

FROM: The Rt Hon. The Lord Joseph CH PC



The Rt Hon. Mrs Margaret Thatcher MP
The Prime Minister
10 Downing Street
SW1A 2AA

30 April 1990

**PRIVATE AND
CONFIDENTIAL**

Dear Margaret,

After Alan Walters had spoken to me about covert exchange controls I had a word with Gordon Pepper and Gordon recommended me to consult Graham Bishop of Salomon's who follows the subject closely. Just in case it may be useful to you and your advisers I enclose a batch of relevant recent papers by Graham Bishop together with a copy of a letter from him to me dated 25th April.

I have also sent copies of all this material to Nicholas Ridley and to Ralph Harris.

No need whatsoever to reply to me.

Yours as ever,

Kevin

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1992 and Beyond

Higher Bank Capital = Securitisation

by
Graham Bishop
(01) 721-3921 (London)

March 1990

Salomon Brothers

European Business Analysis

1992 and Beyond

Higher Bank Capital = Securitisation

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Graham Bishop
(01) 721-3921 (London)

The author wishes to thank Bruce Brittain and many other colleagues in and outside of Salomon Brothers, in addition to Ann O'Kelly, who carried out initial research and final production.

Based on a speech given in Paris on January 29, 1990, at the Business Research International conference "Securitisation in Europe."

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Introduction and Summary

Five years ago, uniform international capital adequacy requirements for banks seemed a remote possibility. However, in July 1988, the Bank for International Settlements (BIS) published capital adequacy guidelines, and in December 1989, the European Community (EC) finance ministers signed the Solvency Ratio Directive that, ultimately, gives the BIS standards legal force throughout the EC from January 1991.

The capital adequacy standards will take effect in a financial environment radically altered by the drive towards a single European market. **We believe that the interaction of these forces will cause spectacular change in the banking environment over the next five years:**

- Financial liberalisation and the creation of a "level playing field" for all financial services will benefit European consumers, both as savers and as borrowers, in the form of lower costs and increased choice.
- Banks will face increased competition on their loan assets, while growing depositor sophistication will increase the cost of their deposit liabilities. Thus, there will be a powerful squeeze on profit margins as costs rise and revenues fall.
- But bank shareholders are already dissatisfied with the return on equity. Because of the capital adequacy requirements, they are contributing new equity — either in cash or higher dividends foregone. They wish to see the return on equity rising, not falling because of shrinking margins.
- Banks will have to respond to investor concerns by unbundling their balance sheets and selling off their prime loan assets. Therefore, securitisation will play the key role in both providing better and cheaper financial services to consumers and in solving the banking system's strategic problem.
- Banks, overcapitalised on the basis of shrunken balance sheets, may repurchase significant chunks of their equity — boosting shareholder value substantially.

The first section of this report discusses the capital adequacy requirements and their implications for bank profitability. The second section considers how banks can maximise the efficiency of their capital structure. The third section analyses the dramatic transformation of the financial environment resulting from the drive to create a "level playing field" for all financial intermediaries.

Bank Capital Adequacy Requirements

Banks have been forced to increase their capital sharply in recent years. From January 1991, EC banks will have to comply with the legal requirements on capital adequacy contained in the Solvency Ratio Directive.

Banking regulation is usually a product of specific banking crises, rather than of analysis from first principles.

- The Barings Crisis of 1890 established the principle that the central bank would be the "lender of last resort." This removes the risk of a domino effect within the financial system, undermining the working of the physical economy.

- Between 1930 and 1935, 9,000 banks failed in the US — out of a total of 24,000. The Federal Deposit Insurance Law, passed in 1933, required the national Government not only to supervise banks, but also to guarantee small deposits. The general public became assured of the safety of their bank deposits, ruling out contagious panic when a bank ran into trouble. Thus, "moral hazard" was abolished for small savers.

During the 1960s, the "cult of the equity" gathered force. Bank stock prices responded to earnings growth, so management accelerated the twin processes of "leveraging the balance sheet" and increasing the yield on assets. In today's jargon, they reduced capital ratios and bought riskier assets, secure in the knowledge that depositors would not suffer, due to the lender of last resort and deposit insurance.

Inevitably, the results of these policies emerged: in Britain, the "secondary banks" collapsed in 1974; in West Germany, Herstatt Bank disappeared overnight; and the long-running less-developed-country (LDC) debt crisis started in 1982 with Mexico. The magnitude of the problem unfolded gradually, creating concern for the health of banks.

Banking regulations were imposed, at first piecemeal and then in a more coordinated manner. However, the abolition of moral hazard had led to a general public presumption that the "competent authority" would bail out all sorts of investors — not merely small, and therefore presumed unsophisticated, depositors. The US led the way, rescuing Continental Illinois and the Federal National Mortgage Association (Fannie Mae).

The current thrift industry bail-out in the US has produced a gigantic bill. The final cost is likely to exceed \$200 billion — some estimates put it at \$400 billion or nearly \$2,000 for every person in the US. Regulators are now taking a new look at the problem. In Europe, the discussions on economic and monetary union within the EC seem to be moving towards an agreement that countries running excessive budget deficits will not be bailed out. This is likely to toughen the attitude towards rescuing financial institutions.

However, regulators believe that society will not let them withdraw free deposit insurance. If taxpayers are becoming restless about the cost of this free insurance, then banks must be required to have sufficient resources to remove the risk of failure. Hence, the capital adequacy requirements.

The Cooke Committee Rules

The major central banks, through the Cooke Committee of the BIS, have agreed that banks should have a minimum capital ratio of 8% of risk-weighted assets. They have defined both capital and a system for weighting the assets to allow for apparent riskiness. These standards have been adopted well beyond the Cooke Committee countries and seem likely to become global standards. The EC has adopted them in the Own Funds and Solvency Ratio Directives.

There is virtually no chance of a relaxation of these standards for banks. Therefore any future development of the financial system must take them as a starting point — no matter what competitive inequalities may appear to result.

Figure 1. Definition of Bank Capital According to the Cooke Committee Rules

Tier I	Equity, disclosed reserves.
Tier II Upper	This must be less than Tier I. Reserves (undisclosed, revaluation, general losses). Hybrid (debt/equity mixture).
Lower	This must be less than 50% of Tier I. Subordinated Debt.

The "tier" structure makes it abundantly clear that the regulators have focused on capital that is "freely and immediately available to meet unforeseen future losses."

Tier I and Tier II capital combined must amount to at least 8% of risk-weighted assets — assets are assigned risk-weightings of 0%, 20%, 50% or 100%, according to category. The regulators have imposed tough standards of capital adequacy on banks specifically to ensure that the taxpayer is protected against further calls on deposit insurance. (This approach may be too harsh. For example, we are not aware of residential mortgage loss rates reaching even 1% annually in recent times. Yet mortgage banks in West Germany are still required to have at least 4% capital to back their mortgage business — although a substantial portion of that is commercial rather than residential.)

Although the minimum capital ratio has been set at 8%, most banks will want to — or will be obliged to — stay well above that minimum. Figure 2 sets out existing ratios for several countries.

Figure 2. Bank Capital Ratios, End-1988

	Tier I	Tiers I and II
Australia	5.7%	9.1%
France	3.9	7.5
Japan	4.1	8.2
Spain	NA	10.9
UK	5.9	10.3
US (Money Centre)	6.4	10.3

NA Not available.

Source: Salomon Brothers Inc.

This suggests that a capital ratio of 10% or more will become a benchmark. Competitive pressure will lead banks to emphasise the safety of money deposited with them and thus will focus publicity on the amount of their "excess" capital. This is already happening in the US and UK. At the other end of the spectrum, French banks, for example, are likely to be hovering close to the minimum capital requirements. The French enabling legislation for securitisation (*tirisation*) may well provide the solution — by shrinking the balance sheet.

The Implications for Profitability

Because Tier II capital cannot exceed Tier I equity, a 10% capital ratio implies a minimum shareholder equity of 5%. Shareholders will demand a return on this capital and, even more importantly, on their equity

Existing Capital Ratios

proportion. Regulators should be concerned that banks, armed with free deposit insurance, will take ever-greater risks to produce an adequate return on these extra resources.

Figure 3. Comparison of Return on Equity^a for Banks by Country, 1985-88

	1985	1986	1987	1988	Average
Australia	16.7%	14.6%	12.6%	14.3%	14.5%
France	11.3	13.5	11.0	11.8	11.9
Japan	11.8	12.8	13.4	13.9	12.9
Spain	15.1	17.9	17.4	21.6	18.0
Switzerland	9.3%	9.1%	8.1%	8.0%	8.6%
UK	13.1	16.1	(3.8)	18.7	11.0
US (Money Centre)	13.9	13.7	(13.5)	21.5	8.9
West Germany	10.5	14.6	7.5	9.2	10.4

^a Net income as percentage of average equity.

Source: *European Banking Integration in 1992*, Thomas H. Hanley et al, Salomon Brothers Inc, June 1989.

The data highlight two points: first, the volatility of returns. This is most pronounced in the UK and US — where heavy provisions against LDC debts have caused overall losses. Shareholders cannot now regard banking as a low risk, stable business. Second, average returns range widely between countries — from Spanish banks at the top to Swiss banks at the bottom. (However, the Swiss banks' position may owe more to accounting conventions than true profitability.)

How do the banks compare with the other opportunities available to investors in the equity markets? Figure 4 shows return on equity for some major markets.

Figure 4. Return on Equity — Total Market, 1985-88

	1985	1986	1987	1988	Average
France	9.8%	9.8%	10.3%	13.0%	10.7%
UK	10.1	11.5	12.7	12.8	11.7
US	9.6	8.9	10.6	13.1	10.5
West Germany	15.9	18.2	15.9	12.6	15.6

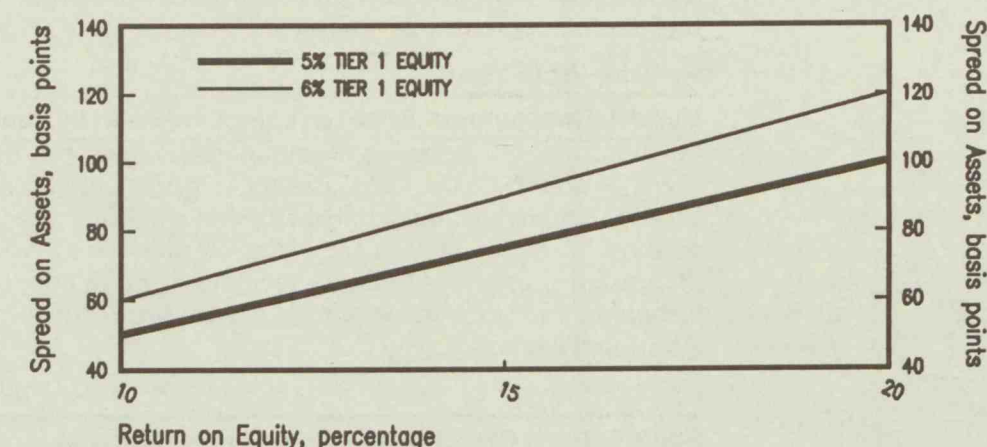
Source: Datastream.

The lower volatility of returns within each country is striking. Moreover, in three of four countries, the total market's rate of return is higher than that of banks. Taking a simple average of these four markets, the rate of return is 12%, while that of their banks is only 10.5%. In sum, banks produced lower returns and had higher earnings volatility.

Although comparisons across markets are always difficult, shareholder pressure will force banks at least to maintain their return on equity and, more likely, look for some increase. This does not sit well with the regulatory requirement to increase the amount of capital for a given level of business. These diametrically opposed requirements will inevitably produce strains. Figure 5 shows some simple consequences.

After paying all the expenses of being in business, including the cost of Tier II capital, a well-capitalised and profitable bank will need to earn 75-100 basis points on its loan assets simply to earn the necessary return on shareholder equity. The precise size of that spread will depend critically on the chosen relationship between Tier I and Tier II capital. It will also depend on the target return on equity: many bankers talk of a 15% target — which seems a reasonable premium over the total market to allow for the evident risks.

Figure 5. Spreads and Return on Equity



Source: Salomon Brothers Inc.

Maximising the Efficiency of the Capital Structure

In many countries there are still no clear official guidelines on the detailed rules to be applied. This is becoming urgent because the Solvency Ratio Directive, and therefore the Own Funds Directive, is scheduled to become effective on January 1, 1991 — now only nine months away.

Tier I capital is the ultimate loss absorber, so the regulators have drawn the definition tightly. The only qualifying securities are "issued and fully paid ordinary shares/common stock and noncumulative perpetual preferred stock (but excluding cumulative preferred stock)."

Preferred Stock Issues

Noncumulative perpetual preferred stock is therefore the only "nonequity" route to raise extra Tier I capital. During 1989, just under \$2 billion was issued, of which nearly half was by EC banks (see Figure 6).

Figure 6. Tier I Capital — Noncumulative Perpetual Preferred-Stock Issues, 1989
(Dollars Equivalent in Millions)

Issuer	Amount
Allied Irish Banks	\$175.0
Bankers Trust	215.0
Barclays	316.2
Barclays	183.8
Chase Manhattan	100.0
Citicorp	\$62.5
Citicorp	62.5
Citicorp	125.0
Continental Bank	285.0
Royal Bank of Scotland	200.0
Westpac	100.0
Total	\$1,825.0

The Cooke Committee rules permit two types of instrument for raising Tier II capital from the market — hybrid and subordinated debt. As shown in Figure 1, subordinated debt must be less than 50% of Tier I capital, due to the "fixed maturity and inability to absorb losses except in liquidation." Moreover, the original maturity must be over five years and must be

Tier I

Tier II

amortised out of the capital over the last five years of its life. The restrictions on proportion and maturity of this "lower" Tier II debt have focussed attention on the creation of "upper" Tier II capital.

Variable-Rate Notes

Variable-rate notes (VRNs) have been issued widely and the amount outstanding now exceeds \$4.5 billion equivalent. UK banks and building societies dominate the list of issuers — principally because the UK supervisors have made detailed rules on eligibility. UK building societies account for nearly 40% of the dated, sterling issues: VRNs enable mutual organisations, such as building societies, to raise upper Tier II capital. This has implications for other mutual banks throughout Europe that need additional capital.

Figure 7. Tier II Capital — Variable-Rate Note Issues

Issuer	Size (Millions)	Maturity (Years)	Launch Margin Over LIBOR ^a
Sterling			
National Westminster	£300	20	12.5bp
Lloyds	200	10	25.0
Bristol & West Building Society	150	5	10.0
TSB	100	15	25.0
Leeds Permanent Building Society	50	5	10.0
Leeds Permanent Building Society	50	12	25.0
Alliance & Leicester Building Society	50	10	35.0
Total, Sterling Dated	£800		
National Westminster	£350	Perpetual	37.5bp
Total, Sterling	£1,100		
US Dollar			
National Westminster	\$200	20	25.0bp
National Westminster	100	20	20.0
Great Western Financial	200	4	20.0
Total, US Dollar Dated	\$500		
National Westminster	\$350	Perpetual	50.0bp
National Westminster	150	Perpetual	40.0
National Westminster	500	Perpetual	35.0
Allied Irish	400	Perpetual	62.5
Bank of Ireland	300	Perpetual	50.0
Bank of Scotland	300	Perpetual	40.0
State Bank of Victoria	250	Perpetual	37.5
Total, US Dollar Perpetual	\$2,250		
Total, US Dollar	\$2,750		

^a The launch margin is heavily influenced by the specific terms and conditions. LIBOR London inter-bank offered rate. Bp Basis point.

A variable-rate note is a floating-rate note where the coupon is set at a margin over LIBOR that is agreed anew on each quarterly reset date via a Dutch auction mechanism. If that margin is unacceptable to a specific investor, he can put the bonds back to the underwriter at par. If, in limited circumstances, the remarketing agent cannot agree with the issuer on the coupon reset margin, then the coupon is set at a maximum spread — at the Alternative Coupon Reset Margin. This is typically LIBOR plus 100 basis points or more, and there is *no* put option in this circumstance. This mechanism ensures that the investor is always assured of a return commensurate with the credit standing of the issuing bank — even if some

future problems arise. The difference between the launch margin and its cap represents the investor's cushion against future problems. Once that cushion is used up, the investor loses the right to put the bonds at par and will then share any incremental credit problems via a decline in the bond's price. Naturally, the issuing bank cannot also be the underwriter, or the effect would be to repurchase its capital.

These comments merely touch upon a substantial topic. The appropriate level, and type, of Tier II capital will be one of the principal determinants of a bank's return on its Tier I equity (see box on page 13 where the implications for Dutch banks are used as an example). This is the key measure for shareholders when evaluating investment alternatives.

The Consequences

Superficially, the direct effects of the new capital adequacy requirements are simple: the shareholders have contributed new equity — in cash or higher dividends foregone — and they want a higher rate of return on all their equity. The obvious solution is to widen margins. But this is more easily said than done, because the provision of credit is a fiercely competitive business. The ability to provide a sufficient volume of Tier II capital will thus be a crucial ingredient in satisfying shareholders' demand for adequate returns on the Tier I equity at the top of the pyramid.

Another component of the solution is the pursuit of fee-generating business — life insurance sales, for example. Originating and then securitising extra loans is only another method of generating fee income.

An alternative approach for a bank with inadequate capital resources is to shrink the balance sheet. Securitisation may have a role in this, but the natural ambition of bankers is to maintain a large balance sheet. That undoubtedly means that securitisation will not be the preferred route. Therefore, the conclusion must be that the new capital adequacy standards for banks will not — *by themselves* — create a general need for asset-backed securities markets.

A Level Playing Field for All Financial Services

The EC's single market programme — "1992" for short — set the ultimate objective of liberalisation: "The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services, and capital is ensured" (Article 13 of the Single European Act). Stage One of the Delors Committee Report on Economic and Monetary Union is a powerful restatement of the single market objectives. It involves the creation of a single financial area free of all barriers to financial integration, "where banking, securities and financial instruments are offered uniformly." The implementation of Delors Stage One has been agreed by the EC Heads of State and is due to commence on July 1, 1990. Whatever the status of discussions on a single European currency, and everything that that implies for monetary policy, a single market for financial services has become inevitable and irreversible.

The European Commission's aim is to provide complete freedom of choice for the consumer. To this end, the Commission is working on a set of Directives affecting every aspect of financial services. Consumer protection and prudential regulation are being balanced against the risk of stifling innovation and competition to such an extent that the consumer pays

excessive prices for outmoded products — it is easy for vested interests to cry “consumer protection” when they really want to protect their own interests.

The European financial services industry is still based upon a series of compartments created by national tax and regulatory regimes. The European Commission aims to change this — the difficulty of harmonising 12 systems for banking, insurance, pensions, and so on has led to an analysis of regulation from first principles. Brussels now places a new and explicit emphasis on providing a “level playing field” for all financial intermediaries.

- The Second Banking Directive, by using the principle of home country control, allows banks to operate on a “single banking passport” anywhere in the EC.
- The UCITS directive allows EC-wide marketing of qualifying mutual funds.
- Last December, Sir Leon Brittan, EC Commissioner for Competition, announced that creating a single market in insurance was now a priority. Using the same principle of home country control, directives are being drafted, for both life and nonlife insurance, to allow insurance companies to operate on a “single insurance passport.”
- He went on to state that proposals are also being drafted to ensure a level playing field for pension services.
- The concept of the level playing field has already been incorporated into EC law — the Solvency Ratio Directive states that “the Commission undertakes to examine whether the Directive as a whole significantly distorts competition between credit institutions and insurance companies and, in the light of that examination, to consider whether any remedial measures are justified.”

Given the size of insurance companies and pension funds, a level playing field has immense implications for competition.

Stripped of the baggage of history — terminology, tax treatment, regulatory requirements, and tradition — the economic functions of long-term savings products are very similar. For the saver, there is not much difference between a bank deposit with a fixed rate, for example, for five years, and a bond mutual fund specialising in five-year bonds. A life insurance policy is a savings product, with attached insurance against premature death. If the insurance company simply buys five-year bonds for its life fund, then all three types of intermediary — bank, bond fund and insurance company — are competing with the same savings product; death insurance could be purchased separately.

Another example comes from the asset side of the institutional balance sheet: a residential mortgage is simply a legal charge on a house — possibly the borrower’s family home. Traditionally, it has been assumed that the funds from the borrowing were used to pay for the house. However, there is no economic reason why this should be true. If a borrower looks at his entire portfolio of assets and chooses to finance some expenditure by borrowing it on the finest terms, then a loan secured on the family home will be the best guarantee of repayment. The only concern of the banker, and in turn the bank’s supervisor, is whether the loan can be repaid, not the moral worth of the borrowing. In the UK, for example, this is already the case.

The Battle for Consumer Savings

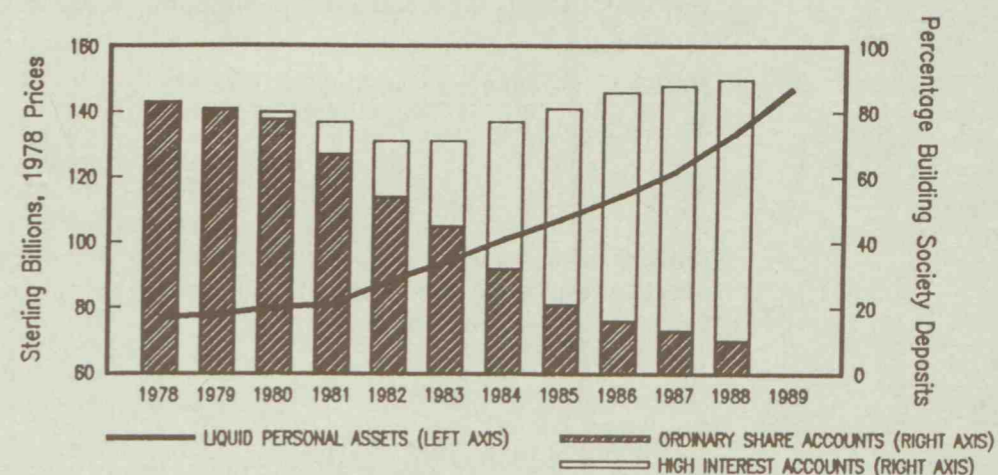
This blurring of distinctions between what used to be separate financial transactions has increased competition between intermediaries. Banks now seek to cater for all the financial needs of their customers — in West Germany, this approach is called *Allfinanz* and in France *Bancassurance*; the UK does not seem to feel the need of a neat name!

Such transactions are becoming easier for the consumer, who now has wider choice and greater control over financial decisions. It is clear that this freedom of choice, once attained, cannot be taken away from savers/borrowers who are also electors. However, the bank regulator’s job has become more complex and that of the controller of monetary policy a nightmare: consumers are rendering impossible a neat classification of their financial transactions into the different monetary aggregates, with awkward consequences for the conduct of monetary policy. The discussions on European monetary union have yet to focus on this problem, despite an excellent summation in the European Commission’s *Annual Economic Report*, 1989-90.

The population of Europe is greying. This involves a rising level of financial saving for old age, a need heightened by growing doubts about how social security systems will cope. There is also a lagged effect from the Second World War, which caused a massive destruction of personal wealth. The postwar generation is now in the process of handing its rebuilt wealth on to the next generation, often in the form of housing property. But the middle-aged and middle class already have a house, and do not need their parents’ house. Instead, financial intermediaries hope that the wealth will be held in the form of financial assets, which they will help manage — for a fee. Hence, the intensifying battle for consumer savings.

In this competitive environment, where traditional boundaries will become blurred and even disappear, two selling points remain: efficient service and investment performance. We believe that the steady rise in consumer sophistication will be matched by a drive for higher performance. UK building society depositors provided a classic example of this during the 1980s.

Figure 8. Liquid Personal Assets Versus Building Society Holdings, 1978-89



Sources: Building Societies Association, Financial Statistics (CSO).

The line in Figure 8 shows that the personal sector's holdings of liquid assets have roughly doubled since 1981 — after allowing for the effects of inflation. The banking system was liberalised in that period and the building societies faced competition. The results were dramatic. Savers switched almost entirely from “ordinary share accounts” paying interest at a discount of 30% or more to the market rate, into “high interest” (read market rate) accounts. Ordinary share accounts have now virtually disappeared — from 80% of funds to nothing in one decade. Note that the building societies' customer base is drawn from the least financially sophisticated section of the population.

The same trends are becoming apparent in West Germany, as savers put their extra money into life insurance or bond funds — rather than 2½% savings deposits. The benefits to West German consumers of competition for savings could be as remarkable as they were for British savers.

The implications of EC-wide financial liberalisation are spectacular.

Result I: Competition on Bank Liabilities

The ageing of the population has two distinct effects: first, older people have had a longer time to save financial assets and second, they have become more financially sophisticated. They may have quite a high risk tolerance for their incremental assets, balanced by an expected higher return. The converse may be even more true: they may not be prepared to sacrifice any return to reduce a risk they believe to be remote.

