of the individual central bank. But an outline of the general character of the new technology may be a helpful introduction to the review of technical developments in each of the countries of the Common Market which will be presented in the following chapters.

Non-Price Credit Rationing

The characteristic which perhaps best distinguishes the new monetary technology from the orthodox tradition of central banking was an unprecedented emphasis upon credit rationing. The central banks were prepared to reduce the rate of new extensions of credit by preventing banks from lending, even in circumstances where they could not allow advances in domestic interest rates which would reduce the demand for funds. To limit availability, these central banks imposed quantitative limitations—both on their own credits to the commercial banks and on credits by commercial banks to the private sector.

At the central-bank level, much greater use was made of non-price measures to limit borrowings of the banking system, especially in Germany, France, and Belgium in the period under review.[7] In Ger-

[7] In Italy, rediscounting was not an important credit source until late in 1963 when the banks began to expand their central-bank borrowings. Since the discount rate was not changed in Italy between 1958 and 1967, it is evident that the mone-

many, announced reductions in rediscount quotas at the central bank were a particularly important measure of restraint after 1964. In Belgium and France, restraint took the form not of changes in the bank's rediscount quotas but of variations in the terms and conditions of discounting. Actions taken included changes in the administration of discount operations, in eligibility and acceptability requirements, in the prior authorization of trade credits by the central bank, and in the liquidity regulations which affected certain assets (such as medium-term paper in France) that the banks might otherwise present to the central bank.[8] The various non-price measures to ration central-bank credit in the countries in the European Economic Community were fully consistent with Garvy's conclusion that "the most significant" recent development in the field of discounting has been "resort to quantitative limitations, and thus diminished use of the (discount) rate."[9]

Changes in the terms and conditions of discounting to make borrowing more difficult were used to support, and on occasion to replace, a rise in the discount rate. Fears of provoking disequilibrating inflows of capital often caused the European central banks to hesitate to advance the discount rate. In addition, a tightening in the conditions of rediscounting—even when they were made public—did not have the same effects on financial markets, on business expectations, and on banking and credit costs as the announcement of a rise in the discount rate. In mid-1964, the German authorities raised reserve requirements "as a means of using monetary policy to contain inflationary pressures without Bank rate."[10] Earlier, during the 1963-64 effort at stabilization, the Bank of France raised the discount rate only once by ½ per cent and applied it chiefly to borrowing from the central bank; the rates on Treasury and export bills were unchanged and the costs of commercial-bank credit increased by only ¼ per cent.

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tary policies of the Bank of Italy were related to credit availabilities rather than to changes in cost.

In the Netherlands, the banking system's buildup of short-term assets abroad severely limits their need to seek central-bank accommodation.

[8] A general review of the discount mechanism in leading countries since World War II may be found in George Garvy, "The Discount Mechanism in Leading Industrial Countries Since World War II" (Board of Governors of the Federal Reserve System, July 1968). Detailed studies of discounting operations in principal countries are to be found in Part II: Belgium, pp. 71-84; France, pp. 98-124; Germany, pp. 125-37; Italy, pp. 138-51; and the Netherlands, pp. 166-79.

[9] *Ibid.*, p. 16.

[10] *The Banker* (London), Vol. 114 (August 1964), p. 528.

At the level of commercial-bank credit, rationing imposed by central banks took the form of ceilings on bank loans to the private sector. Such regulations were in effect in France in 1958 and again from 1963 to 1965 as one component of a broad stabilization program. In the Netherlands, they became perhaps the primary tool of credit restraint from 1960 to 1967, at first temporarily, and later on a more permanent basis. They were in effect in Belgium, on a voluntary basis, from January 1964 to July 1965 and again from April 1966 to June 1967. These ceilings usually set an annual or a monthly rate of increase and sometimes stipulated specific penalties on any excess credits. On occasion, the authorities might cut back the authorized rate of increase as a measure of additional restraint. Use of such ceilings has been discussed in Germany, but the Bundesbank has never been given authority to impose them; they have never been employed in Italy.

Adjusting Foreign Positions of Domestic Banks

Increased use of measures to induce the commercial banks to make marginal liquidity adjustments in their foreign, rather than in their domestic, positions[11] was a second major tool developed particularly in Germany and Italy. These central banks introduced foreign-currency swap transactions with commercial banks in 1958-59 as a temporary offset to the foreign and domestic liquidity effects of payments surpluses at that time. But, with experience, regulations to affect the banks' net foreign position were broadened and were gradually relied on to help control domestic liquidity in these two countries (which did not employ direct ceilings to limit commercial-bank loans). The regulations were chiefly intended: (a) in periods of payments surpluses, to shift excess domestic liquidity into foreign financial markets; and (b) in periods of credit restraint, to limit the extent domestic banks could obtain domestic-currency liquidity, either by borrowing or by liquidating foreign assets.

Arrangements to encourage liquidity adjustments in foreign centers developed differently in the two countries. In Germany, foreign-currency swaps to induce the commercial banks to export funds were activated during periods of payments surpluses; but, to ensure that the commercial banks retained their liquid assets abroad during periods of credit stringency, the Bundesbank subsequently used differential reserve requirements and "offset" privileges.

[11] The regulation of the commercial-banking system's foreign transactions to control domestic liquidity was separate from any balance-of-payments objectives of such measures.

In Italy, where the commercial banks and residents have acted both as substantial borrowers and lenders in the Euro-dollar market, the authorities would instruct the banks to attain a specific *net* position in foreign currencies with nonresidents,[12] and the commercial banks were permitted to choose whether to make their adjustments on the foreign-currency asset or liability side of their balance sheet. The terms of the directive would be changed at times when the banks were in a particularly vulnerable position. A severe credit stringency was created in 1963 merely by instructing the banks to borrow no more abroad; they were then forced to turn to the central bank to replace the internal liquidity they were losing because of the deficit in external payments. In addition, through swap facilities offered by the Italian Exchange Office, the Italian banks were encouraged to place money-market assets abroad, particularly until the end of 1965.