It is already apparent that major corporate depositors are not willing to give up any yield in order to invest in “guaranteed” bank deposits. The commercial paper market demonstrates clearly that investors do not rate banks better than some major companies — despite the superior creditworthiness of banks assumed by the Cooke Committee's risk weighting system of assets.

A key management problem for small institutions, such as the regional banks in France, will be the creation of more sophisticated products. Otherwise, there will be a sharp increase in the concentration of bank deposits, as customers search for better value. The rapid spread of “high interest” retail deposit accounts in the UK underlines savers' willingness to attach virtually no value to the implicit guarantee for bank deposits. **For the banks, this is the worst possible outcome — the loss of submarket funding.**

Result II: Competition on Bank Assets

The consumer of credit has two basic choices: to borrow from a bank or to borrow from “the market.” If a borrower seeks credit directly from the capital market, there is no need for that buffer of capital imposed on banks to protect the saver on the other side of the transaction. At its simplest, the individual who personally buys a bond issued by a company has willingly accepted the credit risk involved, and there is no public policy reason to offer any sort of guarantee.

Ignoring transaction costs, a bank with market-rate funding will have to charge to the borrower the 75-100 basis points attributable to capital requirements, in order to provide the shareholders with the required return on equity. Over time, this cost differential seems bound to push borrowers towards the capital market, when access permits.

Major companies and sovereign borrowers, whose borrowing needs come in market-sized chunks, have shown the way over the past few years. Retail borrowers were shut out until securitisation became possible. The consequent swift growth of the mortgage-backed bond market in the US demonstrates the demand and led Salomon Brothers to introduce the concept to the sterling markets in 1987.

Pooling small loans is not new — King Frederick the Great of Prussia popularised the concept 200 years ago. What is new is the total separation between the loans and any obligation by the originator. The advance of technology also makes it possible to handle a stream of payments — partly interest and partly principal — which would have been impossible even a few years ago. The market has therefore been able to expand beyond the simple, fixed-rate mortgage and can now cope with the complexities of both car loans and credit card receivables.

This development is crucial for the banks, because such loans are their core assets. If the banks begin to lose competitiveness in their prime, high-margin assets, then they will have no option but to compete directly by unbundling their balance sheets and securitising some of these prime assets.

Result III: Securitisation

Origination

The speed of development of the market in securitised assets will be governed by (i) the will of originators and (ii) the response of the regulators. The many regulatory impediments are usually the legacy of history. However, their progressive removal hinges upon the goodwill of the regulators. The speed at which regulators are convinced of the probity, and usefulness, of these markets will therefore be a limiting factor on their development.

Banks will seek to originate securitised assets, either to shrink their balance sheet or to generate fee income. It is already clear that they will not be the only originators. The blurring of the boundaries between banks and insurance companies in the savings market will be mirrored in the credit market. Thus, the *Bancassurance* phenomenon will be seen on both sides of the balance sheet.

The immediate example is the UK mortgage market, where insurance companies have become active providers of mortgage funds, but have also securitised the mortgages to preserve their balance sheet strength. Their motivation is selling the houseowner other products, such as life insurance, rather than becoming mortgage bankers.

There is also substantial potential for nontraditional originators. In the US, General Motors and Ford use cheap credit as a marketing aid for their products. Volkswagen's US activities show that European companies have taken this example to heart. Major retailers could be a fertile source of credit card receivables for the same reason.

The impulse to securitise varies from country to country. In the UK, the residential mortgage market was highly developed before securitisation was introduced in 1987. However, the rising cost of retail funds relative to the market, combined with a perception of poor service and high costs, opened the way to disintermediate the existing mechanisms. This “arbitrage” opportunity may have receded, but the major potential remains — giving different, nontraditional suppliers of mortgages access to funds.

The process in France will be very different. The regulators have set the pace by creating a new legal framework for *titrisation*. The specific intention was to provide the undercapitalised French banking system with a possible solution. In Italy, the incentive is different again. A major competitive innovation for residential mortgages is likely to be much higher loan-to-value ratios than the current 50%. The rising wealth and sophistication of the Italian consumer is also likely to make them increasingly willing to finance the purchase of durables with debt, rather than savings.

In several countries — Italy and Spain, in particular — the operation of withholding tax is a major problem for securitisation. Without such taxes, the legal and regulatory problems would be solved by utilising tried and tested systems from elsewhere in the EC. Thus, withholding tax has emerged as one of the critical barriers to spreading the benefits of liberalisation.

Buyers of Securitised Assets

The buyers of these assets will include bond and money market funds, insurance companies and pension funds, among others. This group of institutions is the very essence of the capital market. A bond fund, for example, is the classic gatherer of retail funds, which it on-lends — purely at the investor's risk and therefore without need of "adequate capital."

Banks will also be buyers of securitised assets. A key condition of their participation will be whether the securitised assets are accorded the same risk weighting as the underlying assets — in other words, if there is a level playing field when the security holder is in the same effective position as the asset holder. At present, the Cooke Committee's rules have not provided that level playing field for mortgages. However, this topic is certainly under discussion, and it seems probable that logic will prevail.

The attractions of securitised assets to banks are very clear: they are prime and they are liquid. Some banks will always have access to submarket deposits — whether due to lack of investor sophistication or to regulation — and a bank with significant submarket funding should find these assets very attractive.

Impact on Banks

Many bankers will look at securitisation with horror. They should not. Instead, they should view it as a positive opportunity. First, they can maximise their distribution capacity and raise their *turnover*, rather than *volume*, of assets. The result will be a series of fee incomes rather than just one interest spread. The second opportunity is the chance of improving shareholder value substantially. The bank may have just gone to great lengths to increase capital to meet the new standards. By unbundling the balance sheet and selling off assets, it will be heavily overcapitalised. An obvious solution is to repurchase equity. This could enhance the performance of bank shares — perhaps substantially!

Bankers who do not turn securitisation to their advantage may find that their prime assets gradually melt away over the next few years. Pressured by shareholders seeking adequate returns on their equity, and believing the depositors to be well protected by implicit taxpayer guarantees, they may be tempted to make too much use of excessively high-yielding assets — lower-quality leveraged buyouts, for example — perhaps without proper credit research and risk control discipline. There is an ultimate and inevitable result: the bank fails, changes ownership — at a cost to the public — and the process that led to the current levels of bank capital will ratchet another notch forward.

A Specific Example

The Dutch banking system is well known as mature and solid. Based on Netherlands Bank data for the system as a whole, the risk-weighted capital ratio is probably between 10% and 11% — substantially above the 8% minimum requirement. Tier II capital is only about 2½ percentage points of the total. Accordingly, there is no reason to securitise any assets for the sole purpose of boosting capital ratios. If, for example, half of the mortgages were securitised — as the easiest asset to securitise — then capital ratios would be boosted to around 12%-13%, or 50%-60% above the minimum.

The impact on profitability is potentially more interesting. Based on a sample of leading Dutch banks, return on equity is about 9%-10%, which is low by international standards. To increase market share within the system, a competitive bank could boost profits by securitising half of its mortgage portfolio (15% of aggregate assets), retaining fee income and correspondingly expanding its origination of new mortgages. This would push the return on equity up in tandem.

At that stage, the capital ratios would seem excessively high. Shareholder value could be dramatically enhanced by issuing Tier II debt and raising it from 3% of assets to 5%. The resulting cash could be used to retire equity and bring the Tier I ratio down from the 9%-10% range to 7%-8%. The capital base would remain extremely strong by any standards — perhaps excessively. However, the repurchase of one quarter or more of the bank's equity would radically improve the return on the remaining equity, as well as have a dramatic impact on shareholder value.

Conclusion

The financial services industry of Europe faces a period of change that has few precedents. The tide of political opinion is sweeping us towards monetary union: the changes in our financial environment are still unclear, but will be vast. The raw material of our industry is the very money that is to be "united." Changes in EC-wide financial regulation are unleashing competitive pressures onto the new level playing field. An inevitable result will surely be the emergence of a major market in asset-backed securities.

* * *

Other Titles in the "1992 and Beyond" Series

Fortress Europe?, October 1988. Examines the potential problems facing Japan in its trade relationships with Europe.

Banking — Will Liberalisation Itself Lead To A Common Currency?, February 1989. Genuine liberalisation of financial services will unleash market forces, which will, by themselves, create effective monetary union.

The Long March To European Monetary Union — Two Practical Steps, May 1989. In part, a response to the Delors Committee Report, pointing out that monetary union was possible without binding rules. Also detailed the barriers to free capital flows caused by regulations such as the West German restrictions on the investment of insurance assets.

The Madrid Summit — European Monetary Union IS Coming, July 1989. An analysis of EC measures on financial liberalisation and the linkage with monetary union. Discusses achievements to date and what remains to be done.

Market Discipline CAN Work In The EC Monetary Union, (with Dirk Damrau and Michelle Miller) November 1989. The lessons from other monetary unions (Canada, Australia, West Germany); the New York City crisis of 1975. The market can be a more effective sanction on fiscal profligacy than binding rules.

Creating EC Monetary Union with Binding Market Rules, February 22, 1990. A plan to ensure that market discipline is certain, yet operates slowly and progressively. This plan proposes specific measures to strengthen the structure of the financial system sufficiently that a Member State's default is not disastrous.

Italian Public Debt at the Dawn of Monetary Union — A Foreigner's View, Graham Bishop, February 1990. An analysis of Italy's debt problems, highlighting the short maturity and proposing a major foreign borrowing programme in other EMS currencies to stabilise the stock of debt.

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RETURN TO C/E

1992 and Beyond

Italian Public Debt at the Dawn of
Monetary Union —
A Foreigner's View

By
Graham Bishop
721-3921 (*London*)

February 1990

Salomon Brothers

European Business Analysis

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Italian Public Debt at the Dawn of Monetary Union — A Foreigner's View¹

By
Graham Bishop

At the Strasbourg Summit in December 1989, the Heads of Government of the European Community (EC) agreed that an Intergovernmental Conference to prepare the road to European monetary union would meet "under the auspices of the Italian authorities" before the end of 1990. Italy will thus once again launch an historic process — as it did with the Single European Act in Milan in 1985.

Some believe that Italy's public debt is one of the greatest obstacles to achieving monetary union. We disagree with that view. If the approach of monetary union is seen as an opportunity to break away progressively from the constraints of the past, then it will be received as a constructive development and not a threat. **We believe that Italy could be the single biggest gainer from monetary union.**

Lower Interest Rates

The most obvious, and dramatic, benefit from monetary union is the potential for lower interest rates. As far as nominal interest rates are concerned, as monetary union approaches, differentials should narrow due to the removal of devaluation fears. If the process reaches the intended conclusion of a common currency, the differentials should be minor, reflecting pure credit considerations — the ability of the Government to repay its debt in a currency that it can no longer print. The potential saving to Italy would be large, whether in real or nominal rates. Although Italy's traditional real premium was eroded during 1989, as monetary policy was tightened throughout the EC, during 1988 and much of 1987 Italian real interest rates were one to two percentage points above the average of the other European Monetary System (EMS) members. A one-percentage-point reduction in the nominal short-term rate equates to about 0.5% of gross national product (GNP) in the first year alone, due to its impact on the interest cost of public debt.

Looked at another way, these potential savings represent the direct cost to the Italian taxpayer of the current financial system. This system includes exchange controls, taxation, the nature and efficiency of the market for debt and the role of the intermediaries who channel, or perhaps fail to channel, Italian and foreign savings into that market.

Why Foreigners Shun the Italian Bond Market

Why do investors require an apparent "risk premium" to persuade them to hold lira instruments? What do they fear?

Devaluation

We believe that the danger of lira devaluation is now much reduced — the last major such devaluation within the EMS was in 1985. In January 1990, Italy narrowed the lira's fluctuation margin within the EMS's exchange rate mechanism (ERM) from $\pm 6\%$ to $\pm 2.25\%$, so that the currency is now constrained within the lower third of its previous band. Exchange controls were also reduced further and are scheduled to be removed entirely by July 1, 1990, underlining Italy's commitment to monetary union. Thus, the approach of monetary union should diminish lira risk.

Debt Crisis

There is frequent talk of a debt crisis in Italy. Continual announcements of the sale of staggering quantities of Government debt — punctuated by tales of failed auctions — lend credibility to these stories. Yet the truth is that Italian debt levels are not that excessive. The relative indebtedness of the EMS member Governments and the corresponding short-term interest rates do not suggest that Italian debt is so high that it warrants a risk premium on interest rates.

¹ Based on a speech given on December 4, 1989, at the Seminar *La Gestione Del Debito Pubblico E I Mercati Finanziari* at the Centre for Monetary and Financial Economics at Università Commerciale Luigi Bocconi, Milan, Italy.

Figure 1. Debt as a Percentage of GNP Versus Three-Month Interest Rates

	Debt as Percentage of GNP 1989E	3-Month Interest Rates Jan 1990
Luxembourg	9%	10%
France	35	11
West Germany	43	8
Spain	44	15
UK	44	15
Denmark	62	12
Portugal	75	
Netherlands	78	8
Greece	82	
Italy	99	13
Ireland	111	12
Belgium	127	10
All EC	58.4%	

E Estimate

Sources: European Commission, *Financial Times*.**Short Debt
Maturity**

However, the short maturity of Italian public debt magnifies the impression of a debt crisis dramatically. The average life of the public debt is now under three years. Thus, on average, debts equal to one third of GNP must be refinanced each year. In our view, 1990 will be a particularly difficult year, with redemptions equal to 40% of GNP. When the new deficit is added in, bonds equivalent to 4%-5% of GNP will need to be issued *each month*. Corresponding data are difficult to compile for other EC States, but the average life of their public bond markets is revealing. Bonds are defined as securities with more than one year remaining life. UK bonds have the longest life, at 10.9 years. Among the major countries, West German bonds have the shortest life, at 5.4 years.

**Bewildering Array
of Instruments**

To a foreigner, the array of debt instruments is bewildering and comparisons are further complicated by three different withholding tax regimes, depending on the date of original issue.

Figure 2. Principal Italian Government Securities, February 1989 (Italian Lira in Trillions)

Type	Maturity Range		No. of Issues	Market Size	Average Issue Size
BOT	3-12 Months	Discount Bill	42	Lit245	Lit5.8
BTP	2-5 Years	Fixed Coupon	54	146	2.7
CCT	5-10 Years	Floating Coupon	86	346	4.0
Others ^a			35	38 ^b	1.1
Total			217		

^a Including ECU-indexed, option, inflation-linked.^b July 1989.

BOT Buoni Ordinari del Tesoro — Treasury bills.

BTP Buoni del Tesoro Poliennali — Treasury bonds.

CCT Certificati di Credito del Tesoro — Treasury credit certificates.

Source: Bank of Italy.

**Low
Institutionalisation**

Foreign financial institutions form the impression that Italian markets are unsophisticated, because they perceive a lack of entities with a correspondingly dominant role to their own. Typically, these pension funds and life insurance companies would expect to see Italian institutions, such as themselves, holding more than half of the Government's debts.

In Italy, however, Government debt directly held by individuals has been substituted for bank deposits on a dramatic scale during the 1980s. Not only are the institutions irrelevant to marketing Government debt, but they also seem to have limited relevance to Italian savers — hence their small role in the financial system. Even worse in the debt management context, they put much of their assets into real estate.

Figure 3. Distribution of Italian Government Debt, December 1988

Private/Foreign	66%
Banks	17
Mutual Funds	3
Pension Funds	1
Insurance Companies	2
Others	11
Total	100%

Source: Bank of Italy.

We believe the low penetration of the savings market by long-term financial institutions is probably the single biggest problem for debt management. Banks must remain prudent and match their assets to the type of liabilities (in the form of saving accounts) that they can sell to the public. Other institutions are so small that, even if they took an extraordinary view and held all their Government debt in the form of CTOs (Certificati del Tesoro con Opzione — six-year fixed-rate Treasury bonds), it would make hardly any difference to the average life of the Government's total debt.

The lack of regulation and transparency in the Italian financial markets is also a major deterrent to foreigners. The foreigner may easily lump the equity and bond markets together, the reputation of one affecting the other. Thus, an efficient and well-structured Government bond market would enhance the attractions of Italian financial markets in general.

The example of France shows what can be done over a period. This market of bewildering complexity was drastically simplified and, in a brilliantly-executed policy, transformed into a highly-liquid market, making it extremely attractive to foreigners. Yields have fallen drastically.

The Opportunities of 1992

Italy should seize the opportunity offered by 1992. The Italian savings market should be opened up to the other financial intermediaries of Europe, so they can market the type of savings products that have been welcomed by the population elsewhere.

Figure 4. Life Insurance Premiums Per Person, 1987 (US Dollar Equivalents)

Italy	\$74.4
France	381.7
West Germany	594.9
UK	705.8
USA	\$678.6
Japan	1,460.7

Source: Swiss Re.

The natural result, in due course, would be an institutionalisation of personal savings that, judged by experience elsewhere, would transform the maturity structure of personal savings. This is surely the prerequisite condition for the Government to lengthen its debt maturity. However, the time lags would be significant — certainly three or four years before a serious impact could be expected.

**Maturity
Transformation**

The more immediate and direct approach would be to satisfy the existing desire of these foreign institutions for high-quality long-term debt. This approach involves selling a lump of long-dated debt in addition to the existing lump of short debt — the "barbell" approach.

Such a plan can succeed only when foreigners' fear of the Italian bond markets has been overcome, which will require a carefully planned and thoroughly implemented marketing strategy. Initially, it will also require a sufficient reward to offset the perceived risk.

Market Needs

A glance at the Government bond markets of Europe reveals that the emerging "standard" European Government bond is a straightforward ten-year fixed-rate bullet issue. West Germany, France and the Netherlands issue this type in large quantity. They ensure liquidity with issue sizes of DM4 billion or more (Lit3 trillion) and an efficient secondary market.

Using this standard bond, Italy should implement a major borrowing programme in as many as possible of the other EMS currencies. The dawning era of monetary union offers Italy the possibility to sell to foreigners debt denominated in their own EC currencies with a diminished risk of devaluation losses — on either side.

Such a programme would be characterised by a progressive build-up of a highly-liquid yield curve, paralleling that of domestic Government debt. These liquid ten-year bonds would eventually shorten to become seven and then five years and so on, providing an opportunity to reopen the issue, if conditions seemed right.

The Deutschmark offers the greatest interest saving. However, the Dutch guilder is not far behind, followed by the French franc. Superficially, the UK's budget surplus has created a shortage of long-dated sterling debt. However, the higher interest rates and, more importantly, the lack of commitment to joining the ERM makes sterling debt much less attractive to Italy.

The implicit exposure of the Italian taxpayer to a major devaluation of the lira within the EMS would reinforce dramatically the credibility of the new currency relationship. Given the depth of the long-term capital markets of the EC member states, we believe that such a programme could make a significant impact on Italy's debt structure within a year or two. However, this is only part of the solution.

Simplify the Domestic Bond Market

The second part of the solution is the creation of a corresponding ten-year lira bullet bond market. The popularity of CCT (Certificati di Credito del Tesoro — variable rate Treasury certificates) shows that Italian savers are sensitive to the reward of an extra 50 basis points in yield compared with that of BOT (Buoni Ordinari del Tesoro — Treasury bills). Nonetheless, the economic characteristics of a ten-year fixed-rate issue are radically different from those of a floating-rate issue. Moreover, Italian long-term savings intermediaries are simply too small to create a sizeable maturity transformation of the debt. Foreigners, therefore, play a critical role in launching and sustaining such a market.

Consider the return that would be required by an Italian saver: CCTs presently yield 14.9% before tax for the next one-year coupon period; CTOs, if held to their six-year maturity, yield 13.6%, again before tax. A ten-year fixed-rate issue should, therefore, in today's conditions, need to carry a coupon of at least 14% to attract Italian savers. In the end, the only way of knowing for certain is to auction the bonds and see what the market really is prepared to pay.

How attractive would a 14% lira bullet bond be to foreigners? Assuming that the first part of the long-term approach was in place, then the institutions of Europe and the world would have been fully educated about the Italian Government's lira indebtedness — they are already familiar with the foreign currency credit standing. Amid the intense debate on monetary

union, foreign investors would look at the Italian commitment, demonstrated by the twin actions of narrowing the lira's fluctuations (in practice, this could be even narrower than the new, formal commitment of $\pm 2.25\%$) and launching a major EMS borrowing programme. They would undoubtedly find an Italian Government yield of, say, about 9% in Deutschmarks or 14% in lira an overwhelmingly attractive return.

Figure 5 shows, under some simple assumptions, the pattern of returns that may be achieved by investors in European bonds in the run-up to monetary union. Figure 5 uses two possible dates — five years ahead and ten years ahead — and assumes that there are no parity changes between these currencies in that time. Our vision of the completed monetary union assumes, perhaps unrealistically, that there will be no differentials between the yields of each country's bonds.

Figure 5. Total Returns of European Government Bonds

Country	10-Year Bond Yield ^a	Monetary Union in	
		5 Years ^b	10 Years ^b
Italy	14.0%	208	331
Spain	14.2	210	335
UK	11.3	182	282
Denmark	12.0	187	291
France	9.9	165	251
West Germany	8.6	151	228

^a Annual payment or equivalent. ^b Feb 19, 1990 = 100.

Note: Total return: capital gain plus income. Convergence of interest rates is assumed to be linear and coupons are reinvested tax-free.

Source: Salomon Brothers Inc.

The relative returns are striking and justify the view that such lira bonds would be highly attractive. Believers in monetary union would be rewarded — if it occurred — with a 50% higher return than the Deutschmark investment in only five years.

Implications of Capital Flows

Undoubtedly, balancing the capital flows involved would be a difficult task. To the extent that the EMS borrowing programme created capital inflows and substituted for lira debt, then lira interest rates should fall sufficiently to persuade Italian residents that it was worth investing abroad. Perhaps they might even buy their own Government bonds, but denominated in Deutschmarks or other currencies, rather than lira. This would partly offset capital outflows. Another component would be the reduction in capital inflows caused by Italian citizens borrowing foreign currency to invest in lira assets. This whole process of balancing flows would be given a further twist by foreigners buying Italian Government ten-year lira bonds.

The overall result would be a sharp fall in Italian interest rates, as well as the direct benefit of low-cost EMS borrowings. This would capture the savings for the Italian taxpayer. More properly, it would remove the cost imposed by the inefficiency of the existing Italian financial system. In addition, this balancing act would have been achieved by utilising — fully and vigorously — the freedoms of 1992 by "borrowing" the sophistication and efficiency of the rest of Europe's financial system.

This policy must only be adopted in the full knowledge that it would expose Italy's budgetary policies to the rigours of market discipline. One of the key aspects of the discussions on the Delors Committee Report is the method of curbing budgetary excesses. We recently argued² strongly that "binding budgetary rules" are unnecessary. A key safeguard against this disciplinary process occurring too abruptly is that the average life of a

² See, *Market Discipline CAN Work In The EC Monetary Union*, Salomon Brothers Inc, November 1989.

Government's debts should be sufficiently long. This underlines the critical importance of stabilising Italy's debt portfolio by lengthening the life.

Structure of the Bond Market

This policy may well create the right investment attractions to draw investors, and especially foreigners, towards longer-maturity lira bonds. However, the whole exercise will be doomed to failure if foreign investors continue to fear being trapped in an illiquid secondary market. The 1988 reforms do not yet appear to have succeeded in creating the aura of an efficient, liquid, transparent and well-regulated market.

Liquidity

The problem of the low institutionalisation of the market resurfaces as soon as liquidity is considered. Half to three quarters of an issue may be locked away in the hands of retail investors who do not trade them. Thus, the free float of issues can be very low. Despite the newly-introduced primary dealer system, it can be very difficult to deal in amounts even of \$5 million equivalent in the secondary market. This compares extremely unfavourably with the liquidity that the world's major financial institutions enjoy in other markets.

Figure 6. Typical Dealing Size for Two- to Five-Year Fixed-Rate Bonds

US	\$200-300 million
UK	20-25
West Germany	20-25
Japan	30-40
France	10-15
Italy	4

Source: Salomon Brothers Inc.

Figure 6 shows the sizes at which Salomon Brothers was prepared to deal on standard terms in a particular week (the Italian sizes were those indicated by various Italian banks, but only for those securities where the primary dealers were committed to making a market). Although some Italian issues are now being reopened in order to increase the size, this policy must be radically extended.

Bond Borrowing

The crucial secondary market liquidity will not appear simply because of the size of an issue. Careful attention must also be paid to the ability of dealers to borrow bonds, so that they can be short of a particular issue while they await the appearance of a genuine seller. The Bank of Italy may have a crucial role here — its holdings are nearly twice the combined holdings of the nonbank financial intermediaries. Bond borrowing can solve the delivery problem and can also be used to hedge the dealers' economic risk that yields may change.

Effective bond borrowing facilities have other uses. They enable dealers to arbitrage anomalies in the yield curve that might otherwise persist. It also enables the dealers to spread out the distribution of new issues by dealing in the expected issue's maturity area.

Repurchase Agreements

There is also a need for the opposite facility — repurchase agreements, or *pronti contro termine*. A dealer that has provided a liquid market to his customer may now be long of a sizeable position. Initially, he will require adequate "own-funds" — this is the subject of a key EC Directive on capital adequacy for securities dealers. Secondly, the dealer will need access to competitively-priced finance for this position. Such finance can take the form of a sale to another institution with a repurchase agreement — a repo — or collateralised loan facilities. The new capital adequacy standards, laid down by the Bank for International Settlements and incorporated into the EC by the Solvency Ratio Directive, should make such lending an attractive business for commercial banks.

Futures Market

Experience elsewhere has shown that the existence of a futures market can play a critical role in generating liquidity. Once ten-year fixed-rate lira issues have been made by the Italian Government, a futures contract should be initiated as soon as possible. Naturally, the specification should follow the successful models of the Bund, gilt and matif contracts to facilitate the management of risk.

Questions of bond borrowing, repos and futures may seem mere technical details. In fact, they are the foundation of a securities dealer's ability to offer customers a liquid market for bonds. Therefore, these technical aspects need to be thoroughly organised, so that the current absence of a "dealer culture" can be overcome. There must be no confusion of legal aspects of ownership of borrowed or lent securities, or of the tax implications — is it a taxable sale? — or of the creditworthiness of all the parties. The present system of forward purchases (or sales) is not nearly sufficient to create proper liquidity in the market.

Taxation

The Italian Finance Ministry announced in January 1990 that it was reviewing taxation on income and capital gains ahead of the July 1, 1990, deadline to remove all remaining exchange controls. While taxation is a large and complex topic, two aspects are noteworthy. First, withholding tax creates many distortions because of the variety of rates and the different treaties concluded with different countries. This results in a discrimination against investors from different EC states and can hardly be seen as being in the spirit of 1992. It is widely stated that there is a *six-year delay* in repaying this tax, where appropriate. This is inordinate and simply makes foreigners, as well as residents, pay more attention to the after-tax yields when making comparisons with other currencies. Perhaps part of the campaign to attract foreign investors should include the abolition of the withholding tax.

Second, the impact of Italian withholding tax on the whole ECU bond market leads to a serious distortion in the pattern of relative returns. This type of distortion can only serve to stunt the growth of this market — again, hardly in the spirit of 1992. This is particularly true when the result is a forced payment by some other Member States to the Italian Treasury.

Conclusion

1992 and the approach of monetary union gives Italy a unique opportunity to remove the costs inherent in the existing financial system. This opportunity should not be missed.

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I problemi associati al prestito di obbligazioni, accordi di riacquisto e contratti a termine potrebbero apparire meri dettagli tecnici. Di fatto, rappresentano le fondamenta dell'abilità di un negoziatore di titoli di offrire al cliente un mercato liquido delle obbligazioni. Di conseguenza, questi aspetti tecnici necessitano di un'approfondita organizzazione in modo da poter superare l'attuale assenza di una "cultura del negoziatore." Non deve esservi confusione di aspetti legali di proprietà di titoli presi in prestito o prestati o di implicazioni fiscali (si tratta forse di una vendita tassabile?) o del valore del credito di tutte le parti. L'attuale sistema di acquisto (o vendita) per consegna differita non basta a creare un'adeguata liquidità del mercato.

Tassazione

Il Ministero delle Finanze Italiano ha annunciato nel gennaio 1990 una revisione delle imposte sul reddito e sui redditi di capitale prima del 1° luglio 1990, scadenza per l'eliminazione di tutti i restanti controlli sui cambi. Nonostante la tassazione rappresenti un argomento ampio e complesso, due sono gli aspetti degni di nota. In primo luogo le ritenute fiscali creano molte distorsioni a causa della varietà dei tassi e dei vari trattati conclusi con diversi paesi. Questo porta ad una discriminazione verso gli investitori provenienti da diversi stati della Comunità Europea e può difficilmente essere considerata come parte dello spirito del 1992. Si dice spesso che esista un ritardo di sei anni nel ripagamento di questa tassa, laddove necessario. Questo crea confusione spingendo stranieri e residenti a prestare più attenzione ai rendimenti al netto di tasse in occasione di confronti con altre valute. Probabilmente una parte della campagna rivolta ad attirare investitori stranieri dovrebbe prevedere l'abolizione delle ritenute fiscali.

In secondo luogo, l'impatto delle ritenute fiscali italiane sull'intero mercato delle obbligazioni in ECU comporta una grave distorsione dello schema dei rendimenti relativi. L'unica conseguenza di questo tipo di distorsione potrebbe essere l'arresto della crescita di questo mercato, che ancora una volta, si inquadra difficilmente nello spirito del 1992. Questo appare particolarmente vero quando il risultato è un pagamento forzato da parte di alcuni Stati Membri al Tesoro Italiano.

Conclusioni

Il 1992 e l'avvicinarsi dell'unione monetaria offrono all'Italia l'opportunità unica di eliminare i costi insiti all'attuale sistema finanziario. E' un'occasione da non lasciarsi sfuggire.

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Il Debito Pubblico Italiano all'Alba dell'Unione Monetaria — Il Punto di Vista di uno Straniero

Di
Graham Bishop
721-3921 (*Londra*)

Febbraio 1990

Salomon Brothers



Il Debito Pubblico Italiano all'Alba
dell'Unione Monetaria — Il Punto
di Vista di uno Straniero

Di
Graham Bishop
721-3921 (*Londra*)

Il Debito Pubblico Italiano all'Alba dell'Unione Monetaria — Il Punto di Vista di uno Straniero¹

Di
Graham Bishop

In occasione del vertice di Strasburgo del dicembre 1989, i Capi di Governo della Comunità Europea hanno convenuto la preparazione di una Conferenza Intergovernativa per aprire la strada all'Unione Monetaria Europea "sotto gli auspici delle autorità italiane" prima della fine del 1990. Ancora una volta l'Italia si farebbe promotrice di un processo storico, come già fece nel 1985 con l'Atto Unico Europeo a Milano.

Alcuni ritengono che il debito pubblico italiano rappresenti uno dei maggiori ostacoli per il raggiungimento dell'unione monetaria. Non siamo d'accordo con questo punto di vista. Se l'avvicinarsi dell'unione monetaria viene visto come un'opportunità per staccarsi progressivamente dalle costrizioni del passato, esso verrà allora percepito come uno sviluppo costruttivo e non come una minaccia. Siamo convinti che l'Italia sarà il paese che trarrà i maggiori vantaggi dall'unione monetaria.

Riduzione dei Tassi di Interesse

Il vantaggio più evidente e rilevante che deriverebbe dalla realizzazione dell'unione monetaria sarebbe la potenziale riduzione dei tassi di interesse. Per quanto riguarda i tassi di interesse nominali, con l'avvicinarsi dell'unione monetaria, le differenze dovrebbero ridursi, venendo meno i timori associati alla svalutazione. Se il processo raggiungerà l'obiettivo prefisso di una valuta comune, le differenze dovrebbero diminuire, rispecchiando puri e semplici elementi di finanza pubblica — la capacità del Governo di ripagare il proprio debito in una valuta che non può più emettere liberamente. Ne deriverebbe per l'Italia un considerevole risparmio potenziale, sia in tassi nominali che reali. Sebbene il tradizionale "premio Italia" sia stato eroso nel corso del 1989, a causa di un irrigidimento della politica monetaria in tutti i Paesi della Comunità Europea, durante il 1988 e gran parte del 1987, i tassi di interesse reali italiani si trovavano di uno o due punti al di sopra della media degli altri membri del Sistema Monetario Europeo (SME). Una riduzione di un punto dei tassi nominali a breve termine corrisponderebbe approssimativamente allo 0,5% del prodotto nazionale lordo (PNL) solo per il primo anno, a causa del suo impatto sul costo degli interessi del debito pubblico.

Considerati sotto un altro punto di vista, questi potenziali risparmi rappresentano il costo diretto per il contribuente italiano dell'attuale sistema finanziario. Questo sistema include controlli sui cambi, tassazione, natura ed efficienza del mercato nei confronti del debito e ruolo degli intermediari che convogliano, o forse non riescono a convogliare, i risparmi italiani e stranieri in quel mercato.

Perchè Gli Stranieri Evitano Il Mercato Italiano Delle Obbligazioni?

Perchè gli investitori richiedono un apparente "premio di rischio" per convincersi a conservare titoli in lire? Che cosa temono?

Svalutazione

Riteniamo che il pericolo della svalutazione della lira sia ora molto ridotto. L'ultima significativa svalutazione di questo genere nell'ambito dello SME è avvenuta nel 1985. Nel gennaio 1990, l'Italia ha fatto rientrare il margine di fluttuazione della lira all'interno del meccanismo dei tassi di cambio dello SME, dal $\pm 6\%$ al $\pm 2,25\%$, in modo tale che la valuta si trovi ora limitata entro il terzo inferiore della banda precedente. Anche i controlli sui cambi sono stati ulteriormente ridotti e se ne prevede la totale eliminazione per il 1° luglio 1990, il che evidenzia l'impegno italiano per il raggiungimento dell'unione monetaria. Per tale ragione, l'avvicinarsi dell'unione monetaria dovrebbe ridurre il rischio della lira.

¹ Da un intervento del 4 dicembre 1989 in occasione del Seminario "La Gestione del Debito Pubblico e i Mercati Finanziari" presso il Centro di Economia Finanziaria e Monetaria dell'Università Commerciale Luigi Bocconi, Milano, Italia.

Si parla spesso di una crisi del debito italiano. Continui annunci di vendite di sbalorditive quantità di debito pubblico — alternati a notizie di aste di collocamento disertate — conferiscono credibilità a queste voci. Tuttavia, la verità è che i livelli del debito italiano non sono così considerevoli. Il relativo indebitamento degli Stati membri dello SME ed i corrispondenti tassi di interesse a breve termine suggeriscono che il debito italiano non è così elevato da giustificare un premio netto sui tassi di interesse.

Figura 1. Confronto tra Incidenza del Debito sul PNL e Tassi di Interesse Trimestrali

	Debito come Percentuale del PNL 1989S	Tassi di Interessi Trimestrali 26 gennaio 1990
Lussemburgo	9%	10%
Francia	35	11
Germania Occidentale	43	8
Spagna	44	15
Regno Unito	44	15
Danimarca	62	12
Portogallo	75	
Paesi Bassi	78	8
Grecia	82	
Italia	99	13
Irlanda	111	12
Belgio	127	10
Comunità Europea	58,4%	

S Stima

Fonti: Commissione Europea, *Financial Times*.

Debito a Breve Scadenza

La breve scadenza del debito pubblico italiano ingigantisce l'impressione di una crisi del debito. La vita media del debito pubblico è ora inferiore a tre anni. Per tale ragione, in media, i debiti pari ad un terzo del Prodotto Nazionale Lordo devono venire rifinanziati ogni anno. A nostro parere, il 1990 sarà un anno particolarmente difficile, con rimborsi pari al 40% del Prodotto Nazionale Lordo. Considerando anche il fabbisogno del nuovo deficit, sarà necessario emettere, su *base mensile*, obbligazioni equivalenti al 4%-5% del Prodotto Nazionale Lordo. È difficile raccogliere dati corrispondenti per gli altri Stati della Comunità Europea, tuttavia la vita delle obbligazioni pubbliche sui loro mercati è significativa. Le obbligazioni sono definite come titoli caratterizzati da più di un anno di vita. Le obbligazioni del Regno Unito hanno la vita più lunga, 10,9 anni di media. Tra i paesi più importanti, le obbligazioni della Germania Occidentale hanno la vita più corta, 5,4 anni di media.

Stupefacente Varietà di Titoli

Per uno straniero, la varietà di titoli del debito italiano è stupefacente ed i confronti sono ulteriormente complicati da tre diversi regimi di trattenute fiscali, a seconda della data di emissione originaria.

Figura 2. Principali Titoli dello Stato Italiano, febbraio 1989

(Lire Italiane in migliaia di miliardi)

Tipo	Gamma di Maturazione		Numero di Emissioni	Volume del Mercato	Volume Medio Emissione
BOT	3-12 mesi	Titolo Scontato	42	Lit245	Lit5,8
BTP	2-5 anni	Cedola Fissa	54	146	2,7
CCT	5-10 anni	Cedola Fluttuante	86	346	4,0
Altro ^a			35	38 ^b	1,1
Totale			217		

^a Inclusi quelli indicizzati sull'ECU, le opzioni e quelli legati all'inflazione.

^b Luglio 1989. BOT Buoni Ordinari del Tesoro. BTP Buoni del Tesoro Poliennali.

CCT Certificati di Credito del Tesoro.

Fonte: Banca d'Italia.

Bassa Istituzionalizzazione

Gli istituti finanziari stranieri hanno l'impressione che i mercati italiani siano scarsamente sofisticati, perché avvertono una carenza di investitori istituzionali che rivestano un ruolo dominante corrispondente al loro. Di norma, queste compagnie assicurative e fondi pensionistici si aspetterebbero di vedere gli equivalenti istituti italiani detenere, come loro, più della metà del debito dello Stato.

In Italia, invece, nel corso degli anni '80 il debito pubblico ha rimpiazzato i depositi bancari quale forme di risparmio finanziario delle famiglie. Gli investitori istituzionali non solo sono estranei alla commercializzazione del debito pubblico, ma sembrano anche rivestire scarsa importanza per i risparmiatori italiani — da qui il loro ruolo irrilevante all'interno del sistema finanziario. Questa situazione si riflette anche nella gestione dei loro portafogli dove impegnano gran parte delle proprie attività nei beni immobili.

Figura 3. Distribuzione del Debito dello Stato Italiano, Dicembre 1988

Privato/Estero	66%
Banche	17
Fondi Comuni di Investimento	3
Fondi Pensionistici	1
Compagnie Assicurative	2
Altro	11
Totale	100%

Fonte: Banca d'Italia.

Riteniamo che la scarsa penetrazione del mercato dei risparmi da parte degli investitori istituzionali finanziari a lungo termine rappresenti probabilmente l'unico problema significativo per la gestione del debito. Le banche devono essere caute ad abbinare le proprie attività al tipo di passività (in forma di conti di risparmio) che possono vendere al pubblico. Altri istituti sono di dimensioni così ridotte che, anche se adottassero politiche straordinarie e mantenessero la totalità del loro debito pubblico in forma di Certificati del tesoro con opzione (CTO), non cambierebbe in modo rilevante la vita media del debito totale dello Stato.

La mancanza di regolamentazione e di trasparenza a livello dei mercati finanziari italiani costituisce anche uno dei principali deterrenti per gli stranieri. Lo straniero può facilmente confondere i mercati delle azioni ordinarie e delle obbligazioni, e la reputazione dell'uno influenzerebbe quella dell'altro. Per tale ragione, un mercato delle obbligazioni efficiente e ben strutturato potenzierebbe le attrattive dei mercati finanziari italiani nel loro complesso.

L'esempio della Francia mostra che cosa è possibile fare nell'arco di un dato periodo. Questo mercato di sorprendente complessità è stato drasticamente semplificato e, grazie ad una politica brillantemente condotta, trasformato in un mercato fortemente liquido ed estremamente allettante per gli stranieri. Si è così registrata una drastica diminuzione dei rendimenti.

L'opportunità del 1992

Istituzionalizzazione dei Risparmi

L'Italia dovrebbe cogliere l'opportunità offerta dal 1992. Il mercato italiano dei risparmi dovrebbe venire aperto agli altri intermediari finanziari europei, in modo tale che essi possano commercializzare il genere di prodotti di risparmio che è stato favorevolmente accolto dalla popolazione di altri paesi.

Figura 4. Premi di Assicurazione sulla Vita Per Persona, 1987
(Equivalenti in dollari USA)

Italia	\$74,4
Francia	381,7
Germania Occidentale	594,9
Regno Unito	705,8
USA	\$678,6
Giappone	1,460,7

Fonte: Swiss Re.

Il naturale risultato, a tempo debito, sarebbe un'istituzionalizzazione dei risparmi personali che, giudicata in base alle esperienze raccolte altrove, trasformerebbe la struttura della maturazione dei risparmi personali. Questa è sicuramente la condizione preliminare affinché lo Stato possa prolungare la scadenza del proprio debito. Tuttavia trascorrerebbero significativi intervalli di tempo, almeno tre o quattro anni prima che si preveda il verificarsi di un impatto considerevole.

Trasformazione della Scadenza

L'approccio più immediato e diretto sarebbe quello di soddisfare l'attuale desiderio di questi istituti stranieri per un debito a lungo termine di alta qualità. Questo approccio consiste nella vendita di titoli a lunga scadenza in aggiunta all'attuale insieme di titoli a breve termine — l'approccio del "bilanciamento dei pesi."

Tale progetto potrà avere successo solo quando si sarà riusciti a superare la paura che gli stranieri hanno dei mercati italiani delle obbligazioni, il che richiederà una strategia di mercato attentamente studiata e approfonditamente applicata. Inizialmente sarà anche necessario un premio adeguato che controbilanci il rischio percepito.

Esigenze del Mercato

Uno sguardo ai mercati europei delle obbligazioni di Stato rivela che l'obbligazione governativa europea "standard" emergente è un'emissione decennale a reddito fisso. Germania Occidentale, Francia e Paesi Bassi emettono un grande numero di questo genere di titoli. Essi garantiscono liquidità con volumi di emissione pari a 4 miliardi o più di DM (tremila miliardi di lire) ed un efficiente mercato secondario.

Utilizzando questa obbligazione standard, l'Italia dovrebbe realizzare un importante programma di prestiti nel maggior numero possibile di altre valute SME. L'era nascente dell'unione monetaria offre all'Italia la possibilità di vendere a stranieri debiti nelle valute della Comunità Europea con minor rischio di perdita per svalutazioni, per entrambe le parti.

Tale programma sarebbe caratterizzato da una progressiva formazione di una curva dei rendimenti ad elevata liquidità, parallela a quella del debito nazionale del Governo. Queste obbligazioni liquide decennali tenderebbero infine a diventare settennali, dopodiché quinquennali e così via, offrendo l'opportunità di riaprire le emissioni, in presenza di condizioni idonee.

Il marco tedesco offre il maggiore risparmio di interessi. Seguono a breve distanza il fiorino olandese e quindi il franco francese. L'eccedenza budgetaria del Regno Unito ha determinato una scarsità di debito in sterline a lungo termine. Tuttavia, i maggiori tassi di interesse e, cosa più importante, la mancanza di impegno per il raggiungimento del meccanismo dei tassi di cambio rendono il debito in sterline molto meno allettante per l'Italia.

Inoltre, l'implicita esposizione del Tesoro e del contribuente italiano ad una maggiore svalutazione della lira nell'ambito dello SME rafforzerebbe notevolmente la credibilità del rapporto della nuova valuta. Considerata la profondità dei mercati finanziari a lungo termine degli Stati membri della

Come Semplificare il Mercato Nazionale delle Obbligazioni

Comunità Europea, riteniamo che tale programma potrebbe esercitare un impatto significativo sulla struttura del debito italiano nel giro di uno o due anni. Questa rappresenta tuttavia solo una parte della soluzione.

La seconda parte della soluzione consiste nella creazione di un corrispondente mercato di titoli decennali a reddito fisso in lire. La popolarità dei Certificati di Credito del Tesoro (CCT) rivela la sensibilità del risparmiatore italiano nei confronti di un rendimento di 50 punti in più rispetto a quello dei Buoni Ordinari del Tesoro (BOT). Ciononostante, le caratteristiche economiche di un'emissione decennale a tasso fisso sono nettamente diverse da quelle di un'emissione a tasso fluttuante. Inoltre, gli intermediari italiani specializzati nella gestione del risparmio a lungo termine sono semplicemente troppo piccoli per poter trasformare in modo consistente la durata del debito. Gli stranieri svolgerebbero dunque un ruolo importante nel lanciare e sostenere un simile mercato.

Considerate quale rendimento verrebbe richiesto da un risparmiatore italiano; attualmente i CCT rendono il 14,9% al lordo di tasse per il prossimo periodo di un anno; i CTO, qualora conservati fino alla loro scadenza di sei anni, rendono il 13,6% sempre al lordo di tasse. Di conseguenza, vista l'attuale situazione, un'emissione decennale a tasso fisso dovrebbe avere una cedola almeno del 14% per poter allettare il risparmiatore italiano. In ultima analisi, l'unico modo per ottenere dati sicuri è quello di vendere all'asta le obbligazioni e vedere quanto il mercato in realtà è disposto a pagare.

Fino a che punto un titolo a reddito fisso in lire al 14% potrebbe attirare gli stranieri? Presupponendo che la prima parte dell'approccio suggerito sia già stato attuato, gli investitori istituzionali europei e mondiali sarebbero già completamente informati in merito all'indebitamento dello Stato italiano; conoscerebbero già il credito della valuta. Durante l'acceso dibattito sull'unione monetaria, gli investitori stranieri considererebbero l'impegno italiano dimostrato dalle azioni contemporanee di riduzione delle fluttuazioni della lira (in pratica tale riduzione potrebbe essere addirittura inferiore al nuovo impegno formale del $\pm 2,25\%$) e del lancio di un importante programma di prestiti in valute SME. Giudicherebbero senz'altro un rendimento dello Stato italiano, diciamo, del 9% in marchi tedeschi o del 14% in lire, un utile irresistibilmente interessante.

La Figura 5 illustra, in ipotesi, gli utili che gli investitori potrebbero ottenere con i titoli europei nella corsa verso l'unione monetaria. La Figura 5 utilizza due possibili date: cinque anni e dieci anni e presuppone che non avvengano fra queste valute cambiamenti in parità. La nostra visione dell'avvenuta unione monetaria presuppone, forse irrealisticamente, che non vi siano differenze fra i rendimenti delle obbligazioni di ciascun paese.

Figura 5. Utili Totali delle Obbligazioni Statali Europee

Paese	Rendimento Obbligazioni decennali ^a	Unione Monetaria	
		fra 5 Anni ^b	fra 10 Anni ^b
Italia	14,0%	208	331
Spagna	14,2	210	335
Regno Unito	11,3	182	282
Danimarca	12,0	187	291
Francia	9,9	165	251
Germania Occidentale	8,6	151	228

^a Pagamento annuale o equivalente. ^b Feb 19, 1990 = 100.

Nota: Utile totale: plusvalenza più reddito. Si presuppone una convergenza dei tassi di interesse lineare e le cedole vengono reinvestite esenti da tasse.

Fonte: Salomon Brothers Inc.

Implicazioni sui Flussi di Capitale

Gli utili relativi sono sorprendenti e giustificano l'opinione secondo la quale dette obbligazioni in lire sarebbero decisamente interessanti. I sostenitori dell'unione monetaria verrebbero compensati, se questa si verificasse, con un utile del 40% in più rispetto all'investimento in marchi tedeschi nel giro di soli cinque anni.

Senza dubbio, il bilanciamento dei flussi di capitale interessati, rappresenterebbe un'ardua impresa. Se il programma prestiti SME creasse afflussi di capitale e sostituisse il debito in lire, i tassi di interesse in lire registrerebbero una diminuzione sufficiente da convincere i residenti italiani della convenienza degli investimenti all'estero. Potrebbero addirittura acquistare le obbligazioni del loro Paese ma in marchi tedeschi o in altre valute piuttosto che in lire. Questo controbilancerebbe in parte le uscite di capitale. Un'altra componente sarebbe la riduzione degli afflussi di capitale provocata dai cittadini italiani che prendono in prestito valuta straniera per investire in titoli in lire. Un'ulteriore scossa a questo processo di bilanciamento dei flussi verrebbe dall'acquisto da parte di stranieri di obbligazioni decennali in lire dello Stato italiano.

Il risultato globale sarebbe una netta diminuzione dei tassi di interesse italiani nonché il beneficio diretto per le casse dello Stato grazie ai prestiti in valute SME. Questo attirerebbe risparmi a vantaggio del contribuente italiano. Più precisamente, annullerebbe il costo imposto dall'inefficienza dell'attuale sistema finanziario italiano. Inoltre, questa operazione di bilanciamento verrebbe conclusa utilizzando pienamente ed efficacemente le libertà del 1992 "prendendo in prestito" la complessità e l'efficienza del sistema finanziario del resto dell'Europa.

Questa politica deve venire adottata soltanto nella piena consapevolezza del fatto che esporrebbe le politiche budgetarie italiane alla severa disciplina di mercato. Uno dei punti chiave delle discussioni sulla Relazione della Commissione Delors è rappresentato dal metodo per tenere a freno gli eccessi budgetari. Abbiamo di recente dibattuto² l'inutilità di "norme budgetarie vincolanti." Un punto chiave di difesa contro la troppo brusca evoluzione di questo processo disciplinario consisterebbe in una durata sufficientemente lunga della vita media dei debiti di uno stato. Questo evidenzia l'enorme importanza della stabilizzazione del portafoglio debiti italiano tramite l'aumento della durata.

Struttura del Mercato delle Obbligazioni

Questa politica potrebbe creare anche le attrattive di investimento adeguate per richiamare gli investitori, in particolar modo stranieri, verso obbligazioni in lire a scadenza più lunga. Tuttavia, tale politica sarà destinata al fallimento se gli investitori stranieri continueranno a temere di restare intrappolati in un mercato secondario a scarsa liquidità. Le riforme del 1988 non sembrano ancora essere riuscite a creare l'aura di un mercato efficiente, liquido, trasparente e ben regolamentato.