Reduced Importance of Uniform Reserve Requirements

A third major change in central-banking practice was the tendency for European central banks to depend less upon *uniform* reserve ratios and more upon *special* reserve requirements between 1958 and 1967. By the end of this period, uniform reserve ratios, both of the cash and the liquid-asset variety, were less widely used in these countries than they had been in 1958 (see Table 1).

As a tool of credit, cash-reserve requirements have never been as significant in the countries of the European Economic Community as in the United States and the United Kingdom, and the importance of these requirements declined between 1958 and 1967 (see Table 1). In 1963 they were withdrawn in the Netherlands; they were tried only briefly in Belgium during 1964. In Germany, changes in cash ratios were used aggressively during 1959-60 but less actively in the period of restraint from 1964 to 1966. In Italy, cash requirements contributed to the arrest of inflation in the late 1940s but were much less important during the 1960s. A cash ratio was introduced in France in 1967 for the first time; it coincided with a phasing out of the liquidity-reserve requirement and has not yet been deployed as an effective tool of restraint.

Because a number of European central banks turned to liquidity reserve requirements in the decade after World War II, the shift away

[12] From the late 1950s, the Bank of Italy encouraged the commercial banks to make foreign-currency credits to Italian importers and exporters to bring down the cost of credit in the country.

TABLE 1

COUNTRIES OF THE EUROPEAN ECONOMIC COMMUNITY: SUMMARY OF RESERVE REQUIREMENTS AND OTHER CREDIT-CONTROL TECHNIQUES, 1958 AND 1967

	Belgium[1]		*France*[2]		*Germany*[3]		*Italy*[4]		*Netherlands*[5]	
	1958	1967	1958	1967	1958	1967	1958	1967	1958	1967
Primary Reserve										
Vault cash and balances with central bank	4%	none	none	4½ demand[d] 2% time	R-6-13%[h] NR-10-30%	R-5½-13%[h] NR-10-30%[i]	25%[j]	10%	10%	none
Secondary Reserve										
Total Liquid Assets	—	—	25%[e]	none	none	none	—	12½%	none	none
Treasury paper	46-61%[a]	none	—	—	—	—	25%[j]	—	—	—
Commercial paper	—	—	—	16%[f]	—	—	—	—	—	—
Rediscount Ceilings	Formal	Formal	Formal	Formal	Formal	Formal	Informal	Informal	none	none
Ceilings on Bank Lending	none	Occasionally[b]	Occasionally[g]	Occasionally[g]	none	none	none	none	none	Frequently[k]
Encouraging Capital Outflows	none	none[c]	none	none	none	Frequently	none	Frequently	none	Frequently

[1] *Belgium.* [a]In January 1959 the cover ratio (*coéfficient de couverture*), consisting of a variety of government-guaranteed securities, ranged from 46% for regional and special banks to 56% for medium-sized and 61% for major banks. [b]Voluntary ceilings for individual banks were in effect from January 1964 to July 1965 and from April 1966 to June 1967. [c]In 1966, to reduce domestic liquidity, the National Bank sold on the "free" foreign-exchange market part of the proceeds of the government's foreign borrowing.

[2] *France.* [d]These requirements were announced on January 21, 1967, and they became fully effective on October 21. [e]In January 1959 French banks were required to hold in Treasury bills 25% of deposit liabilities. (In 1960 a new system of minimum reserve requirements—*coéfficient de trésorerie*—required the banks to hold any combination of cash, Treasury certificates, export paper, and medium-term commercial paper against their deposits.) [f]Medium-term paper rediscountable at the Bank of France. [g]In March 1963, ceilings on bank lending were imposed and removed on June 30, 1965. Such ceilings had also been imposed from February 1958 to February 1959.

[3] *Germany.* [h]R=deposits of residents; NR=deposits of nonresidents. The percentage varies with size of banking institution and its geographic location. [i]In February 1967, reserve requirements for nonresident deposits became the same as for resident deposits.

[4] *Italy.* [j]Italian banks were required to hold a 25% reserve in the form of either balances at the central bank (which earned the same rate of interest as did Treasury bills) or Treasury bills.

[5] *Netherlands.* [k]Monetary policy is now being carried out through ceilings on bank-credit expansion.

from these ratios during the 1960s is particularly striking. Belgium first introduced a liquid-asset requirement in 1946, Italy in 1947, France in 1948, and the Netherlands in 1954.[13] A changed attitude toward such ratios emerged during the 1950s as the monetary authorities came to recognize, with experience, that these were less a means to restrain bank lending than they were a way to force commercial banks to finance the Treasury more cheaply. By 1967 Belgium had abolished such requirements overnight, and Italy had reduced them. More important, in Italy and in France the compulsory proportion of Treasury securities was steadily reduced (see Table 1). This change was made possible by the lessened dependence of the Treasury on the banking system in these countries, a result which was, of course, an outgrowth of the rebuilding of flows of private savings and the structural improvements in European financial markets which enabled the Treasury to be financed outside the banking system. In this sense, the reduced significance of liquidity ratios in European central banking can serve as one measure of the extent of financial rehabilitation that was realized in Italy, Belgium, and France between 1958 and 1967.

[13] Peter G. Fousek, *Foreign Central Banking: The Instruments of Monetary Policy* (Federal Reserve Bank of New York, 1957), pp. 57-68. The liquidity ratio in the Netherlands was on a stand-by basis only and has never been put into effect.