Liquidità

Il problema della scarsa istituzionalizzazione del mercato riemerge non appena viene presa in considerazione la liquidità. Da metà a tre quarti di un'emissione può essere bloccata nelle mani di investitori al dettaglio che non mettono le obbligazioni in commercio. Di conseguenza la libera fluttuazione delle emissioni può essere decisamente limitata. Malgrado il sistema di distribuzione primario di recente introduzione, può risultare molto difficile trattare sul mercato secondario somme persino equivalenti a 5 milioni di dollari. Questo risulta estremamente sfavorevole rispetto alla liquidità di cui godono i maggiori istituti finanziari mondiali in altri mercati.

² Cfr. *Market Discipline CAN Work In The EC Monetary Union*, Salomon Brothers Inc, Novembre 1989.

Figura 6. Volume Tipico di Operazioni di Titoli a Tasso Fisso da Due a Cinque Anni

USA	200-300 milioni di dollari
Regno Unito	20-25
Germania Occidentale	20-25
Giappone	30-40
Francia	10-15
Italia	4

Fonte: Salomon Brothers Inc.

Prestito di Obbligazioni

La Figura 6 illustra i volumi che Salomon Brothers era disposta a trattare in condizioni "standard" in una data settimana (i volumi italiani sono quelli indicati da varie banche italiane, ma soltanto per quei titoli per cui i principali negozianti erano impegnati a trattare). Benché alcune emissioni italiane siano oggi in fase di riapertura, per aumentarne il volume, appare la necessità di estendere in maniera radicale questa politica.

L'importante liquidità del mercato secondario non si deduce semplicemente dal volume di un'emissione. E' necessario fare anche attenzione all'abilità dei negozianti nel prendere in prestito obbligazioni così da poter permettersi di essere a corto di una particolare emissione nell'attesa di trovare un venditore vero. La Banca d'Italia potrebbe svolgere in questo caso un ruolo importante, le sue posizioni sono circa il doppio rispetto all'insieme delle posizioni di intermediari finanziari diversi da banche. Il prestito di obbligazioni può risolvere il problema della consegna e può anche essere utilizzato per arginare il rischio economico per i negozianti rappresentato dal cambiamento di rendimenti.

Efficienti strutture di prestito delle obbligazioni hanno altri utilizzi. Consentono ai negozianti l'arbitraggio delle anomalie nella curva di rendimento che potrebbero altrimenti persistere. Consentono anche ai negozianti di ampliare la distribuzione di nuove emissioni trattando nella prevista area di scadenza dell'emissione.

Accordo di Riacquisto

Vi è anche l'esigenza della struttura opposta: gli accordi di riacquisto o pronti contro termine. Un negoziante che ha fornito un mercato liquido al suo cliente potrebbe disporre ora di una posizione consistente. Inizialmente avrà bisogno di adeguati "fondi propri" e questo è l'argomento di una direttiva chiave della Comunità Europea sull'adeguatezza del capitale per i negozianti di titoli. Secondariamente, il negoziante dovrà poter accedere ad un sistema finanziario di prezzi competitivi per questa posizione. Questo potrebbe assumere la forma di una vendita ad un'altra istituzione con un accordo di riacquisto, o "repo," o strutture di mutuo collateralizzate. Le nuove norme di adeguamento del capitale, messe a punto dalla Banca Internazionale dei Regolamenti ed incorporate nella Comunità Europea tramite la Direttiva sul Coefficiente di Solvibilità, dovrebbero fare del detto prestito un'attività interessante per le banche commerciali.

Mercato a Termine

L'esperienza fatta altrove ha mostrato che l'esistenza di un mercato a termine può svolgere un ruolo importante nella creazione di liquidità. Una volta che lo Stato italiano avrà emesso titoli decennali in lire a tasso fisso, sarà necessario avviare il prima possibile un contratto a termine. Naturalmente le specifiche dovranno seguire i modelli di successo dei contratti "Bund," "Gilts" e "Matif" allo scopo di agevolare la gestione del rischio.

I problemi associati al prestito di obbligazioni, accordi di riacquisto e contratti a termine potrebbero apparire meri dettagli tecnici. Di fatto, rappresentano le fondamenta dell'abilità di un negoziatore di titoli di offrire al cliente un mercato liquido delle obbligazioni. Di conseguenza, questi aspetti tecnici necessitano di un'approfondita organizzazione in modo da poter superare l'attuale assenza di una "cultura del negoziatore." Non deve esservi confusione di aspetti legali di proprietà di titoli presi in prestito o prestati o di implicazioni fiscali (si tratta forse di una vendita tassabile?) o del valore del credito di tutte le parti. L'attuale sistema di acquisto (o vendita) per consegna differita non basta a creare un'adeguata liquidità del mercato.

Tassazione

Il Ministero delle Finanze Italiano ha annunciato nel gennaio 1990 una revisione delle imposte sul reddito e sui redditi di capitale prima del 1° luglio 1990, scadenza per l'eliminazione di tutti i restanti controlli sui cambi. Nonostante la tassazione rappresenti un argomento ampio e complesso, due sono gli aspetti degni di nota. In primo luogo le trattenute fiscali creano molte distorsioni a causa della varietà dei tassi e dei vari trattati conclusi con diversi paesi. Questo porta ad una discriminazione verso gli investitori provenienti da diversi stati della Comunità Europea e può difficilmente essere considerata come parte dello spirito del 1992. Si dice spesso che esista un ritardo di *sei anni* nel ripagamento di questa tassa, laddove necessario. Questo crea confusione spingendo stranieri e residenti a prestare più attenzione ai rendimenti al netto di tasse in occasione di confronti con altre valute. Probabilmente una parte della campagna rivolta ad attirare investitori stranieri dovrebbe prevedere l'abolizione delle trattenute fiscali.

In secondo luogo, l'impatto delle trattenute fiscali italiane sull'intero mercato delle obbligazioni in ECU comporta una grave distorsione dello schema dei rendimenti relativi. L'unica conseguenza di questo tipo di distorsione potrebbe essere l'arresto della crescita di questo mercato, che ancora una volta, si inquadra difficilmente nello spirito del 1992. Questo appare particolarmente vero quando il risultato è un pagamento forzato da parte di alcuni Stati Membri al Tesoro Italiano.

Conclusioni

Il 1992 e l'avvicinarsi dell'unione monetaria offrono all'Italia l'opportunità unica di eliminare i costi insiti all'attuale sistema finanziario. E' un'occasione da non lasciarsi sfuggire.

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1992 and Beyond

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1992 And Beyond

Market Discipline CAN Work In The EC Monetary Union

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Summary

Monetary union... In June 1988, the European Council "confirmed the objective of progressive realisation of economic and monetary union." The Delors Committee was appointed to propose "concrete stages leading towards this union." In purely economic terms, there are probably two principal requirements for such a union to be credible and permanent:

- Fiscal prudence — to guard against inflation; and
- Internal balance — to prevent weaker countries from becoming impoverished.

Through budgetary rules...

The Delors Committee's *Report On Economic And Monetary Union in the European Community*, published in April 1989, stresses the need for the coordination of fiscal and budgetary policy to achieve "internal balance." To achieve fiscal prudence, it proposes to set binding budgetary rules, to exclude monetary financing and put limits on external borrowing. In its choice of tactics, the Committee specifically took the view that — as a major alternative policy — market forces could not be relied upon to provide the necessary discipline to prevent the development of budgetary excesses.

Or market discipline?

On the contrary, market forces have exerted powerful disciplinary pressures — when given the freedom to do so. This study explores the factors that enable — and are technically necessary for — the markets to sense the need for discipline and then to exert it progressively. We define this discipline as, initially, a widening of the differential in the price of the debt of the deteriorating debtor compared with the European average. Further down the road, there is the inevitable, ultimate sanction of market discipline: the markets may no longer be willing to provide credit at any reasonable price.

Three necessary conditions

Three conditions must be satisfied in order for market discipline to work properly as markets fulfill their natural function:

- Capital must be able to move freely;
- Full information must be available on the creditworthiness, and the debts, of the borrower; and
- The markets must be convinced that there is no possibility of a bail-out — that there are no formal or implicit guarantees that obligations will be met.

Whether governments choose to pay attention to the market's message — and whether they do so at an early or a late stage — remains their own sovereign political decision. In principle, this decision corresponds to their willingness to abide by the overall budgetary controls suggested in the Delors Committee Report — the only difference is the source of the disciplinary pressure.

Market discipline can readily provide the flexibility to respond to changed circumstances — and the certain and final sanction of rejection from the credit markets. But can "detailed binding budgetary rules" offer the same combination of flexibility and certainty of ultimate sanction — and what is their final sanction?

Lessons From Other Monetary Unions

The European Community (EC) has barely, if at all, started to construct a federal system of government, and it would be premature to conclude that there is any broad political consensus to "build a nation." Indeed, many people oppose this concept and it may not even be appropriate for Europe. The Delors Committee Report states that, "even after attaining economic and monetary union, the Community would continue to consist of individual nations with differing economic, social, cultural and political characteristics." Monetary union is not a new concept, so other examples should be analysed to identify their objectives, the methods used to achieve those objectives and the problems.

The history of monetary unions suggests that the desire to build a nation has been a critical factor in determining the extent of central Government assistance in a financial crisis. A key reason for the emergency assistance has been pinpointed as the belief that the union's international credit standing would be damaged, with a corresponding impact on its ability to borrow or refinance debt abroad. This factor may have been a real constraint for a developing nation looking to attract capital. However, the mature States of the European Community are, if anything, in the opposite position. Over the past 30 years, the Community's members have only run significant collective current account deficits during each of the two "oil shock" years. Thus, there is no aggregate Community need to import capital. The absence of this requirement will have a vital bearing on the design of European monetary union, because it is not necessary to attract risk-averse and volatile foreign investors. Instead, it is sufficient merely to avoid frightening domestic investors to the point where they feel obliged to protect themselves by exporting their capital.

It is instructive to look at the mechanisms that have evolved in other monetary unions, such as Australia, West Germany and Canada. Australia and West Germany are "tight" federal systems, where the central Government exerts such a degree of fiscal control that credit distinctions between the constituent states are almost nonexistent: this is, in fact, the precise intention of these systems.

Canada, on the other hand, has a much "looser" federal system, where individual credit ratings exert considerable market discipline on the provinces. In contrast to Australia and West Germany, the Canadian system sets out to apply a measure of market discipline — and has succeeded. Interestingly, Canada unites this market discipline with a successful and wide-ranging system of monetary transfers to the provinces — without this being seen as an implicit guarantee of provinces' budgetary deficits.

Australia

The Australian central or Commonwealth Government, through a Loan Council system functioning since 1933 (and a dominant role in revenue collection assumed during World War II and not acceded back to the States since that time), has obtained *de facto* control over the fiscal policies of each of the six States. Differences in the States' borrowing terms in the domestic market are determined more by liquidity and technical considerations than by any marked distinction in fiscal policies or budgetary priorities. Both American rating agencies (Moody's and Standard and Poor's) have recognised that Commonwealth Government fiscal control and explicit budgetary support are more important than differences in State fiscal policies and have assigned ratings to all of the States, borrowing authorities and State-owned enterprises that are identical to those of the Commonwealth (Aa2/AA). This is discussed further in Appendix I (see page 8).

**"Tight" unions
with budget
control, not
market discipline**

West Germany

The Federal Republic of Germany represents a strong commitment to federation, primarily because of provisions in the 1949 Basic Law aimed at achieving homogeneous living standards throughout the Republic and allocating responsibility for "financial and economic harmony" on a nationwide scale to the Federal Government. The Federal Government supervises a fiscal equalisation system that attempts to provide all citizens with a roughly uniform standard of public services. More importantly, it exerts significant control over the budgetary policies of the 11 States, or Länder, through a Fiscal Planning Council that attempts to coordinate overall fiscal policy in carrying out the stable growth mandate of the Federal Government. Moreover, the Länder are permitted to borrow only for investment purposes, and the Federal Government can impose ceilings and rules regarding terms, conditions and timing for borrowings by all levels of Government if national economic balance is disturbed by such activities. This is discussed further in Appendix I (see page 8).

The monetary unions represented by the federal systems in Canada and the United States are much looser fiscally and politically and thus more market-oriented than those in Australia or West Germany. The Federal Government in the United States has historically taken a benign role in regional development, and there is no concerted effort to reduce economic disparities among the 50 States.

Canada

Canada's vast geography but small population has caused the Canadian Federal Government to become deeply involved in alleviating regional inequalities and contributing to economic development in remote or economically depressed areas. Nevertheless, Canada's implicit credit support for its provinces is much more subtle than Australia's or that of the Federal Republic of Germany, falling far short of either control over fiscal policy or a guarantee of creditworthiness. The domestic provincial bond market in Canada does "rank" the provinces according to typical credit measurements: laxity or tightness of fiscal policy, economic dynamism and political commitment to budgetary stabilisation. A similar "ranking" of the provinces exists in the other international markets in which they borrow (primarily the Yankee and Eurobond markets).

Provincial concern about the ratings of the two Canadian agencies and the two US agencies (and thus the cost of servicing debt), and a spate of provincial downgrades by these agencies between 1980 and 1987, is undoubtedly one of the reasons why almost all of the provinces have reduced their budgetary deficits in the past three years. The Canadian monetary union, because it combines significant economic support with only an extremely vague "guarantee" of fiscal support, is probably the best existing example of a monetary union in which market sanctions work well against the constituent members. This is discussed further in Appendix I (see page 9).

Applying the Lessons

**Binding budgetary
rules can be
circumvented**

The New York City debt crisis of 1975 provided a classic example of the problems of a monetary union. Probably the most powerful lesson is that a determined administration could circumvent any prudent constitutional arrangements. In this case, the legislative "check" of the superior body — New York State — failed entirely, because New York State systematically permitted its checks to be avoided by abuses of borrowing powers. Moreover, New York State had little moral standing to enforce these checks, because its own finances were parlous — also due to budgetary excesses.

Looking at the growth of European "pork barrel" politics — perhaps exemplified by the EC's Common Agricultural Policy — there can be little confidence that late-night, budget cooperation deals would not fall into the same trap. That would be the precise moment when "vital national interests" were at stake and could easily warrant a threat to leave the union. The EC's proposed "binding budgetary rules" could well be vulnerable under these circumstances. How can these rules be enforced? What is the ultimate sanction that corresponds to the financial markets' undoubted ability to cut off new supplies of credit?

New York City, for example, succeeded in circumventing the rules and chose to ignore the ever-rising interest rate signals from the market. Having ignored this stage of the market's discipline, the City's fiscal imprudence was finally brought to a halt by the brutal discipline of total rejection, rather than the application of any budgetary rules. This is discussed further in Appendix II (see page 14).

This example of the failure of constitutional rules to prevent budgetary excesses raises two issues. First, how can the EC impose rules? What will the sanctions be? Second, how can the rules be specified in a manner that takes proper account of the variation of conditions both between Member States and over time? There must be a risk that the rules will be too easily circumvented by creative accounting or, alternatively, too rigid and therefore arbitrary.

*Conditions
necessary for
market discipline*

If binding budgetary rules are one end of the spectrum of possible policies, then strict market discipline is the other end. This will require lenders to be explicitly clear that the donors of financial support will not pay more than they have already willingly agreed. As monetary financing is precluded by the proposed fact of monetary union, Member States will have to borrow from the financial markets — principally those that intermediate the pool of all Community savings. We believe that the financial markets can provide the "check" of market discipline if the agreed "balance," such as revenue transfer, is exceeded. **The ultimate check will be a complete withdrawal of new credit supplies.**

In summary, there are three obvious conditions that must be satisfied for market discipline to work properly.

*Free movement of
capital*

First, savers must not be legally coerced into lending money to a particular state. This coercion may be the effective result of exchange controls or perhaps controls on the investment of assets, which are no longer necessary for proper, prudential regulation. The historic agreement in June 1988 to end exchange controls within the EC was the key step forward in achieving this goal.

Full information

Second, to make an informed judgement, savers must be fully informed about creditworthiness, including the debts of the state in question. Although much of the obvious data is already published by the European Commission, probably very few investors are aware of this fact. However, in many states, much government finance is transacted through private placements, where maturity and interest rate sensitivity are not necessarily published. Full data on the maturity structure of all of the debt servicing obligations likely to be faced by a government, even under the worst circumstances, are essential if the markets are to form a proper judgement of the risks.

The critical problems are likely to arise in the very areas that are not obvious, for example, entities or corporations that are owned by, or associated with, the public sector. Should their debts be included? What about "moral obligations?" Binding budgetary rules will inevitably encourage creative accounting. A review of the New York City debt crisis of 1975 provides a lesson on creative public finance. It might be appropriate to categorise the types of public sector debtors. Member States

should then be required to report those institutions that fall within those categories and provide timely and continuing details of their debts and servicing obligations on the basis of standardised accounting. Correspondingly, the European Commission should be required to collate and publish these reports. (A thorough clarification of the exact standing of many debtors is already necessary to manage the risk-weighting system that will be imposed on banks by the EC's Solvency Ratio Directive.)

No bail-out

The third and single most critical condition — that a fiscally imprudent state will not be bailed out by the Community — should probably be incorporated in an amendment to the Treaty of Rome itself. Such an amendment could well include specific measures to eliminate the possibility of formal guarantees or other powers to ensure the solvency and liquidity of Member States.

Subsidiary legislation should spell out the requirements necessary to make Member States' overall indebtedness transparent to investors, including standardised accounting. It should also set minimum prudential standards of debt management (the corollary to those that the Member States have just imposed on their banking system by setting minimum capital standards). It may be necessary to prohibit the European System of Central Banks from purchasing public sector debt, which would negate the market's discipline. Prudent debt management can ensure that this disciplinary process becomes progressively tougher only over many years.

This subsidiary legislation should be subject to majority voting, so that any moves against abuses cannot be blocked by the abuser. Correspondingly, it would be extraordinary if a blocking minority could not be mustered to prevent any significant weakening.

The intention of such tactics is to put the financial markets on notice that there can be no formal guarantee of any Member State by the others. Theoretically, such a treaty amendment could be reversed, but the financial markets would be aware of the difficulties and lengthy timescale for unanimous agreement and ratification. In the event that a Member State reached financial crisis, such a process would be too lengthy and uncertain to give investors any comfort that they would be paid on time. Thus, any real signs of impending crisis would induce a flight by investors sufficient to send a clear and visible signal of the price of that State's debt.

(If the cause of the financial crisis were not fiscal imprudence, but some major national disaster, for example, then there are already mechanisms available that the other Member States could use to volunteer extra assistance during the adjustment.)

Even if the market is convinced that there are no explicit and formal guarantees, or other methods of ensuring that obligations are met, how can it be convinced that there are no implicit guarantees? Resource transfers are important in gluing a monetary union together and maintaining internal balance. The difficulty is in achieving the balance between first, supporting the poorer constituents sufficiently to make credible their continued membership of the union, and second, effectively offering an implicit guarantee. The Canadian system provides a fascinating example of how far-reaching transfers of resources can be combined with a considerable measure of market discipline.

If these three conditions are met, then it seems inconceivable that the financial markets would fail to observe the signs of progressive financial deterioration and charge an appropriate premium for extra loans. Indeed, markets already make credit distinctions between the EC States when they

borrow outside their domestic currency. These States are extremely sensitive about the terms on which they borrow, precisely because it is a reflection of their creditworthiness. This is discussed further in Appendix III (see page 18).

The United States has provided a lesson in the perils of even starting down the "bail-out" road. Moral obligations can become a serious budgetary item, as shown by the bail-out of the thrift industry. At a cost to the public of well over \$150 billion, the bail-out in effect protects all depositors — not merely those who are formally insured. **The European Community should learn this lesson thoroughly.**

Building in the Safeguards

Gradual application of market discipline

Given the sudden and drastic withdrawal of new credit supplies from New York City in 1975 and the less developed countries (LDC) after 1982, there may be concern that the disciplining process could be too abrupt. Indeed, the Delors Committee Report specifically raised this issue. European monetary union must be designed to exert discipline in a progressive manner: first, a steady increase in the relative price of debt, and then — only after a lengthy period — a withdrawal of new supplies of credit at any reasonable price.

Prudent debt management

A key feature of the New York City and LDC crises was the combination of floating interest rates and very short debt maturities. While both types of debt have their place in a debt portfolio, strict prudential guidelines for debt management could create the necessary buffer. This could provide a reasonable number of years for the problem to be recognised by the markets, accepted by the government and electors and for an adjustment programme to be formulated and implemented. There could be provision for a minimum average life of a Member State's debt of at least five years (New York City recovered in six years — although greatly assisted by the effects of a period of double-digit inflation). Thus, any difficulty in selling new debt would compound progressively over several years — correspondingly exerting a cumulative increase in the severity of the discipline. At this stage, it would be important to prevent the growing liquidity crisis from being unintentionally escalated by the effect of floating interest rates rising sharply. Therefore, there should be a prudently low limit on the proportion of the floating-rate debt.

Prevent the central bank from negating market signals

It would be critical that the central bank — the European System of Central Banks — was not obliged, or persuaded, to negate the markets' signals by purchasing the debt of the deteriorating country. The quantity of money in the economy can readily be controlled by purchases of private sector securities — as the West German Bundesbank, for example, does with its "repurchase agreements."

Diversified financial assets

In a nation state, there may be merit in requiring the financial system to hold large volumes of "safe" assets — government obligations. In a crisis, the central bank will control the interest rate on the risk-free asset by providing liquidity to the system through purchases of these assets. This will convert the crisis from that of rising interest rates into one of a falling currency, but will preserve the solvency of the domestic financial system. Moreover, the government has the power to ensure that these obligations are met — by printing more money, if necessary. Naturally, this only solves the very short-run problem.

However, in a monetary union, the opposite asset policy is appropriate. The central bank must not offset the market's signals by purchases of public debt, nor may the government print more money to meet its

obligations. Therefore, the "safe asset policy" will no longer be one of concentrating on domestic government obligations. Prudence will then dictate that the financial system should diversify its asset holdings widely among the various public and commercial entities, because none have the power to stave off default by creating more money. Instead, the only safe assets are those that are the liabilities of prudently financed and managed entities.

A diversified asset portfolio will ensure that the financial system is not overexposed to any single state. The banks will then be able to resist pressure for additional loans and, correspondingly, the EC as a whole will not have to contemplate a bail-out to protect the solvency of the financial system of Europe.

Conclusion

We believe that a monetary union can be developed in modern Europe. The fear of losing national sovereignty is widespread and is exacerbated by proposals for "binding budgetary rules." Such rules may be useful for other purposes, but are not necessary for attaining monetary union. So, if the objective is limited solely to a desire for such union, rather than nation building, then the lessons from other unions point a way forward, based on the economic freedoms that are an explicit objective of the Treaty of Rome. **We believe that free movement of capital can induce the fiscal prudence that is one of the two principal conditions for achieving a credible and permanent monetary union.**

The second condition is internal balance. In Appendix IV (see page 23), we analyse the resource transfers already planned by the EC. Specifically, the doubling of the "structural funds" agreed at the 1988 Brussels Summit was a clear, intentional step towards evening out regional disparities by providing significant assistance to less developed areas. These resources, if properly utilised, have the potential to ignite a boom that will produce a more rapid growth in prosperity than anything seen in the past 20 years. If such a boom were to occur, it seems unlikely that the creditworthiness of any Member State would be questioned on grounds of relative poverty or desire to leave the union. **Accordingly, we believe the EC is well on the way to passing a key test of its ability to operate a monetary union.** However, policy must not be steered so far to the other side of the narrow channel that market discipline is undermined by equating large resource transfers with an implicit guarantee.

An historic prize is within Europe's grasp.

Appendix I: Other Monetary Unions

Australia

Close fiscal control

The Australian Commonwealth provides a close parallel with the monetary union envisaged in the Delors Committee Report, in which a central authority heavily influences constituent fiscal policies.

Under the Financial Agreement of 1927, the Commonwealth Government is empowered to borrow on behalf of the six States and, during the annual Conference of State Premiers, State Governments have to submit their borrowing plans to a Loan Council dominated by the Commonwealth Government. In 1936, a gentleman's agreement expanded the Loan Council's authority to impose limits on semi-government and local authority borrowings as well. In the early 1980s, each State established a borrowing authority that was not technically subject to Loan Council limits or included through the gentleman's agreement. To bring the increasingly important borrowing authorities under the auspices of the Loan Council, the gentleman's agreement was cancelled in June 1984, and "global limits" were imposed on all public sector borrowing by each State. International borrowing is further limited as a percentage (22% in 1989) of each State's global limit. In exchange for global limits on their borrowing, the Commonwealth Government has granted these authorities (and, thus, the States) access to international capital markets that had previously been closed to them.

No individual credit ratings

The fiscal relationship between the federal constituents is so tight in this monetary union that market forces do not distinguish between the States in terms of individual State creditworthiness. Internationally, this is reflected in the fact that all of the rated States have received the same ratings (Aa2/AA) as the Commonwealth Government, and borrowing terms are essentially the same. In the domestic market for State semi-public (borrowing agency) securities, liquidity and technical structure are more important than fiscal differences in determining borrowing terms. No State has taken advantage of this situation by running a consistently large fiscal deficit in comparison to other States. Moreover, it is doubtful that any State could pursue such a policy with the firm control over State finances exercised by the Commonwealth Government.

Australia's tight federal system, and the strong fiscal control exercised by the Commonwealth Government over the States, makes the Australian system a poor model for a European monetary union in which market discipline is to be exercised on budgetary balances.

West Germany

Revenue distribution

The Federal Republic of Germany consists of the Central Government (the Bund) and 11 States (the Länder). The Federal Republic has a strong commitment to federation, primarily because of provisions in the 1949 Basic Law aimed at achieving homogeneous living standards throughout the Republic and allocating responsibility for "financial and economic harmony" on a nationwide scale to the Federal Government. Economic and financial unity stems from a constitutionally mandated system of tax allocation and revenue redistribution (Finanzausgleich) designed to redress economic imbalances among the Länder, as well as from the sharing of financial burdens between the Central Government and the Länder. Revenue distribution occurs in three ways: the distribution of taxation authority and tax revenues between the Central Government and the Länder; "vertical revenue equalisation," whereby the Central Government contributes revenues to the Länder; and "horizontal revenue equalisation," whereby the Länder redistribute revenues among themselves. Other factors contribute to the unity of the system, including investment grants made by

the Central Government to economically weaker Länder, the constitutional requirement for the Central Government and the Länder to coordinate their expenditures to ensure overall economic balance, and the authority of the Central Government to impose limits on borrowing by the Länder under certain circumstances.

Central fiscal control

The Federal Government exerts significant control over the budgetary policies of the Länder by means of a Fiscal Planning Council, which is an attempt to coordinate overall fiscal policy in carrying out the stable growth mandate of the Federal Government. Moreover, the Länder are permitted to borrow only for investment purposes, and the Federal Government can impose ceilings and rules regarding terms, conditions and timing for borrowings by all levels of government, if national economic balance is disturbed by such activities.

No credit differentiation

The Länder borrow in their own name, and the Federal Government is not liable for their debts. However, the unique structure of the Federal Republic provides the Länder with a level of credit safety very close to that of the Federal Republic and without significant variation among them. The fiscal relationship between the Central Government and the Länder is so tight that market forces scarcely distinguish between the Länder.

Like Australia, the Federal Republic's strong fiscal control over the fiscal policy of the Länder makes the West German system an equally poor model for a European monetary union in which market discipline is exercised on budgetary balances. The Federal Government's heavy hand in determining the optimal level of borrowing for a balanced national economic policy, and an extensive revenue transfer system, limits the market's need to exercise discipline on Länder fiscal policies, even if Länder deficits merited such discipline.

Canada

Summary

Canada has a looser federal system than Australia or West Germany. Canada's vast geography but small population has caused the Canadian Federal Government to become deeply involved in alleviating regional inequalities and contributing to economic development in remote or economically depressed areas. Nevertheless, Canada's implicit credit support for its ten provinces is much more subtle than Australia's or that of the Federal Republic of Germany, falling far short of either control over fiscal policy or a guarantee of creditworthiness. The Canadian provinces are individually ranked by both the domestic provincial and the international bond markets. Provincial concern about ratings (and thus the cost of servicing debt) is undoubtedly one of the reasons why almost all of the provinces have reduced their budgetary deficits in the past three years. Thus, Canada provides a very interesting model for a monetary union in which market discipline regulates budgetary balance.

Strong financial linkages

Although the Canadian federal system is looser than the federal systems of either Australia or West Germany, mechanisms have been implemented that provide implicit Central Government support for the individual provinces. These mechanisms should not be construed as reassurance that the Canadian Federal Government can or will directly prevent a province from pursuing misguided policies or that it formally guarantees payments on provincial debt. There is no national review of state borrowing as exists in Australia (although this has been seriously discussed in Canada), nor is there a direct attempt to ensure the fiscal solvency of individual provinces as with the West German financial equalisation system. Nevertheless, the financial linkages between the Federal and provincial Governments provide a series of buffers that constitute an important safety net against rapid economic decline and fiscal deterioration at the provincial level. This safety net is comprised of several specific linkages.

The nation-building role of the Federal Government

The Canadian Government has felt the need to play a very active part in economic development and regional policy to ensure Canada's independence from the United States and its coherence as a nation. Canada's enormous size and sparse population has necessitated strong public sector leadership in transportation, communications, population settlement and the utilisation of vast natural resources. Moreover, linguistic, ethnic and geographical differences are natural centrifugal forces in Canada, and the Federal Government historically has been the primary impetus in countering these forces.

Regional development programmes

Efforts to compensate for regional disparities and provincial geography were included in the original British North American Act in 1867. The 1982 Constitution reiterates the national commitment to regional development, and the system of regional subsidisation and economic development flourishes today. In 1987, regional development programmes were decentralised: a Federal department became responsible for programmes in Quebec and Ontario, and two new regional agencies were established — the Western Diversification Programme (covering Saskatchewan, Alberta, Manitoba, and British Columbia) and the Atlantic Canada Opportunities Agency (involving Newfoundland, Prince Edward Island, New Brunswick, and Nova Scotia) are currently responsible for disbursing Federal development assistance within their respective regions.

Much of the Federal Government's current regional development assistance is more subtle than that embodied in these specific initiatives. Tax rebates, assistance to regionally-specific activities (such as wheat production, petroleum extraction, forestry or fishing) and federally-funded megaprojects are among the tools used by recent Canadian Governments to prevent a widening of provincial economic disparities.

Through these economic assistance and development programmes, the Federal Government helps to prevent any province from deteriorating economically to the point where its creditworthiness could seriously be questioned. There is no firm evidence that these specific programmes have reduced economic disparities between provinces, and some continue to lag in terms of economic growth and industrial development, but the Federal Government has periodically ensured that this lag is not critical.

Intergovernmental revenue sharing

Canada maintains a sophisticated revenue-sharing arrangement between the Federal and provincial levels of government. Since the 1930s, the Federal Government has transferred an increasing amount of its revenues to the provinces (although the rate of increase has slowed in the 1980s) so that provincial governments can carry out the educational, health and social welfare maintenance roles delegated to them by the Constitution. The Federal Government uses a large share of the taxing power in Canada, while the provinces have seen their constitutional duties increase with the development of a modern welfare state. Transfer payments are an important compromise between the fiscal power of the Federal Government and the expanding public services burden of the provinces. Both of Canada's major intergovernmental revenue-sharing schemes include strong equalisation components.

Comparable levels of public services

The Constitution Act of 1982 commits the Federal Government to "ensuring that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." The formal system of equalisation has evolved since the Rowell-Sirois Commission publicised its proposals for reforming Canada's fiscal arrangements in 1941. The Commission asserted that a formal equalisation grant system was required "to make it possible for every province to provide, for its people, services of average Canadian standards and...will thus alleviate distress and shameful conditions which weaken national unity

and handicap many Canadians." The system that developed from these recommendations is set forth in the Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act of 1987.

Canada's system of intergovernmental revenue sharing has two components: the first is conditional programmes that include the Established Programmes Financing (EPF) transfers and cost-sharing programmes such as the Canada Assistance Plan (CAP). The second component is the system of unconditional transfers known as equalisation and stabilisation payments programmes.

Per capita transfers

The EPF transfers are granted by the Federal Government on an equal per capita basis to help defray the costs of national health and post-secondary education programmes. A progressive national tax system applied to a country with marked regional income disparities, coupled with the per capita nature of these conditional grants to the provinces, has a strong equalising impact. A second form of Federal transfer involves cost sharing. Under the largest of these programmes, the Federal Government shares 50% of the cost of welfare assistance under the CAP.

Unconditional transfers

Unlike the EPF and CAP transfers, equalisation payments are totally unconditional transfers, explicitly aimed at narrowing differences in the ability of provinces to provide public services. The payments are made from the Federal treasury and so have no effect on the financial position of the wealthy provinces. The poorer provinces, however, receive revenues from the equalisation programme. The equalisation formula determines an average level of fiscal capacity or average national tax capacity by calculating the average of five representative provinces (currently British Columbia, Manitoba, Ontario, Quebec and Saskatchewan). Provinces in which fiscal capacity falls below the average level receive payments to align them with the national standard.

Stabilisation programmes

While equalisation helps to stabilise the revenues of recipient provinces, a separate stabilisation programme exists to compensate all provinces for an unexpected decline in tax revenue. This programme is most likely to apply to the western resource-dependent provinces, which could suffer from a drop in resource-related revenue. The programme has been used only once — for British Columbia in fiscal 1982-83. Nevertheless, it provides an important safety net for those provinces, which are outside the scope of the equalisation programme. Provinces often cite the stabilisation programme as assurance to investors that provincial revenue will not fall below a certain level, thereby affecting the province's ability to service debt.

Clearly, the Federal transfer arrangements provide an important source of fiscal support for the less wealthy provinces. The Atlantic provinces in particular rely heavily on fiscal transfer payments, with equalisation providing between 30% (Newfoundland) and 21% (Nova Scotia) of total revenue. The constitutional goal of enabling provinces to provide reasonably comparable levels of public service is, to a large degree, met by the transfer payment system. **Most important, at least in terms of provincial credit standing, the Federal Government's contribution to revenues in the poorer provinces makes them decisively stronger fiscally than they would be in the absence of such Federal support.**

Historical precedent

During the early 1930s, before the current Federally supported revenue-sharing arrangements had been legislated, the Federal Government rescued at least three provinces that experienced financial difficulties. British Columbia, Manitoba and Saskatchewan each received emergency Federal assistance in the depths of the depression between 1933 and 1936, when they were threatened with having to default on outstanding bonds. In at least five cases, under both Conservative (up to November 1935) and Liberal (after November 1935) leadership, the Federal Government granted loans to these provinces to avert a liquidity crisis and to prevent default or

delayed payments to bondholders. Officials in both Governments during this period emphasised their concern about the ramifications of provincial delays or defaults on the ability of the Federal Government to borrow internationally on favourable terms.

In only one instance did the Federal Government permit a province to default. In 1936, an actively centralist Liberal Government demanded that a province accept Federal supervision of its finances under a loan council scheme, which would oversee provincial debt accumulation before the province could receive Federal funds. A devolutionist provincial Government refused to accept this proviso, as did several other provinces that received emergency loans. Despite possible national credit ramifications of a provincial default, the Federal Government stood firm, and the province defaulted on one bond issue. The province eventually accepted Federal Government fiscal supervision and subsequently received Federal loans; by 1945, all creditors had been fully compensated for all principal and interest that had been suspended.

The current revenue-sharing system and economic support mechanisms make such individual provincial financial crises highly implausible. Nonetheless, the experience of the 1930s illustrates that, even before the development of the modern federal system in Canada, the Federal Government provided direct support to ailing provinces. Although this experience does not guarantee that the Federal Government will again come to the financial assistance of a province, it is an important precedent in determining the strength of Federal-provincial financial links and assessing the likelihood of Federal emergency support.

Despite the strong financial linkages between the Canadian Federal Government and the provinces, both the international and domestic debt markets distinguish quite clearly between the credit quality of the ten provinces and thus send clear messages on fiscal appropriateness to the provincial governments. In the domestic provincial bond market, there is a yield spread of up to 50 or 60 basis points between the stronger (fiscally and economically) provinces and the weaker provinces. A spread gap of around 40 basis points exists between Ontario and the weaker provinces in the United States Yankee bond market.

Although the ratings spectrum among the provinces is overly wide considering the implicit Federal Government support, both the international and domestic rating agencies assign significantly different ratings to the various provinces. This reflects an informed, objective judgement on the credit quality of the Canadian provinces based on economic strength, budgetary deficits, overall debt levels and political commitment to fiscal adjustment. Figure 1 summarises the diversity of the ratings.

Figure 1. Credit Ratings of the Canadian Provinces

Province	Moody's	Standard & Poor's	Canadian Bond Rating Service
Alberta	Aa1	AA+	AA
British Columbia	Aa2	AA+	AA+
Manitoba	A1	A+	AA-
New Brunswick	A1	A+	A
Newfoundland	Baa1	A-	BBB
Nova Scotia	A2	A-	A-
Ontario	Aaa	AAA	AAA
Prince Edward Island	NR	NR	BBB+
Quebec	Aa3	AA-	AA
Saskatchewan	A1	AA-	AA-

Note: Moody's Investors Service and Standard & Poor's are New York-based rating agencies which rate the provinces' international issues. Canadian Bond Rating Service is a Montreal-based agency that rates the provinces' Canadian issues.

Between 1981 and 1986, all of the Canadian provinces saw their budgetary deficits and debt increase significantly. The world recession of the early 1980s, the precipitous fall in the price of oil in 1985, weak world markets for commodity exports, increasing debt servicing requirements, and pressure on the Federal Government to reduce its own deficit and thus slow the increase in transfer payments to the provinces were the major factors contributing to fiscal pressure and mounting debt. The provincial budgetary deficits reached an average of 12.4% of revenues in fiscal 1987. The credit deterioration was most obvious in rating action during the period. The ratings of all nine provinces that borrow internationally were lowered at least once between 1981 and 1987 — two provinces were downgraded twice. This was a clear market signal that deteriorating financial circumstances would result in more expensive borrowing terms.

Since 1987, virtually all of the provinces have reversed this downward fiscal trend. The anticipated average budgetary deficit as a percentage of revenues is expected to decline to 3.4% in fiscal 1990 (ending March 31, 1990) and new borrowing by the provinces should be at the lowest level in almost a decade. As a result of this improved performance, two provinces have had their ratings raised since 1988 (none has been lowered). Additionally, in June 1989, Standard & Poor's placed four provinces on a positive rating outlook list (one had been upgraded a week earlier and the other four have stable rating outlooks). Although a buoyant Canadian economy was the primary contributor to vastly improved provincial fiscal performance, the market sent clear signals through the pricing and ratings of provincial debt.

Despite strong linkages between the Canadian Federal Government and the provinces, the market continues to distinguish among the provinces in terms of fundamental credit quality. **The lack of an explicit Federal Government guarantee to come to the assistance of a financially distressed province (i.e., only a vague commitment of support), has ensured that the market continues to send signals on the appropriateness of provincial budgetary policies.**

* * *

The market still sends clear signals

Credit ratings

Appendix II: The 1975 New York City Debt Crisis

This section analyses one of the incidents often cited as an example of the failure of market discipline: New York City's fiscal crisis of 1975 (a brief history of events is given on page 16). This crisis involved specific factors that seem unlikely to be present in the EC or can readily be avoided by proper structuring of the monetary union of Europe.

The Delors Committee Report specifically refers, in paragraph 30, to the risk that market forces will be too weak and slow or, alternatively, too sudden and disruptive. We believe that a study of this leading example provides valuable lessons on how market discipline can be used as a genuine and simpler alternative to binding budgetary rules.

The lessons relevant for EC monetary union

- Probably the most powerful lesson is that a determined administration could circumvent any prudent constitutional arrangements. In this case, the "check" of the superior legislative body — New York State — failed entirely, because New York State systematically permitted its checks to be avoided by abuses of borrowing powers. Looking at the growth of European "pork barrel" politics — perhaps exemplified by the EC's Common Agricultural Policy — there can be little confidence that late-night, budget cooperation deals would not fall into the same trap. That would be the precise moment when "vital national interests" were at stake and could easily warrant a threat to leave the union.

- The speed and severity of the crisis, when it ultimately arrived, can be traced directly to the progressive increase in the proportion of short-term debt. This occurred partly because it was easier to avoid the statutory debt limits with short-term debt, but also partly because of the fatal illusion that it was "cheaper," due to the positive yield curve. This problem underlines the need for stable debt servicing expenditure. Public policy should always favour stability and the avoidance of a liquidity crisis, even at the cost of higher, current interest costs. **The nature of the debt portfolio should be disclosed — fully and in a readily accessible and comprehensible form — so that the markets can make a proper judgement.**

- As New York City was part of a monetary union, it had no possibility of escape through printing more money. Therefore, its default could not be along an inflationary route — it had to threaten a formal failure to pay obligations, when due. This put its financial system directly at risk, rather than indirectly via the problems of inflation. Although this risk did not crystallise, there would have been even less of a reason for the central authority of the political federation to contemplate the need for a bail-out if its financial system had possessed a more widely-diversified portfolio of assets.

New York City's fiscal crisis is particularly instructive, because it happened to the public authority within which one of the world's most sophisticated financial markets flourishes. Moreover, the higher legislative body was, systematically and publicly, persuaded to override the constitutional checks intended to prevent exactly this type of crisis. The persuasion was not difficult, because that higher body was also in financial difficulties. The EC's binding budgetary rules could well be as vulnerable.

How the Constitutional Checks and Balances Were Avoided

The roots of the problem go back to the 1960s. New York City's Charter required a balanced budget (paragraph 1515). The crisis arose because of abuses of both short- and long-term borrowing powers, as well as the use of Public Benefit Corporations to avoid statutory debt limits. The operating expense budget was to be balanced by setting the real estate tax (the major revenue source) at the level necessary to achieve that balance, although

subject to a ceiling. There was a separate capital budget for capital projects and borrowing was permitted — but subject to limits laid down by the State of New York.

The State limited the maturity of debt to the "probable usefulness" of the life of the project. The city sought, and obtained, numerous amendments to this law; effectively, operating expenses were capitalised. Despite criticism as early as 1966 about whether these were really capital projects, the practice grew, and borrowing for current expenses rose from 4% of the city's funds in 1965 to 53% in 1975.

Abuses of short-term borrowing centred on Revenue Anticipation Notes (RANs), Tax Anticipation Notes (TANs) and Bond Anticipation Notes (BANs). RANs were simple borrowings against tax revenue due to be paid in the following budget year, but which accrued in the current year. In the 1965-75 decade, RANs increased sixfold. This process failed to allow for budgetted revenue that, for whatever reason, was never collected. This problem became most acute with TANs, which were largely used to anticipate real estate taxes. By 1975, US\$380 million of TANs were outstanding against taxes receivable of \$502 million — per annual report. However, the State auditors ultimately reckoned that revenues unlikely to be collected amounted to \$408 million of that total.

BANs were another significant misuse of short-term borrowing powers, because they allowed temporary financing, for example, for the construction period of a project, prior to "permanent" financing by a bond issue. By continuously rolling over BANs, cheaper financing was provided due to the positive yield curve and, helpfully, no principal had to be repaid.

Public Benefit Corporations (PBCs) were created by the State of New York to run revenue-producing facilities, such as public utilities. Increasingly, these PBCs began to finance non-revenue-producing activities, yet their bonds were still held to be a "moral obligation" of the sponsoring authority. A "full faith and credit" commitment was not previously necessary, because the revenue stream would repay the bonds. These off-balance-sheet commitments became large — New York State public authorities had \$15 billion of "nonguaranteed" debt outstanding in 1977, versus only \$3.7 billion of guaranteed debt.

The resultant debt portfolio

Figure 2. City of New York Combined Debt Position, 1965-76 (Dollars in Billions)

	1965	1970	1975	1976
Net City Funded Debt	\$3.9	\$4.4	\$6.8	\$6.5
Net MAC Debt	—	—	—	\$3.5
Net Debt of PBCs	—	—	—	\$0.9
Subtotal	\$3.9	\$4.4	\$6.8	\$10.9
Short-Term Debt	0.5	1.3	4.5	2.1
Total Net Debt	\$4.4	\$5.7	\$11.3	\$13.0
Net Debt Per Capita	\$571	\$716	\$1,513	\$1,753
Net Debt as Pct. of Personal Income	16.0%	15.0%	22.9%	25.0%

MAC Mutual Assistance Corporation. PBC Public Benefit Corporation.
Source: Annual Reports of the Comptroller.

In its 1981 rationale for the restoration of a credit rating to New York City, Standard & Poor's noted that the city's reliance on long-term bond issues to finance operating expenses had begun to weaken the market for its bonds even in the late 1960s. As a result, BANs had become particularly attractive, as they were also cheaper. The resulting build-up in short-term

debt flooded the municipal market with New York City paper — which accounted for perhaps 40% of total volume at the peak. When the market would no longer buy city paper at any reasonable price, the scale of the short-term liabilities inexorably led on to a liquidity crisis as they fell due in enormous quantities and could not be rolled over. Figure 2 sets out the rapid growth in total debt and its shortened maturity. It also illustrates the role of Public Benefit Corporations — the total debt was nearly 10% higher than was readily visible, because of the off-balance-sheet nature of their debts.

Brief History of the Crisis

By 1974, creditworthiness problems were already apparent and the State of New York set up the Stabilisation Reserve Corporation (SRC) to help raise funds for New York City. Drastic budget cuts were proposed, including heavy lay-offs of workers, but the credibility of these proposals was increasingly questioned.

Figure 3. The Events of 1975

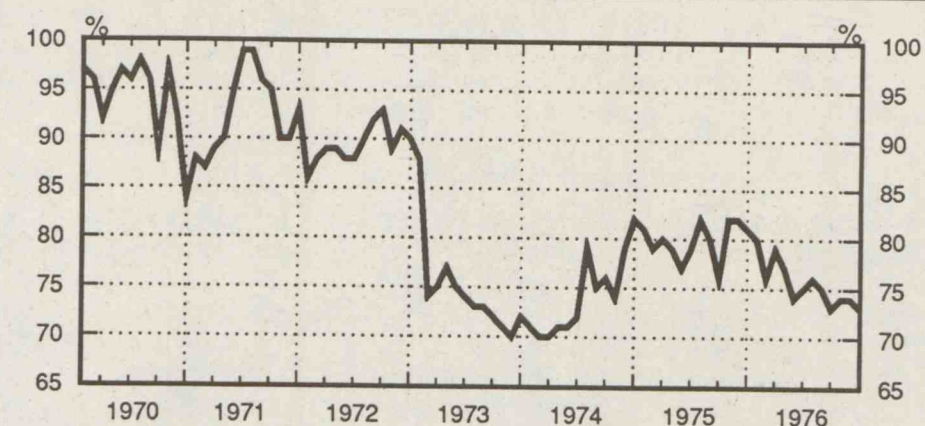
February	Legality of SRC challenged, Urban Development Corporation (of New York State) defaulted on the rollover of short-term debt, souring market perceptions about New York-related paper. Failure of TAN sale after it was found that the pledged tax payments would not exist.
March	Short-term city notes offered for sale at yields close to twice those offered by other municipalities; only 40% sold.
April	Standard & Poor's suspended its "A" rating, citing "New York City's rapidly deteriorating ability to raise money in the capital market... the possible inability or unwillingness of the major underwriting banks to continue to purchase the City's notes and bonds..."
June	State of New York created Municipal Assistance Corporation (MAC) with a "moral obligation" to repay its bonds. Specific New York City tax revenues were pledged to MAC, which was authorised to borrow up to \$3 billion, principally to refinance short-term city debt with long-term MAC bonds.
July	MAC bonds rated "A" and the largest-ever municipal financing was attempted. Half was left with the underwriters, despite yields 50% above comparable bonds.
September	Special audit by the State reveals that the city's cumulative budget deficit was effectively understated substantially. State of New York created Emergency Control Board, MAC's borrowing authority raised to \$5 billion — \$2 billion needed to keep city afloat until November — the crisis becomes acute.
October	President Ford reaffirmed his stand against a Federal bail-out.
December	State of New York passed Moratorium Act to allow MAC to offer bonds due in 1986 in exchange for bonds that had matured in July — or the holders would face a three-year principal moratorium and a reduced interest rate.

Thereafter, the immediate crisis eased. However, as the full magnitude of the debts unfolded, MAC's borrowing powers were raised in 1978 and again in 1980 to \$10 billion (although \$4 billion of this was "new money," rather than refinancing). Even then, the city's debt structure was still felt to be too short — 50% of debt was due within five years and 75% within ten years. The subsequent burst of double-digit inflation helped New York City enormously by raising tax revenues relative to the debts. In March 1981, Standard & Poor's restored a credit rating of BBB to New York City's obligations, symbolising the end of the financial crisis.

The impact on financial markets

Despite the publicity and discussion about the potential implication of default, our data reveal that the markets as a whole were little affected. The interest on municipal bonds was tax-exempt and therefore always yielded less than Treasury securities. Figure 4 sets out the long-run history of the ratio of prime municipal yields as a percentage of pretax Treasury bond yields. The rise in the ratio in the second half of 1974 suggests some anticipation of the problem, but it still remained well below the peaks of the beginning of the decade. Even within the municipal bond market, the severe crisis of one of the largest issuers was recognised as a specific, rather than general, problem. The spread between medium grade and prime long-term municipal bonds averaged 40-50 basis points in 1974 and 60-70 basis points in 1975, depending on maturity. Although this spread hovered around 100 basis points at the height of the crisis, within a year it had collapsed back to 20 basis points.

Figure 4. 30-Year Prime Municipal Yields as a Percentage of Pretax Yields on 30-Year Governments, 1970-76



Source: Salomon Brothers Inc.

There was some fear that the banking system would be undermined by default, because it held \$7 billion of New York's \$12 billion of securities. The New York City banks held \$2 billion of city securities and, for six of the 12 banks, the holdings amounted to 70% of their equity. The Federal Reserve Board emphasised its willingness to fulfill its role as lender of last resort and no problems materialised.

* * *

Appendix III: The Existing Framework

Existing Market Differentiation

One of the questions raised by the debate over monetary union is whether the international capital markets will differentiate between the constituent parts of a monetary union. The Canadian provinces, where credit ratings range from Aaa/AAA to Baa1/A- and where borrowing costs between the strongest and weakest provinces diverge by about 40 basis points, provide a good example of this differentiation between credits within a monetary union.

While a European monetary union does not yet exist, it is interesting to note the range of market discrimination that is currently exercised regarding the external debt of the Member States of the European Community. One must examine how and why these distinctions are drawn to determine whether they would remain after the formation of a monetary union.

Borrowing costs

Evidence of market discrimination is found in the borrowing costs faced by different borrowers. While factors such as maturity, size of an issue, its structure and market conditions clearly contribute to the pricing of a new bond issue, much of the price differentiation is related to the credit fundamentals and credit rating of a country. Under current conditions, the yield spread for a new fixed-rate bond issue might be 50-60 basis points — for example, between Italy and Greece.

Secondary market trading

Another example of market differentiation is provided by bonds of sovereign issuers trading in the secondary market. As shown in Figure 5, a spread of nearly 40 basis points exists between one of the strongest members of the European Community (the United Kingdom) and one of its weaker members (Portugal). Even allowing for liquidity and structural factors, this is a significant credit differential.

Figure 5. Eurodollar Floating-Rate Note Market

(Discount Margin Versus Six-Month LIBOR, Mid-Market, at Oct 31, 1989)

United Kingdom ^a	(33)bp
Republic of Italy	(33)
Credit Foncier (Gtd. France)	(20)
Kingdom of Belgium	(19)
Kingdom of Denmark	(18)
RENFE (Gtd. Spain)	(16)
Republic of Ireland	(2.5)
Republic of Portugal	5.5

^a Three-month LIBOR. Bp Basis point.

The Eurodollar straight bond market provides another example of this differentiation. A seven-year bond issued by the European Community itself trades at 45 basis points, and a six-year bond issued by the Republic of Italy at perhaps 50 basis points, over comparable US Treasuries. Reflecting market differentiation, a comparable Kingdom of Denmark issue trades in a substantially wider range, at 70 basis points over US Treasuries.

Credit ratings

Among other factors, market differentiation reflects the range of credit ratings assigned to sovereign issuers. One or both of the two major rating agencies, Moody's Investors Service and Standard & Poor's, have rated the debt of all of the members of the European Community. These ratings range from triple A to triple B, spanning the full investment grade spectrum (see Figure 6). (In cases where no sovereign debt is outstanding, the rating agencies have assigned implicit ratings.) The example of the Canadian provinces suggests that even within a monetary union, a range of credit ratings (as well as borrowing costs and secondary market trading spreads) would persist. (This would hold true for the domestic debt of countries, as well as for their external obligations).

Figure 6. Credit Ratings of EC Member States

	Moody's	Standard & Poor's
France	Aaa	AAA
West Germany	Aaa	AAA
Netherlands	Aaa	AAA
United Kingdom	Aaa	AAA
Luxembourg	Aaa	NR
Italy	Aaa	AA+
Belgium	Aa1	AA+
Denmark	Aa1	AA
Spain	Aa2	AA
Ireland	Aa3	A+
Portugal	A1	A
Greece	NR	BBB

NR Not rated.

Sovereign credit assessment

A key factor in determining market differentiation is the way in which market participants, including the rating agencies, institutional investors and underwriters, analyse and assess various sovereign credits. A wide array of information is available to the analyst interested in arriving at a credit judgement regarding a sovereign borrower. Finance ministries and central banks publish timely and reliable data on the finances of sovereign borrowers. International entities, such as the Organisation for Economic Cooperation and Development (OECD), the International Monetary Fund (IMF), and the European Community itself, regularly monitor the economies of European sovereigns. Because these countries are industrialised democracies with free political debate and highly educated populations, issues related to sovereign credit quality are fully debated in the press, in professional journals and in public political forums.

The methodology for assessing sovereign credit is explored in detail in the publications of rating agencies and other sources.¹ In focusing on a country's creditworthiness in foreign bond markets, rating agencies and analysts have concentrated on assessing the size of, trends in, and the serviceability of a sovereign's external debt. In doing so, they must examine many factors. Standard & Poor's, for example, looks at *political* factors such as the political system, social environment and external relations; and *economic* factors such as the debt burden, international liquidity, balance of payments flexibility, economic structure, growth performance, economic management and economic outlook to arrive at a rating judgment.

Changing focus of sovereign assessment

The development of a monetary union will change the focus of sovereign credit analysis, narrowing the number of factors on which a market judgment of creditworthiness can be based. In a monetary union, a country's *external* balance will become irrelevant for the creditworthiness of constituent members; the current account balance will be the concern of the monetary union as a whole. Instead, a country's *internal* balance (its budget deficit or surplus) will become more important. Other factors, such as inflation, growth rates and living standards will remain relevant indicators, and under a monetary union are expected to converge. Increasingly, rating agencies and credit analysts will focus on the budget deficit and levels of internal debt to assess relative creditworthiness, as they do in the case of the Canadian provinces. Through these credit judgments and the market discrimination they engender, the market will exert discipline on the fiscal policies of members of the monetary union.

¹ See *Credit Quality in the Yankee Market — Sovereign-Backed Issuers Offer Opportunity*, by John F.H. Purcell, Michelle B. Miller, Dirk W. Damrau, Salomon Brothers Inc, November 10, 1988.

Trends in the Indebtedness of EC Member States

International investors are familiar with the data on external debt and debt servicing capacity. This is one of the key ingredients for the application of market discipline to external debt. However, those same international investors are probably not so familiar with the internal indebtedness of some Member States. An increase in knowledge will be necessary as the international markets focus on the internal debt, once that is known to have become more like external debt — that it cannot be inflated away.

For the EC as a whole, Government borrowing has declined recently to 3% of gross domestic product (GDP) (see Figure 7). This is well below the levels seen in the early 1980s, but is still half as high again as the much criticised US budget deficit. Moreover, the degree of fiscal stimulus is barely below the "crisis response" to the first "oil shock" in the mid 1970s. The persistently high, even rising, deficits of Greece and Italy stand out — at roughly seven and three times the Community average, respectively.

Figure 7. General Government Lending (Borrowing), 1974-90E (As a Percentage of GDP)

	1974-81	1982-85	1986	1987	1988	1989E	1990E
Belgium	(6.6)%	(10.0)%	(8.8)%	(7.0)%	(6.5)%	(6.0)%	(5.7)%
Denmark	(1.4)	(5.6)	3.5	1.8	0.2	0.1	0.7
France	(1.0)	(2.9)	(2.7)	(2.0)	(1.4)	(1.2)	(1.1)
Greece	—	(9.9)	(12.5)	(12.3)	(14.9)	(19.9)	(20.0)
Ireland	(10.5)%	(11.5)%	(11.1)%	(9.1)%	(3.7)%	(3.7)%	(1.5)%
Italy	(8.4)	(11.5)	(11.7)	(11.2)	(10.6)	(10.3)	(9.8)
Luxembourg	1.4	2.3	3.1	2.5	2.5	2.4	2.8
Netherlands	(2.9)	(6.2)	(6.0)	(6.5)	(4.9)	(4.4)	(4.2)
Portugal	—	(10.4)%	(7.2)%	(6.9)%	(6.5)%	(6.0)%	(6.1)%
Spain	(1.3)%	(5.7)	(6.1)	(3.6)	(3.2)	(2.6)	(2.4)
UK	(3.8)	(3.1)	(2.4)	(1.5)	0.8	1.5	1.1
West Germany	(3.0)	(2.2)	(1.3)	(1.9)	(2.1)	0.0	(0.4)
All EC	(3.7)% ^a	(5.3)%	(4.8)%	(4.3)%	(3.6)%	(2.9)%	(2.9)%
US	(1.4)	(4.2)	(4.4)	(2.3)	(1.8)	(1.8)	(1.7)
Japan	(3.5)	(2.6)	(1.1)	(0.3)	0.5	0.4	0.4

^a EC without Greece and Portugal. E Estimate.

Source: European Commission, Annual Economic Report, 1989.

Gross public debt

Figure 8. Gross Public Debt, 1973-90E (As a Percentage of GDP)

	1973	1985	1986	1987	1988	1989E	1990E
Belgium ^a	63.2%	115.4%	118.8%	125.5%	127.5%	126.6%	126.0%
Denmark	8.8	74.5	67.2	63.9	64.0	61.6	58.1
France	22.7	33.2	33.7	35.1	35.7	35.4	35.2
Greece ^b	19.5	57.9	58.3	66.6	73.9	82.1	91.8
Ireland ^b	54.7%	104.7%	115.7%	118.5%	115.4%	110.9%	105.3%
Italy	54.2	84.0	88.5	92.9	96.1	98.5	100.5
Luxembourg	20.4	13.8	13.6	12.2	10.1	9.1	7.9
Netherlands ^a	43.4	69.7	71.7	75.3	77.4	78.3	78.5
Portugal	—	69.5%	68.4%	71.7%	74.5%	75.3%	76.3%
Spain	12.8%	47.2	48.0	48.3	44.1	43.8	42.0
UK	66.1	57.3	56.2	54.6	49.1	44.1	40.4
West Germany	18.6	42.5	42.7	44.0	44.7	43.4	42.7
All EC	37.4% ^c	56.8%	57.7%	59.4%	59.1%	58.4%	57.8%

^a Excludes social security funds. ^b Central Government only. ^c Excluding Portugal. E Estimate.

Source: European Commission, Annual Economic Report, 1989.

The impact on the Community's indebtedness of such large and persistent borrowing is hardly surprising. Figure 8 shows that gross debts, in relation to GDP, have risen by nearly two thirds since the eve of the first oil shock and now stand at almost 60% of Community GDP.

Reviewing the individual components, Danish indebtedness may have risen spectacularly, but it is still only just above average and falling. Only Belgium is more than twice as indebted as the Community average. The two countries facing the most rapid deterioration — Greece and Italy — are in different positions. After a long period of sharp relative deterioration, Greece has only recently seriously exceeded the Community's average indebtedness. Italy is already 60% above average. Interestingly, among the major countries, France is noticeably least indebted and the UK's level may soon be lower than that of West Germany.

Interest payments

Total indebtedness equals 60% of output, therefore, interest payments on such an accumulated debt are heavy budgetary expenditure items (see Figure 9). Indeed, for the EC as a whole, interest payments are 4.8% of GDP. Not surprisingly, Belgium and Greece have conspicuously heavy interest burdens — at about twice the EC average. Both Greece and Italy borrow afresh all their interest payments.

Figure 9. Interest Payments on Public Debt, 1973-90E (As a Percentage of GDP)

	1973	1985	1986	1987	1988	1989E	1990E
Belgium	3.3%	10.6%	11.1%	10.5%	10.2%	10.5%	10.6%
Denmark	1.3	9.9	8.8	8.3	8.1	7.6	7.1
France	0.8	2.9	2.9	2.8	2.7	2.7	2.8
Greece	1.0	5.4	5.7	7.6	8.3	9.6	10.5
Ireland	3.6%	10.3%	9.8%	9.7%	9.4%	8.9%	8.5%
Italy	2.2	8.0	8.6	8.1	8.2	9.0	9.1
Luxembourg	0.9	1.1	1.1	1.1	0.9	0.8	0.7
Netherlands	2.8	6.3	6.2	6.2	6.0	6.0	5.9
Portugal	—	7.9%	9.2%	7.8%	7.7%	7.9%	7.8%
Spain	0.6%	3.2	3.8	3.5	3.3	3.4	3.5
UK	3.6	4.9	4.5	4.3	3.9	3.5	3.1
West Germany	1.1	3.0	3.0	2.9	2.8	2.7	2.6
All EC	1.9% ^a	5.0%	5.0%	4.8%	4.7%	4.8%	4.8%

^a Excluding Portugal. E Estimate.

Source: European Commission, Annual Economic Report, 1989.

Perhaps a more relevant consideration is the proportion of Government revenues that are preempted by interest charges, which gives a measure of fiscal flexibility. The Community divides sharply: the statistical average is that 11% of revenues are required for interest charges, but five States preempt roughly 9% or less. Five others already commit 22%-26% of their revenue to interest payments.

From this data alone, it seems that the Community as a whole has passed the worst of its debt deterioration relative to output — indebtedness has virtually stabilised, interest payments are declining slightly and the proportion of revenues committed to interest payments has fallen noticeably. However, these trends are far from uniform and there are conflicting examples.

The existing, readily available data is interesting, but may not tell the whole story. The bondholder is particularly interested in the certainty of interest and principal repayments even under adverse economic circumstances. Does the data include all entities that are formally guaranteed? And any obligations that these entities may have undertaken? What about "moral obligations," whether formal or merely implicit due to national prestige or the like?

There is insufficient readily available data to enable international investors to judge the stability of these debt portfolios. In many States, much Government finance is transacted through private placements, where maturity and interest rate-sensitivity are not necessarily published. For data on the maturity structure of all the debt servicing obligations likely to be faced by the Government, even under the worst circumstances, is essential if the markets are to form a proper judgement of risk.

* * *

Appendix IV: Internal Balance Within the European Community

A key element of any monetary union is that none of the constituents should be, or become, so disadvantaged that their best interests might be served by leaving the union. Adequate levels of resource transfer are vital if the less-developed members are not to be penalised by the markets simply because they have greater development finance needs.

Are the disparities in the wealth of EC Member States so great, or so unlikely to narrow, that the creditworthiness of these States might be doubted, or perhaps their ability, or desire, to remain within a European monetary union?

Regional Disparities

The 12 EC Member States can readily be split into two groups for analytical purposes: the four less advanced countries, Greece, Spain, Ireland and Portugal — Eur-4, and the remaining eight — Eur-8.

Figure 10. Per Capita GDP at Current Market Prices and Purchasing Power Standards, 1989 (Eur-12 = 100)

	1989 ^a
Eur-8	
Luxembourg	124.9
West Germany	113.5
France	108.4
UK	108.2
Denmark	107.1
Italy	102.7
Netherlands	102.6
Belgium	100.3
Eur-8 Weighted Average	107.7
Eur-4	
Spain	75.6
Ireland	63.1
Portugal	55.5
Greece	51.1
Eur-4 Weighted Average	67.8

^a European Commission Autumn 1988 forecasts.
Source: Eurostat and Commission Services.

With per capita GDP in the Eur-4 countries only 61.1% of that of the four strongest countries, there is clearly a wide discrepancy between the two groups. However, that discrepancy has already narrowed substantially, and is likely to narrow further in the years ahead. Thirty years ago, long before any of these countries had joined the EC, the Eur-4's per capita GDP was only 45% of that of the four strongest countries. The ratio reached its peak, at 63.5%, in 1975 and then fell back with the recession after the first "oil shock." Despite above-average growth since then, Eur-4 per capita GDP has slipped because their population growth rate has been about three times that of Eur-8.

Since the late 1960s, the ratio of the original six members of the EC has converged to reach 90% of the average, so that degree of convergence between the Eur-12 and Eur-4 countries is likely to be readily acceptable. To reach that target by 1992, the Eur-4 would have to achieve an implausibly high growth differential of 5.6% annually. However, over a decade, that convergence could be achieved with a differential slightly above the 2.3% average recorded in the period 1961-73. Over two decades, the required differential is only 1.4% annually.

Planned Resource Transfers

The Member States have already agreed a major programme of resource transfers to the least advanced countries. At the Brussels Summit in February 1988, the EC agreed to double the size of the "structural funds" by 1992. Figure 11 indicates the scale of the resource transfer, including that agreed at the Brussels Summit. For the four less-advanced countries as a group, this transfer could exceed 2% of their GDP, but the three poorest could receive between 3% and 6%.

Figure 11. Resources Allocated Through Structural Funds and Financial Instruments in 1987 and 1992-93E (As a Percentage of GDP)

	Structural Funds ^a	Financial Instruments ^b	Total
1987			
Greece	1.46%	0.41%	1.87%
Ireland	1.86	0.71	2.57
Portugal	2.56	1.24	3.80
Spain	0.48	0.29	0.76
Eur-4	0.88%	0.42%	1.30%
1992-93E^c			
Greece	2.63%	0.72%	3.36%
Ireland	3.22	1.22	4.44
Portugal	4.23	2.05	6.28
Spain	0.77	0.46	1.22
Eur-4	1.44%	0.69%	2.13%

^a Regional Fund, Social Fund, European Agricultural Guidance And Guarantee Fund, including commitments and provisional figures. ^b European Investment Bank and New Community Instrument, including loan agreements; Euratom, including loans paid out and provisional figures. ^c Figures are based on the following two, very tentative, assumptions for 1992-93. (1) Grants under the structural funds are doubled in real terms for the four less-advanced countries and Italy, and held constant for other countries, as percentage of real GDP. (2) Loans under the financial instruments are up by 100% in real terms for the four less-advanced countries and Italy, and held constant for other countries, as percentage of real GDP. The figures for 1992-93 should by no means be interpreted as forecasts; they are only points of reference for discussions.

Source: Commission Services.

Even before taking these transfers into account, the Commission forecast that the Eur-4's per capita GDP would rise somewhat, to 63.5% of Eur-8's by 1992. However, the Commission also hypothesises about the potential impact of such large transfers. The ideal circumstances are that this support is fully reflected in an increase of the investment/GDP ratio and that marginal capital productivity recovers to the levels of the late 1960s. The Eur-4's per capita GDP growth in 1992 would then be 7.5% instead of 3.9%. Such a growth path could narrow the wealth gap substantially, taking per capita GDP to over 75% of Eur-8's.

These resources, if properly utilised, have the potential to ignite a boom that will produce a more rapid growth in prosperity than anything seen in the past 20 years. If such a boom were to occur, it seems unlikely that any Member State's creditworthiness would be questioned on grounds of relative poverty.

Accordingly, we believe the European Community is well on the way to passing a key test of its ability to operate a monetary union. However, policy must not be steered so far to the other side of the narrow channel that market discipline is undermined by equating large resource transfer with an implicit guarantee.

* * *

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Creating an EC Monetary Union with Binding Market Rules

Introduction

In a recent report, we expressed the view that the ultimate market sanction — cutting off further credit supplies — could enforce fiscal prudence in a more flexible way than was possible under any system of “binding budgetary rules.”¹ Flexibility remains, but the sanction is certain.

Administrative budgetary rules will be more difficult to develop and apply. At a minimum, they should require European Community (EC) finance ministers to exert peer group pressure by vigorously, and publicly, warning on budgetary excesses. The key question is how effective these rules can be in creating a binding sanction. Irrespective of success on this score, the simple fact that market discipline *does* have a final sanction demands that a financial structure be created that would not collapse under the weight of this sanction. The system must be designed to perfect, rather than eliminate, market discipline and so to complement budgetary rules.

In this report, we set out the basic principles necessary to ensure that market discipline is certain and that it operates slowly and progressively, rather than abruptly and catastrophically.

A deterrent deters only if all parties know that it is capable of working effectively and that the will to use it exists. Our proposed deterrent involves a series of ever-tougher credit crunches before the final sanction: the withdrawal of new credit. If the electors of a particular state are bent on ruin, then they will be made painfully aware for several years of their progress down the long and bumpy slope to fiscal collapse.

The will to use the deterrent is another matter entirely. A plan that relies for success on the structure of the financial markets must recognise that it cannot negate political will. The political system that creates a financial structure today can change it at any stage in the future. Today's generation can merely put in place a set of rules that will require lengthy, careful and widespread debate about the consequences of any change.

Our plan has two components: a statement of principle that the fiscally imprudent will not be bailed out; and a set of measures to create a financial structure that is manifestly strong enough to make that principle credible. If a structure is so weak and flawed that a significant default would inevitably cause the system to collapse, then no one — market participant or politician in the country at risk — is likely to believe in the “no bail-out” principle.

¹ *Market Discipline CAN Work in the EC Monetary Union*, Salomon Brothers Inc, November 1989.

The "No Bail-Out" Principle

This principle should be enshrined in the Treaty of Rome. This would represent the EC's strongest possible statement of its intention to break with past practices of solving problems at the taxpayers' expense. Every participant in the whole process would be conscious of this express intention. Investors would recognise the lengthy procedures that would be necessary before such a provision could be removed; if an investor were operating on the cynical assumption of an ultimate bail-out, this alone would ensure uncertainty about the timely payment of principal and interest.

The Structure of the Financial System

Financial systems are normally structured on the assumption that central government debts, if not those of the public sector as a whole, are free of credit risk. This assumption, explicitly restated in the Cooke Committee rules for the capital adequacy standards of banks, has been incorporated into Community law through the Solvency Ratio Directive. The assumption that central government debts carry no credit risk is based, in part, on a government's power to tax, but this power has limits when labour and capital are freely mobile: New York City demonstrated this in 1975. And the Single Market programme aims to create such mobility.

In the final analysis, however, a government can always print money to repay the nominal amount of its debts. (The consequences for the real value of the debts are a separate issue.) **The essence of the Delors Committee Report is that, when monetary union occurs, Member States should lose this power to create money to repay their debts,** thus eliminating a fundamental tenet of current financial regulation.

The consequences of this change, when incorporated in the financial framework, will be the key to ensuring that market discipline *does* work in the EC monetary union. The directives that create this structure should be subject to qualified majority voting. On the one hand, an abuser will be unable to stop measures to halt the abuse. On the other hand, a blocking minority should be able to prevent a serious weakening of the system.

Six elements should be embedded in the structure of the financial system:

The Single Market programme — restated in Stage 1 of the Delors Committee Report proposals — must be fully implemented and the market for financial services completely liberalised. Exchange controls must be removed. Finally, the free flow of capital requires the removal of the secondary barriers created by regulations on the investment of institutional assets beyond those necessary for prudential supervision.

All participants must be aware of the full magnitude of a debtor's obligations in order to assess its debt servicing capacity. This must include the contingent liabilities of entities beyond the central government, such as public sector and state-guaranteed bodies. The Prospectus Directive (89/298/EEC) already requires publication of "information necessary to enable investors to make an informed assessment of the financial position of the issuer." However, Articles 2 and 5 exempt Member States and their subsidiary bodies from this requirement.

The position of commercial trading entities owned by the state — in particular, banks and insurance companies — must also be considered, as should that of private banks whose major business is gathering retail funds, purchasing government debt and holding it to maturity. The risk weighting system for bank assets, set out in the Solvency Ratio Directive, already requires a careful clarification of the exact status of these entities.

Accounting conventions and practices must be standardised sufficiently so that fully comparable data can be published promptly — perhaps by the European Commission. Prior to a common currency, the exact status of liabilities represented by notes and coins may present a problem, but that will be removed once they become the liability of the new central bank.

Powers of the ESCB

The ultimate reason for the proposed creation of the European System of Central Banks (ESCB) is the need for EC-wide control of monetary policy. (The supervision of banks and of the payments system are issues for separate discussion. Historically, these two roles have conflicted with the conduct of sound monetary policy. Hence, separate technical agencies may be better placed to perform these regulatory functions.)

The ESCB should be prohibited from holding public sector debt. This would prevent its open-market operations from masking the emergence of a credit spread between different Member States and would remove completely any risk of direct monetary financing of government deficits. While an absolute prohibition may seem severe, it would remove temptation. For example, even if the ESCB did not specify the assets it wished to receive in response to a general offer to purchase securities outright (rather than with a repurchase option), the market would very likely sell its worst assets. Thus, the ESCB would find its portfolio skewed towards the deteriorating state. In effect, this state would then have preempted a disproportionate share of any monetary financing. All risk of monetary financing can be removed (as advocated by paragraph 32 of the Delors Committee Report) by this prohibition.

The scale of private financial instruments within the EC as a whole should offer ample scope for the purchase or sale of securities to create, or eliminate, money. Central banks have developed a wide variety of techniques for open-market operations involving private instruments. For example, the Swiss National Bank utilises the spot and forward foreign exchange markets, because government debt levels are negligible. The Bank of England, in the past, has used a large portfolio of prime trade bills. The Bundesbank's principal method of controlling liquidity is the scale of the repurchases of "Lombard-eligible" assets, which are primarily private sector.

"Large Exposure" Rules

The prudential regulation of any financial institution generally involves a limit on the exposure to any single debtor (or group of associated debtors): at a certain threshold of exposure, separate reports to the supervisor are often required, and exposure above the level where a loss would be catastrophic to the whole institution is prohibited.

Currently, the EC does not apply exposure limits to central government debts, which are seen as free of credit risk. **The crucial, and essential, change is the recognition that, in a European monetary union, public debt will involve credit risk.** Hence, some limits should be applied, even though public debt will remain the best credit within the Community. Exposure limits would be set out in the directives governing the particular type of institution. Two examples illustrate how this could be done by amending existing texts:

● Article 22, paragraph 1 of the UCITS Directive (85/611/EEC), which liberalises mutual funds, limits the exposure to any one entity to 5%. Paragraph 3 raises this to 35% for "securities issued by a Member State...", while Article 23 raises the limit for such securities to 100%, but "in accordance with the principle of risk-spreading," exposure to this one debtor must be in at least six different securities.

● The Recommendation on Large Exposures of Credit Institutions (87/62/EEC) proposes a limit of 40% of own funds in Article 4, paragraph 1. Paragraph 4 then states that "the competent authorities may fully or partially exempt... the public authorities of any of the Member States"

The recognition that public debt carries some risk, even if only a small degree, argues that these exemptions from accepted prudential standards of risk diversification be removed.

Given the aggregate of the cash value of these limits on each institution, a Member State should have adequate borrowing power within the Community. As a broad concept, the financial institutions within a given Member State might have an aggregate limit equivalent to 60% of that state's gross national product (GNP) — providing that the corresponding individual institutional limits were not so large that default would undermine the institution. As the existing debt levels of the Community average out at 60% of GNP, institutions within a "prudent" Member State would not be compelled to change their behaviour. A further 60% of GNP as an aggregate credit limit for that Member State might be spread amongst the financial institutions elsewhere in the Community.

A financing envelope equal to 120% of GNP — nearly matching the heaviest debt burden within the Community currently — might seem lax. In reality, however, this would represent a major obstacle. Once a state had used up its domestic credit limits, its total reliance on nondomestic institutions would be a powerful brake on further borrowing. Even under the best conditions, a major state rarely has had a substantial proportion of its total debt held by foreigners. Spreading limits of even 60% of GNP around the rest of the EC would probably imply quite low limits at individual institutions, reducing the risk to the Community's financial system of a default.

Because total exposure limits would be based on GNP, the financing of a reasonable annual deficit should face few impediments. A state's relative debt burden would rise only if its new deficits exceeded the growth rate of its GNP. Thus, this approach would create a cumulatively tougher financing problem for "excess" deficits, but only if these were sustained for several years.

If a Member State wished to be ever more indebted, then it would have to raise the funds from non-Community institutions (or directly from individuals) — a difficult and expensive process. External creditors would be on notice, from the public warnings of the group of EC finance ministers, and would undoubtedly demand a significant premium.

Marking to Market of Public Debt

If the price of a country's debt begins to deteriorate, then all financial institutions should be obliged to recognise this immediately, marking the asset down to the new market price and deducting the loss from their capital bases. Provided that the market price accurately reflects the risk of default, then the financial system would adjust continuously, and the actual event of default would not create a shock; the loss provisions would have been made every day along the way.

Member States would have to be encouraged to issue debt in a marketable form, so that the market for such debt would be genuinely liquid and substantial and the market price would be seen as a reliable indicator. All nonmarket debt would be valued using the appropriate rate interpolated from the yield curve. For valuation purposes, nonmarket debt should be valued at a penal yield premium, perhaps one percentage point above the

corresponding market yield. The same principle could be applied to nonmarket debt outside the Member State's own currency. The applicable yield curve would simply be that of the domestic government.

If all public debt were marked to market, any decline in the market price would force both institutions and supervisors to recognise fully the magnitude of their exposure. The direct impact on capital would create a rising disincentive for banks, for example, to continue lending to such a state.

An additional benefit of a mark-to-market system would be an improvement in the system's response to monetary policy changes. To the extent that the yield curve moved to reflect a rise in official short-term rates, then the impact on bank capital would constrain the growth of bank credit.

**Prudential
Standards for Public
Debt Maturity**

As the maturity of a debt portfolio shortens, the risk of a sudden liquidity crisis rises correspondingly. In some cases, confidence can be shaken by events that are completely outside the control of the debtor, who then will have difficulty in rolling over maturing debt, resulting in a rapidly deepening liquidity crisis; the New York City crisis of 1975 was a classic example. Instead of a gradual slide over several years to fiscal ruin, the debtor is catapulted there with little warning.

The risk of a liquidity crisis is particularly difficult for markets to price, because while the debt burden itself may be acceptable, it may be poorly structured. This problem is well known to supervisors of financial institutions. A corresponding "prudential supervision" of public debt portfolios will be necessary. The "average life" of the debts will be the critical factor in allowing the relevant parties sufficient time to recognise the problem and adjust policy accordingly. Although there are no obvious historical precedents, it took New York City six years to recover its credit rating after its crisis. Perhaps five years might be an appropriate minimum average life. The occasional tremors of a liquidity crisis in Italy suggest that an average life of less than three years is definitely too short.

The Solvency Ratio Directive has just introduced a system of risk weighting for bank assets. This approach could readily be used to develop a sliding scale of risk weights for public sector debt based on average portfolio life.

However, a better method might be to build on the mark-to-market approach and introduce a sliding scale of required write-offs for all financial institutions, rather than merely singling out the banking system. (The concept of a regulatory requirement for standard write-offs against substandard debt is not new. Perhaps the most public example is the Bank of England's matrix for Less Developed Country debts.) The appropriate sliding scale is a matter of debate, but the clear intention would be to force the financial system to write down asset values sufficiently such that a serious default would already have been fully provided for in the capital of those institutions holding the debt. Therefore, the threat of a disastrous default — as an alternative to a forced bail-out — would be widely recognised as hollow.

Naturally, compulsory write-offs against capital would be a major disincentive to any financial institution considering the provision of further funds to a country sliding towards a liquidity crisis and a correspondingly heightened risk of default — even if only a partial default. As soon as such write-offs become significant, institutions would require a yield premium to compensate them for the loss. Thus, the sliding scale of write-offs should induce a progressive rise in interest costs as the debts' average life declined.

Conclusions

Our plan is based upon a matrix approach. Along one axis is a set of exposure limits for Community financial institutions. These limits would be low enough to ensure that the default of a public borrower would not undermine any institution. On the other axis of the matrix is the price effect. Taking a level playing field approach to all financial institutions, the marking to market of all public debt would progressively freeze out of the credit markets those countries about whose creditworthiness the market became concerned for any reason. Hence, at the moment of threatened default, the financial system would already have written off the problem, so the threat could then be viewed entirely in the political context.

All these mechanisms would merely serve to put all parties — politicians, regulators, electors, and investors — on notice that a problem is growing. They would create a series of ever-tougher credit crunches. Ultimately, they would ensure that the final sanction of withdrawing further credit supplies is not catastrophic for the financial system of the Community. They would not withdraw the right of any Member State to slide down the bumpy slope to fiscal ruin.

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S E D

The Madrid Summit — European Monetary Union IS Coming

The monetary landscape of Europe is changing irreversibly. In June 1988, the European Community (EC) Heads of State agreed to abolish exchange controls. They also set up a committee chaired by EC President Jacques Delors to study "concrete steps leading towards the progressive realisation of economic and monetary union" (EMU). The Heads of State considered the resulting "Delors Report" at the Madrid Summit on June 26/27, 1989, and agreed to the following agenda:

- The first stage of Economic and Monetary Union will begin on July 1, 1990;
- The preparatory work will be undertaken for an intergovernmental conference to lay the ground for subsequent stages, which would meet after the first stage had begun in 1990.

On July 10, just ten days into the six-month French presidency of the European Council, the EC finance ministers agreed on an aggressive timetable for the preparatory work.

This report analyses these developments from the perspective of the business opportunities that will open up for the financial services industries. Genuine liberalisation of these industries is likely to lead to such a degree of financial integration that monetary union will, effectively, be created by market forces.

The Council has requested the adoption of the "provisions necessary for the launch of the first stage" (see text of communiqué on page 5). The Delors Report names the creation of a Single Financial Area as a key step in Stage One, and much work has already been achieved towards this end, but there are shortcomings in some of the measures and proposals. Current political commitment provides an excellent opportunity to ensure that the "provisions necessary" do, in practice, create a genuinely liberal financial market. This, in turn, will develop a powerful market discipline that should obviate the need for complex and bureaucratic budgetary coordination policies and minimise any functions that need to be delegated to a European System of Central Banks.

On balance, remarkable strides have been made towards achieving the Single Financial Area that will realise the European Council's decision in Madrid. Given a continuation of that degree of political commitment, the remaining problems can be overcome, permitting progress towards monetary union.

Principal Stage One Steps

The Delors Report describes Stage One as "the initiation of the process" of creating EMU. For practical business purposes, the key steps are as follows:

- "In the economic field ...firstly, there would be a complete removal of physical, technical and fiscal barriers. The completion of the internal market would be accompanied by a **strengthening of Community competition policy.**"

● "In the monetary field the focus would be on removing all obstacles to financial integration... Firstly, through the approval and enforcement of the necessary Community Directives, the objective of a single financial area in which all monetary and financial instruments circulate freely, and banking, securities and insurance services are offered uniformly throughout the area would be fully implemented."

The first statement merely reaffirms the principles of the 1992 programme. However, the second statement comprises a remarkably powerful and clear definition of the liberalised financial services market that we should now expect to unfold. **The Heads of State, in accepting Stage One of the Delors Report, have implicitly set a "quality standard" for the directives, as well as the areas to be covered.**

Impact of financial innovation

There is an implicit timetable: Stage One requires not only the approval and enforcement of the directives, but also their "full implementation." The importance of this point may have been overlooked: it implies the enactment of enabling legislation in each of the 12 member states. Only then — and probably after a considerable time lag — will the full consequences of liberalisation unfold as financial intermediaries offer new products. The willingness of consumers to purchase these products will determine the degree of permanent and substantial financial innovation that will exist in the Community.

The Delors Report states that "account would also have to be taken of the continued impact of financial innovation on monetary control techniques (which are at present undergoing radical changes in most industrial countries)." The "preparatory work" to develop the "provisions necessary" for the new EC institutions, such as the European System of Central Banks, will certainly need to analyse these "monetary control techniques." The analysis will be difficult in the absence of practical evidence of liberalisation in the markets — and even more difficult if the legislative programme has not even been agreed.

To proceed beyond Stage One to the "subsequent stages" of monetary union requires revision of the Treaty of Rome by an intergovernmental conference. Currently, it seems probable that this conference will be called by majority vote at the earliest possible opportunity — shortly after July 1, 1990. However, because conference decisions require *unanimous* voting, such an early date could be premature: Stage One will have only just started and if any major parts of the Single Financial Area have not even been approved — including agreement on strengthening competition policy — it would be hard to feel that there was enthusiastic, unanimous support for the more difficult stages ahead.

The Single Financial Area — Can The EC Achieve Its Target?

The genuinely liberalised financial markets envisaged by the Delors Report are a quantum leap from the status quo, but progress seems to be accelerating. The French Presidency of the EC could be crucial in creating a climate where the Single Financial Area appears a realistic probability.

The following actions highlight the progress made to date:

Abolition of exchange controls

This historic and far-reaching measure was agreed in June 1988. The major EC countries have agreed to abolish the few remaining controls by July 1, 1990. The most visible exchange controls have, effectively, been abolished already, and the European Monetary System (EMS) has survived remarkably well at a time of sharp dollar fluctuations. The only remaining controls are those preventing individuals from holding foreign currency

bank deposits. Evidence, particularly from the UK, indicates that individuals do not diversify their transaction balances — only their savings — so freeing liquid balances should not create a crisis.

Overall, the agreement to abolish visible exchange controls was *the* change that has probably made the drive towards some form of monetary union irreversible, because of the need to remove the risk of destabilising capital flows. Under *current* scenarios, there seem few reasons to expect abolition of the remaining visible exchange controls in the EC to destabilise the EMS.

However, there is still an array of restrictions on the investment policies of many financial institutions, which has a similar economic effect to exchange controls. These restrictions are analogous to the "nontariff" barriers that have always bedevilled liberalisation of trade in physical goods, and they amount to invisible exchange controls.

Mutual funds

On October 1, 1989, the directive on Undertakings for Collective Investment in Transferable Securities (UCITS) — the first liberalisation — comes into effect. This directive permits qualifying mutual funds to be sold freely throughout the EC. Tested against the Heads of State "quality standard," the directive falls short, because money market funds are not permitted. However, the principal opponent of such funds — West Germany — is about to permit its own mutual funds to have up to 49% of their assets in money market instruments. Bundesbank President Pöhl recently accepted the likelihood of further changes in West Germany.

Banking

The Spanish Presidency succeeded in obtaining the Council's agreement on a common position — the vital hurdle — on the Second Banking Directive and the Solvency Ratio Directive. The Second Banking Directive permits an EC bank to offer — in any EC country — the services for which it is authorised in its home country. The Solvency Ratio Directive is the measure that implements the risk-weighted capital adequacy standards proposed by the Cooke Committee of the Bank for International Settlements. Together, these measures seem to go a long way towards meeting the quality standard for banking services (including mortgages). This freedom is expected to be extended fully to foreign banks' services.

Investment services

The proposed Investment Services Directive would give nonbanks and financial intermediaries the same freedoms as those given to banks by the Second Banking Directive. Progress on this "EC passport" for investment banks seems to be lagging, because, in general, it is only UK-based entities that are affected. In the capital markets, an uneven playing field for banks and nonbanks would not be compatible with the "quality standard."

Insurance

The directives already approved and proposals made so far do not, realistically, begin to measure up to the Heads of State "quality standard." The problem stems from the European Court of Justice 1986 rulings on whether there was sufficient harmonisation of EC law to give consumers adequate protection. As a result, the current proposals have avoided the individual consumer and, certainly for the nonlife risks, concentrated on freeing insurance for medium- to larger-sized companies. This focus avoids the very area where the European consumer — who is also the elector — hopes to see tangible benefits from enhanced international competition. However, the Commission plans to address this problem in 1990.

If they are to be prudently and efficiently managed in the liberalised market, insurance companies' assets must reflect properly the type of liabilities undertaken to the public. Thus, foreign assets would not be appropriate where the premiums are likely to be paid out again as claims in a short period. At the other end of the spectrum, a life insurance policy that participates in profits is essentially a savings vehicle with attached insurance against death. That savings element should be free to be invested in an internationally diversified, profit-maximising portfolio.

Life insurance companies play a key role in the EC's capital markets: as the repository of much of the Community's long-term savings, they are major buyers of long-term Government bonds. With a choice of assets constrained only by prudence, the capital markets will have the genuine freedom, not only to judge the budgetary position of member states, but also to exert discipline by moving assets accordingly. The same principles should apply to pension funds.

Unless liberalisation of insurance — both assets and liabilities — meets the Heads of State "quality standard," a vital component of the Single Financial Area will be missing.

Securities issuance

The Prospectus Directive goes some way towards harmonising conditions for issuing securities by requiring member states to recognise a prospectus published in another member state. However, many member states continue to impose conditions that restrict issuance — originally for the proper purpose of ensuring an orderly market. Typically, conditions comprise the nationality of the lead-manager, nationality of the applicable law, physical location of the securities, and nationality of the paying agent. Even the most liberal country — the UK — requires the lead-manager of sterling issues to have a full UK presence. Although the original purpose of these regulations remains necessary, the current regulations have the effect of discriminating against lead-managers outside the member state. If issuance is restricted, then free circulation of financial instruments is effectively limited — contrary to the spirit of the "quality standard." "Mutual recognition" of other member states' standards is necessary.

Competition policy

UK Prime Minister Thatcher has emphasised, particularly, that the European Council had accepted the need for strengthening the Community's competition policy — as specified in Stage One of the Delors Report.

Competition policy potentially covers a wide area, but the current principal topic is the proposed merger regulation. This regulation would give the European Commission power to review "large mergers." The raising of the definition of "large" — perhaps to an annual turnover of ECU5 billion, declining over a period to ECU2 billion — has overcome many objections. There seems to be a reasonable chance that this measure could be approved later this year. However, Prime Minister Thatcher may have broadened the requirement of an acceptable competition policy by highlighting the Delors Report's call for a reduction in state aid.

It seems quite feasible that the EC can meet the "strengthening of Community competition policy" condition set for Stage One.

Appendix

Extracts from **Presidency Conclusions — European Council**
Madrid, 26 and 27 June 1989

“The European Council, meeting in Madrid, reviewed the situation and the prospects for progress towards European Union.

“...The completion of the Internal Market and the strengthening of economic and social cohesion were the priority objectives of this new chapter in the history of the Community.

“...The European Council noted that the forward thrust in achievement of the Internal Market was making an ever-increasing contribution to expansion and improvement in the employment situation. This thrust had hitherto resulted mainly from the decisions taken to remove technical barriers to trade. It was now necessary to make similar progress towards the elimination of physical and fiscal obstacles with a view to achieving an area without internal frontiers by 31 December 1992 in accordance with the provisions of Article 8a of the Single Act.

“The growing rate at which decisions were being taken meant that well over half the measures listed in the White Paper had been adopted. The Council recalled certain priority fields identified at its meetings in Hanover and Rhodes, and welcomed the fact that important decisions had been taken in the areas of public contracts, banking and financial services, the approximation of technical standards and transport. However, it noted that there were still decisions to be taken in these priority fields, including transport, in particular cabotage, and asked the Council to intensify its work in these sectors.

“The European Council invited the Commission to submit to the Council the remaining proposals provided for in the White Paper at the earliest opportunity, and expected the Council to finalise adoption, as quickly as possible, of the instruments that would permit the completion of the Internal Market.

Economic and Monetary Union

“The European Council restated its determination progressively to achieve Economic and Monetary Union as provided for in the Single Act and confirmed at the European Council meeting in Hanover. Economic and Monetary Union must be seen in the perspective of the completion of the Internal Market and in the context of economic and social cohesion.

“The European Council considered that the report by the committee chaired by Jacques Delors, which defines a process designed to lead by stages to Economic and Monetary Union, fulfilled the mandate given in Hanover and provided a good basis for further work. The European Council felt that its realization would have to take account of the parallelism between economic and monetary aspects, respect the principle of “subsidiarity” and allow for the diversity of specific situations.

“The European Council decided that the first stage of the realization of Economic and Monetary Union would begin on 1 July 1990.

“The European Council asked the competent bodies (the ECOFIN and General Affairs Councils, the Commission, the Committee of Central Bank Governors and the Monetary Committee):

- “(a) to adopt the provisions necessary for the launch of the first stage on 1 July 1990;
- “(b) to carry out the preparatory work for the organization of an intergovernmental conference to lay down the subsequent stages; that conference would meet once the first stage had begun and would be preceded by full and adequate preparation.”

Other Titles in the “1992 and Beyond” Series

Fortress Europe, Graham Bishop, Salomon Brothers Inc, October 1989.

Banking — Will Liberalisation Itself Lead to a Common Currency?, Graham Bishop, Salomon Brothers Inc, February 1989.

The Long March to European Monetary Union — Two Practical Steps, Graham Bishop, Salomon Brothers Inc, May 1989.

European Banking Integration in 1992 — The Competitive Challenges Facing U.S. Multinational Banks, Thomas H. Hanley *et al*, Salomon Brothers Inc, June 1989.

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Amendments to the German Insurance Supervisory Law

German insurance companies are governed by the Law on the Supervision of Insurance Companies (Versicherungsaufsichtsgesetz - VAG). This stipulates how insurance companies may invest their committed assets. Committed assets are divided into the coverage fund, covering the premium or legal reserve in life insurance, and "other committed assets," covering existing liabilities from insurance contracts and technical reserves as well as reserves for policyholder dividends.

At present, the committed assets must be invested "in assets located within the territory of application of this law" (i.e. the Federal Republic of Germany). There is a catalogue of permitted investments (the Deckungsstockregelungen), as follows:

- Loans secured by mortgages on property within the Federal Republic.
- Domestic bearer bonds or registered bonds.
- DM bonds issued abroad, if they have been admitted for regular trading on a domestic exchange - however these may not exceed 5% of committed assets.
- Claims entered on the Debt Register of Bund or Land.
- In fully paid shares admitted to regular trading on a domestic exchange. Shares of any one corporation may not exceed 5% of the capital stock of that corporation.
- All investment in equities may not exceed 20% of the coverage fund or 25% of other committed assets.
- Other committed assets may be invested in fully paid shares admitted for regular trading on a foreign exchange. Investment in foreign equities may not exceed 20% of the total limit for equities.
- In debts secured by mortgages, securities issued within this country and admissible as a security for loans by the Bundesbank, or registered bonds.
- In loans to the Federal Government or the Laender.
- Real estate - this is regulated in detail. Real estate covered by a building, in the process of being built on or about to be built on. Investment in commercial property may not exceed 10% of committed assets and investment in real estate either in the process of being built on or about to be built on may not exceed 5%. Investment in property for the business operations of insurance company requires official approval.
- Shares of separate property accounts managed by a domestic investment corporation containing domestic real estate.
- Congruency rules: for foreign currency liabilities, the coverage stock should be invested in assets expressed in the same currency and conforming to the above regulations.

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25th April 1990

Lord Joseph
House of Lords
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Dear Lord Joseph

Following our telephone conversation, I have pleasure in enclosing two sets of the publications I sent you. Naturally, I am honoured that you wish to send them on to the Prime Minister and Mr Ridley. I would also be very happy to elaborate on them, if that would be helpful.

For your information, I have a very good working relationship with the 'European' officials at both Treasury and Bank of England. Contacts at the DTI are limited to areas of specifically regulatory concern - for example, on the Capital Adequacy Directive. At the political level, I shall be meeting Peter Lilley next week, as well as talking to the Conservative Finance Committee. In the European context, I have regular contact with the European Democratic Group - especially Sir Christopher Prout and John Stevens.

Salomon Brothers takes no political views so I also circulate my material to the Labour Party. I have yet to receive any response at all! I shall take up your suggestion of writing to Sir Alan Walters.

Thank you for your interest in my work - I will always be pleased to discuss these topics as I believe they are amongst the key issues at this turning point in Europe's history.

yours sincerely,
Graham Bushy

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In January 1989, draft new regulations were circulated. These proposed farreaching changes, broadening the present detailed catalogue of permissible investments. However, this comprehensive draft was put on ice in 1989 until after the November 1990 elections.

The Federal Government then proposed a new draft of some far less comprehensive changes. This looks like being adopted unchanged.

The main points of this new Jan 1990 draft are as follows:

- 5% of the coverage fund and 20% of other committed assets may be invested abroad - foreign investments already permitted by the regulations must be included in this amount. The authorities may allow further exceptions to this rule in individual cases.
- The total limits on equities are raised to 30% of the coverage fund and 30% of other committed assets (from 20% and 25% respectively). The limits on foreign equities remain at 20% of the total permissible for equities (and must be included in the overall limits above).

The draft makes the point that this increase in the equity limit is beyond what is required by EC law and goes on to say: "Additionally, it is to be noted in this connection that the existing insurance supervisory law allows insurance companies to engage in futures business by means of which exchange and interest rate risk for assets and in building up a stake may be eliminated. Within this significant framework the insurance sector can contribute to the development of the German Futures Exchange."

- Real Estate: the existing detailed regulations are replaced by the following:

[The committed assets may be invested:] "In real estate covered by a building, in the process of being built on or about to be built on in the immediate future as well as in rights equivalent to real property; the insurance company must check the appropriateness of the purchase price on the basis of an appraisal by a sworn expert or in a similar manner."

This removes the present limit of 5% of committed assets for real estate under construction and 10% for commercial property. Approval of property investments for the business operations of insurance companies is no longer required.

- Congruency rules: Committed assets are to be invested in assets in the same currency as the expected liabilities.

The draft includes a new "Appendix C" which takes into German law the matching rules contained in the appendix of the Second Directive on Non-Life Insurance. The main points are as follows:

Cover and liabilities are to be in the same currency. However, 5% of the coverage fund and 20% of other committed assets may remain unmatched. 50% of the amounts expressed in the currencies of other EC member states may be invested in ECU assets.

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1992 And Beyond

**The Long March To European
Monetary Union**

Two Practical Steps:

- **West Germany Should Abolish Its
“Exchange Controls”**
- **Sterling Should Be Excluded From
The ECU**

by
Graham Bishop

May 1989

Salomon Brothers

1992 And Beyond
The Long March to European Monetary Union
Two Practical Steps:

- West Germany Should Abolish Its "Exchange Controls"
 - Sterling Should Be Excluded From The ECU
-

by
Graham Bishop

It is a great honour to discuss this historic topic with such a distinguished group. My task today is to put forward the views of a practical financial businessman: I am an analyst of business opportunities for Salomon Brothers International Limited — a securities firm headquartered in London, with a subsidiary bank in Frankfurt and offices in Madrid and Zürich. I want to propose two important practical steps towards monetary union: first, West Germany should abolish those regulations that are effectively exchange controls; and second, sterling should be excluded from the European Currency Unit (ECU).

There has been renewed debate in the past year about the steps required to achieve monetary union, which reached a climax with the recent publication of the Delors Report. Much of the debate focussed on grand theories, such as the impact on national sovereignty — in other words, the view from the "top down." As a student of practical financial services, I would like to share with you a day-to-day business view, or the "bottom up" approach.

Business people are trying to determine what the citizens of Europe are actually prepared to do with their money and savings. If, in the fullness of time, consumers who are also electors *are* prepared to put their savings where the politicians' mouths are, then this will represent a very powerful statement of political will — with far-reaching implications. If they are *not*, then the debate about a European System of Central Banks will simply remain a grand theory for many years to come.

In this discussion, I feel rather like an infantryman in the trenches. The generals and the infantry are united in sensing that a historic victory is possible. The generals are clustered around a map that supposedly charts the road to the final objective — monetary union. They have given some of the infantry the freedom to go "over the top" and to set off on the long march down that road. As encouragement, the generals say they will probably arrange for some of the bigger landmines to be removed from the road. The whole army knows that if no one takes any steps at all, then victory will definitely not be achieved.

While I would like to comment briefly on some aspects of the generals' broad strategy, my position as an infantryman in the trenches means that I am primarily concerned with the landmines. I would like to discuss two of these in particular, although there are, of course, many others. Dodging these particular landmines will be two major steps on the long march to monetary union.

I have no doubt that genuine and complete liberalisation of financial services will itself lead to a common currency.

Speech given at the London School of Economics' Financial Markets Group Conference on "A Single European Currency," London, May 9, 1989.

The author wishes to thank Ann O'Kelly for her unstinting assistance in the research for this speech — especially the translation of so many legal proposals.

I would now like to comment on four aspects of the Delors Report:

- Coordination of budget policy;
- The alternative to devaluation;
- Parallelism and the ECU; and
- Participation.

I should first define my use of the term "monetary union." My analysis assumes that this ideal state of "monetary union" will be attained over a lengthy period of time and in an evolutionary manner — not suddenly imposed in a revolutionary fashion.

In this context, the Werner Committee Report of 1971 still seems extremely relevant. For example, in its definition of monetary union it said: "the Community currencies will be assured of total and irreversible mutual convertibility free from fluctuations in rates and with immutable parity rates, or preferably they will be replaced by a sole Community currency."

With that definition as background, I shall make four observations on the Delors Report:

The first is *coordination of budget policy*. This topic is at the heart of the debate on national sovereignty. Specifically, the Report calls for upper limits on budget deficits of member states; and the definition of the overall stance of fiscal policy, *including* the size and financing of the aggregate budgetary balance. As there will not be much national economic sovereignty left at the end of such a process, I question if it is necessary to impose such rigidity — with all its overtones of "central planning." Indeed, a cursory comparison of the budgetary positions of the UK and the Federal Republic of Germany does not reveal a clear link with monetary growth, price stability or external balance. Instead of this coordination, could we safely rely on the operation of market forces? A glance at the results of monetary union within two different federal systems is revealing.

Figure 1. Canadian Provinces, Total Debts and Budget Deficits

	Debts ^a	Deficits ^b
Saskatchewan	54.2%	27.8%
Newfoundland	62.4	18.5
Nova Scotia	45.3	16.8
New Brunswick	53.9	13.7
Manitoba	50.1	12.5
Alberta	14.1	11.8
British Columbia	28.8	9.1
Quebec	39.2	5.9
Ontario	25.0	4.6

^a Estimates of direct and guaranteed debt as of March 31, 1988 as a percentage of Gross Provincial Product.

^b Fiscal 1985-89 average as a percentage of revenues.

Source: See *Canada and the Provinces, A New Framework for Assessing Provincial Credit*, Purcell, Miller et al, Salomon Brothers Inc, December 1988.

My first example is Canada, in which the largest Provincial budget deficit is six times the smallest, and the largest ratio of accumulated debt is more than four times the smallest. The credit ratings of the Provinces vary from AAA to A, and the bond market currently charges the best-rated borrower 10.6% for ten-year money and the worst rated an extra 45 basis points.

Clearly, there is a very wide and sustained divergence of fiscal policy within this monetary union, and the credit markets *do* distinguish between the constituents — but certainly nothing resembling the spread of 700 or so basis points which would probably exist between ten-year West German

and Italian Government bonds — if there were corresponding bonds. Precisely because it is a monetary union, the Provinces cannot finance themselves by printing money and eventually devaluing. The financial markets can exclude that risk and therefore look solely at the credit quality. Before the 1930s, Canadian revenue-sharing arrangements were not well developed and several Provinces threatened defaults during the Depression — although only one occurred. The existence of adequate revenue-sharing arrangements now gives the financial markets sufficient comfort that the risk of crisis is limited.

My second example is the monetary union operated in West Germany by the Federal States (the Länder):

Figure 2. West German States — Total Debts and Budget Deficits
(As a Percentage of Gross State Product)

	Total Debt		Budget Deficit 1986
	1982	1986	
North-Rhine Westphalia	13.5%	17.2%	1.3%
Bavaria	8.1	8.3	0.4
Baden-Württemberg	10.4	10.3	0.3
Lower Saxony	15.7	17.7	1.2
Hesse	11.7	12.6	0.8
Rhineland Palatinate	15.1	17.3	1.2
Hamburg	14.8	17.7	1.4
Berlin (West)	23.6	20.4	0.9
Schleswig-Holstein	20.2	23.1	1.3
Bremen	32.7	42.1	3.0
Saarland	20.8	28.5	2.6
Weighted Average	13.3%	15.0%	0.9%

Source: See *The West German Federal System: Credit Implications for the Länder*, Purcell, Miller et al, Salomon Brothers Inc, September 1987.

The range of fiscal policy and indebtedness is even wider than in Canada: the largest deficit ratio is over seven times the smallest and the greatest indebtedness is more than five times the smallest. Yet the credit spreads are much narrower than in Canada — perhaps only five to ten basis points. The explanation lies in the *Finanzausgleich* — the revenue equalisation system that makes the financial markets regard the credit of the Länder as very close to that of the Federal Republic itself.

Both these monetary unions operate among entities with a range of fiscal policies probably wider than that among the sovereign nation states of the Community itself. Yet, the credit markets do not seriously differentiate between the constituents. The reason, of course, is that the monetary union operates within a political federation — with the naturally consequential revenue-sharing arrangements — *which the markets believe to be implicit guarantees*.

Without such implicit guarantees, would highly mobile capital be prepared to finance fiscal profligacy? The answer is, at a price and for a while. But the price would be measured in percentage points of yield rather than basis points. The citizens of that nation-state would be well aware that they were paying dearly for their fiscal imprudence. The fiscal crisis of New York City in the mid-1970s shows how far the financial markets are prepared to extend credit to a constituent of a monetary union *until* the profligacy becomes unacceptable. Then the invisible hand of the market showed itself to be a more powerful and rigorous disciplinarian than the Council of the European System of Central Banks is ever likely to be. Yield levels virtually doubled, followed by several years of extreme fiscal austerity.

My conclusion is that a monetary union can tolerate a very wide range of fiscal policies in the context of a political federation that offers implicit guarantees to its constituents. Without effective federation and/or guarantees, financial markets have exerted, and will exert again in the

future, a powerful disciplinary force on fiscal imprudence. If there is a genuinely free capital market, then rigid, centralised budget controls may be unnecessary.

Dissenters often say that political union is a necessary condition of monetary union. The close linkage between the two is frequently illustrated by the example of German Unification in the nineteenth century. It is pointed out — as highly significant — that the Reichsbank (forerunner of the Bundesbank) was founded in 1875, four years *after* the political union of 1871. However, in a recent paper,¹ Holtfrerich showed that an effective parallel currency was established in 1838 by the Dresden Coin Convention. A silver standard was created, with coins that were legal tender throughout all states participating in the *Zollverein* — the Customs Union. This preceded political union by more than 30 years.

My second topic is *the alternative to devaluation*. The Delors Report certainly underlines the need for the availability of adequate funds to “promote regional development and to correct economic imbalances” within a monetary union. How are those funds to be provided? The Report speaks only of the reform and strengthening of structural funds and regional policies. As a representative of the financial services industry, I am naturally curious about why the private sector is not mentioned. Shouldn't worthwhile investment projects be funded by bond issues on the European capital market, subscribed by institutions drawing upon voluntary savings throughout Europe? If the projects are not seen as worthwhile, or will strain the credit rating of the issuer, then the discipline of the market will soon be applied.

Therefore, I would argue that the correction of economic imbalances — as a condition for monetary union — will be satisfied most easily by ensuring the free movement of long-term capital — which requires freedom for both borrowers and lenders. “Stage one” of the Delors programme requires, in effect, members to eschew devaluation and “make the functioning of other adjustment mechanisms more effective.” Genuine liberalisation of the capital markets is a key mechanism.

My third topic is *parallelism and the ECU*. The Report makes the point, powerfully and correctly, that “monetary union without a sufficient degree of convergence of economic policies is unlikely to be durable and could be damaging to the Community.” That said, it seems surprising that the Committee “was of the opinion that the ECU has the potential to be developed into such a common currency.” Eventually that will be true but, in the meantime, trying to promote the ECU as a common currency before there is that “sufficient degree of convergence” is *already* damaging the Community.

The ECU has existed for some time, but does not seem to have caught the imagination of the European peoples. Its share of external bank loans has hovered around 2%-3% since 1986. Its share of bond issues has risen from 3% in that year to about 6% in 1988. This may appear to be progress — but these modest percentages are of *external* transactions. The significance of ECU transactions to the *total* transactions of Europe's citizens is minimal — at best!

If a new market is really filling a need, it takes off. Issuance of sterling mortgage-backed bonds started in 1987 and £4 billion were issued in 1988. After five years of effort, the “booming” ECU market of 1988 issued about a £7 billion equivalent. The ECU has failed to cross that threshold of acceptance and the momentum has been lost. In reality, the people of

¹ See *The Monetary Unification Process In Nineteenth-Century Germany: Relevance And Lessons For Europe Today*, by Carl-Ludwig Holtfrerich, in *A European Central Bank?*, M. De Cecco and A. Giovannini, Cambridge University Press, 1989.

Europe do not regard the ECU as a genuine alternative, or as a parallel currency. Not enough people trust its stability sufficiently to be prepared to hold their savings in ECU financial assets. The credibility of monetary union will only be damaged as the ECU limps along with such a miserably small role — shunned by the overwhelming majority of European savers.

My final observation on the Report itself is to welcome the comments on *Participation* — “influence on the management of each set of arrangements would have to be related to the degree of participation by member states.”

Not all the generals seem to be agreed on whether the goal is a good one, but the chiefs of staff have formulated a reasonable plan and the infantry has been given permission — in fact, encouraged — to set off down the road. As good capitalists, the infantry is eager to get their share of the expected fruits of victory. In the absence of a better plan to create even larger fruits of victory, it seems proper for the enthusiastic generals to leave their dissident colleagues in the desert and lead the rest of the army forward to the promised land.

The scene is now set for a two-speed Europe.

Two Steps Forward

In discussing the generals' grand strategy, I have stressed that there may well be tasks that can be achieved quite simply by the infantry — provided it has the necessary freedom to avoid the more obvious roadblocks.

These practical, micro-economic problems certainly include a number of thorny issues. These issues must have a leading place on the “macro” agenda. As Chancellor Lawson pointed out in his recent Chatham House speech, there “is still a great deal of hard, detailed work to hack away at the remaining barriers and clear the ground for wider competition... uncomfortable vested interests will be challenged and disturbed.” The difficulty in shaking off the power of those vested interests was vividly illustrated when, two months later in his Budget speech, the Chancellor extended Personal Equity Plan tax relief to include “unit trusts investing mainly in UK equities.” Was this the raising of a new barrier?

However difficult it is to remove the barriers, this essential task must not be shirked. Nor should it be. The financial services infantry has begun to realise the magnitude of the prize available and, as good capitalists, is eager to obtain its share. Genuine liberalisation of the road ahead will create a rush that, in itself, will ensure victory. But dreams alone are not enough: the practical problems must be solved — though with the ideals firmly in mind.

Step One: The Federal Republic of Germany should abolish its “Exchange Controls”

Many people believe that the historic Directive in June last year sounded the death-knell of exchange controls within the Community. In a narrow legal sense, it is true that the battle has already been won. Sadly, in the economic sense relevant to freedom of choice and monetary union, such a notion is quite wrong. When it comes to international investment, the great bulk of the funds will be channelled through the long-term savings institutions: mutual funds, pension funds and life insurance companies. Thus, regulations governing the assets that these institutions can purchase could still amount to a second tier of exchange controls.

Even within the domestic market, regulations requiring these institutions to hold a certain percentage of their assets in Government bonds, for example, can seriously distort the flow of savings into that asset class — at the clear

expense of those areas starved of funds. Classic examples of this regulation can be found in the French mutual funds (Sicavs) or Italian life insurance. This is not to say that someone in France should be denied the opportunity to invest in Government bonds through a fund or that an Italian should not be able to buy an insurance policy that guarantees certain payments — where Government bonds would be the proper asset to match the liability. The financial intermediary's objection is to the compulsion — the saver is not free to choose.

Do these controls matter? Is there significant damage done to savers by regulations originally intended to protect them? Is the potential for crossborder flows sufficiently large that it might have a material impact in stabilising the European Monetary System (EMS) by private sector capital flows, offsetting flows from trade imbalances. The answer to all these questions is an unequivocal YES. Let me illustrate by example.

We are all regularly reminded that West Germany has no exchange controls. I would like to dispute the economic truth of that statement. I am using West Germany as a detailed example, not because I want to upset my friends there, but because the Deutschmark is the anchor of the EMS and therefore flows in and out of Deutschmarks are absolutely critical.

It is true that money is fungible so, if a trade imbalance is to be financed, the source should be immaterial. However, the LDC debt crisis is still such a vivid reminder of the perils of relying on short-term "hot" money that it may be more prudent to look for sources of medium- to long-term funds — to match the timescale of the necessary structural trade adjustment. These flows of funds will finance regional policy and are the "other adjustment mechanisms" referred to in the Delors Report. They are the alternative to devaluation.

However, it would be alarming, and very risky, if all these long-term trade adjustments were to be financed by short-term funds — bank deposits, ECU Treasury bills, or the like. Therefore the freedom for long-term savings institutions to make long-term investments is crucial — IF the adjustments are prudently financed.

Ideally, such sources of funds should, by their nature, indulge in "stabilising" speculation. If the Deutschmark/French franc were trading at its DM3.43 limit and "the market" feared a 3% devaluation of the franc, a long-term buyer of ten-year Government bonds might still purchase French bonds yielding 8.6%, rather than the 6.7% West German bonds. During the bond's life, such an investor would reckon on nearly 20% extra return from this French bond — if only one devaluation occurred. If that investor believed — for whatever reason — that monetary union might occur within that bond's life, then the decision to buy the French bond would be a "no-brainer." Thus, the "speculative" purchase would create a stabilising flow of funds into the franc. If the investor were a corporate treasurer whose financial year-end was in three months, then the three-month deposit rates would add only 0.5% extra interest in the period that the francs were held. Faced with a serious risk of a 3% devaluation, the corporate treasurer would probably indulge in "destabilising" speculation and sell the francs. In this simplified example, if long-term financial intermediaries were forbidden to own foreign bonds, then the ultimate saver is damaged by losing the chance of making an extra 20% and, second, the flow of private capital is in only one direction, the franc devalues, the credibility of the ERM is damaged, and dreams of monetary union are postponed another year or two.

The West German current account surplus with the rest of the EC is so massive that many commentators talk about the need for a major Deutschmark revaluation. The alternative policy — and one which

supports the concept of monetary union — is to ensure a corresponding capital outflow. Foreigners may add to, or subtract from, their stock of West German assets but, over the years, the dominant factor is likely to be the domestic savers and their wish to diversify their holdings.

Figure 3. Acquisition of Financial Assets by West German Households, 1987

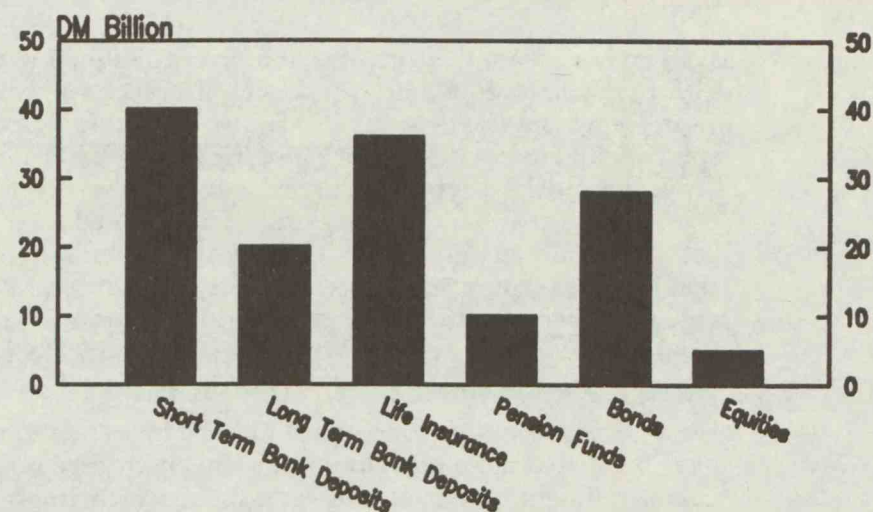


Figure 3 shows the pattern of acquisition of financial assets by West German households in 1987. The striking feature is the scale of the investment in life insurance. The life company is merely an intermediary between the retail saver and the ultimate user of the funds. In turn, the life insurance companies put about 80% of their inflows into fixed-income instruments. This highlights the enormous importance of competitive returns from such instruments — if they are to be attractive to West German savers.

The purpose of this figure is to illustrate that, if a European citizen is to have the true economic freedom to express his preference along the risk-return profile, then the chosen financial intermediary must also have the corresponding freedom to invest in assets that match the liability that the intermediary has undertaken to the saver.

However, a subsidiary implication of Figure 3 is the simple, but unstated, assumption that "life insurance" is nothing but another form of long-term saving — together with an attached contract for insurance against early death. "Death insurance" can easily be purchased separately, leaving the return from the "life insurance" contract as a straightforward competitor to bank deposits, bonds or equities. Historically, death insurance has been thought to be "good" and therefore encouraged with tax incentives. Over the years, these tax benefits have gradually been spread away from death insurance and towards the "life insurance" savings product. The UK has been particularly vigorous recently in "levelling the tax playing field" for the different savings media — the West German life companies may well be fearful that such concepts will be an unwelcome export from the UK. This may explain their reluctance to damage any illusions about the savings nature of a life policy.

Then there would have to be a rigorous conceptual — if not actual — separation of death insurance and a managed investment portfolio where the saver shares directly in the long-term results of the management expertise BUT has no guarantee of the rate of return. The portfolio of assets required to match such a profit-sharing type of liability may be radically different from that required to meet a guaranteed, insurance liability. This subsidiary implication is absolutely critical: the type of liability sold by the insurance company will govern — quite properly — the nature of the assets it holds.

As the battle heats up for retail savings in West Germany, the competition between banks and insurance companies — the *Allfinanz* debate — has the potential to create a sharp change in the type of liabilities that insurance companies want to sell. The example of banking products — especially mortgages — shows that genuine liberalisation of financial services would, itself, lead to a common currency.² On this occasion, I shall use the example of life insurance in general and West German life insurance in particular.

In West Germany, the medium- to long-term savings markets have historically been dominated by the life insurance companies. The *Versicherungsaufsichtsgesetz* (VAG), or Law on Insurance Supervision, specifies that assets held to meet contractual insurance liabilities — the “coverage stock” assets, which represent 90%-95% of the companies’ assets — must be one of 12 specified types. If a proposed asset type is not on that list, it may not be purchased — end of discussion. Foreign assets are not on that list — except of course to back foreign insurance! Thus, this obscure regulation prevents the dominant part of long-term West German savings from going abroad. I contend that this is economically equivalent to an exchange control and should therefore be abolished.

West Germany is not alone in having such investment restrictions, and I have only cited these regulations at such length because of their importance in controlling the flows of long-term funds which are so vital if monetary union is to be anything other than a dream. This is also the moment to pay tribute to the liberalisation measures being proposed in West Germany to implement EC obligations. These have not attracted as much attention as such revolutionary plans warrant. But I believe that the combined effect of the freedom to issue securities within West Germany AND a substantial broadening of the investment powers of insurance companies and mutual funds will be revolutionary in the fullness of time.

My only criticism of these proposals is that they do not go far enough. On the question of currency diversification, the proposal says “for life insurance [currency matching] should always be used, because here the obligations are usually expressed in a particular currency.” There are ways of mitigating the rigours of this prohibition, but they fall within the 30% of assets permitted to be invested in everything other than bonds and real estate. Thus, in one stroke, this proposal misses the point of the growing structural upheaval in the savings market. As a result, it fails to give any credit to the concepts of modern portfolio theory and prudent diversification of assets — within and across currencies.

If the West German insurance companies were not constrained by this regulation, what proportion of their assets might be held abroad? In the UK, the corresponding long-term institutions, at the end of 1986, had 12% of their assets abroad, while pension funds had 17% abroad. In the Netherlands, a substantial sample of private pension funds had 17% of their assets abroad at the end of 1987. Importantly, 11% of their fixed-income portfolios were held abroad. Dutch insurance companies had only 5% of assets abroad, but, in their public bond portfolios, 38% were foreign. I feel it is not unreasonable to postulate that, if unconstrained, West German insurance companies might put 10% of their assets abroad, once they had varied their policies. That total would represent a private sector capital outflow of approximately DM50 billion — a colossal sum. For perspective, it would amply cover West Germany’s 1988 current account surplus with the other EC member states. Would such flows help to stabilise the EMS if they stayed within it?

² See 1992 And Beyond: Banking — Will Liberalisation Itself Lead To A Common Currency?, Salomon Brothers Inc, February 1989.

These examples establish beyond doubt that controls on eligible assets DO matter. Unfortunately, the response to these conjectures by the vested interests concerned is highly predictable: “West German savers are very cautious and would be concerned if their savings were invested abroad.”

It is worth examining what “cautious West German savers” have actually done when they have had freedom of choice — rather than being constrained by the cultural caution imposed on their intermediaries by regulation. Bundesbank data shows that, in 1986, West German households put DM36 billion into life insurance and DM10 billion into bond funds. Interestingly, even in 1986, 40% of that DM10 billion went into foreign bond funds. In the first half of 1988, they put about 14% more into insurance than in 1986, but flows into bond funds were up 400% on the 1986 figures. For 1988 as a whole, German households astonishingly sold over DM1 billion of domestic bond funds and invested DM32 billion into bond funds investing internationally.

Figure 4. Total Rates of Return, Dec 1986-Mar 1989

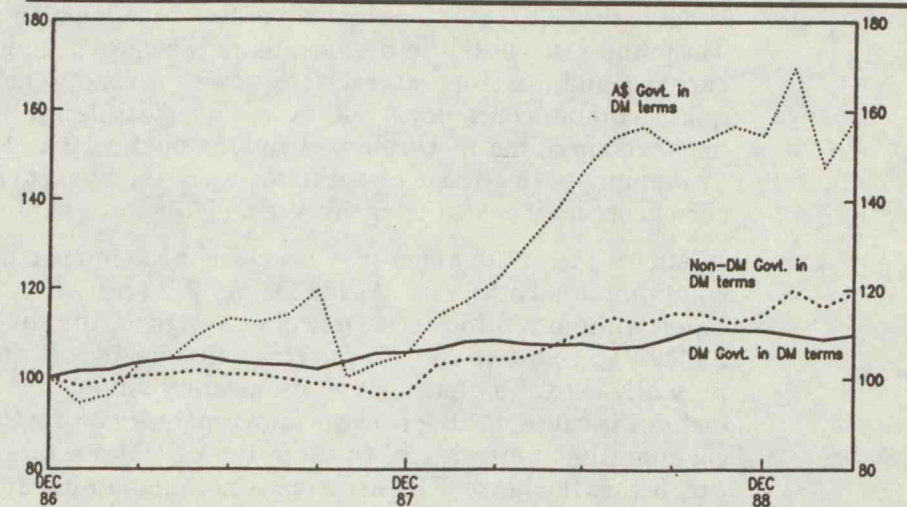


Figure 4 shows a remarkable expression of freedom of choice in selecting higher returns — even at higher risk, as the Australian example indicates. The proposal to introduce withholding tax was certainly a factor, but is more likely to have influenced only the split between West German or Luxembourg-based funds. Whatever the reason, the fact remains that West German savers moved their money — on a huge and decisive scale — out of the regulatory “protection” of the West German authorities, into another EC member state — Luxembourg. Having taken this crucial step, probably about three-quarters of the funds were invested in European bond markets. The Luxembourg funds hold virtually no Deutschmark investments. Some of these funds left European currencies altogether and will have contributed to the EMS group’s weakness versus other currencies, such as the dollar. The positive side of this account will be the potential scale of the capital inflows attracted by a unified European capital market. I believe the implications of these movements are enormous — the largest pool of long-term savings in Europe is prepared to look across EC borders when extra returns are available, especially if the exchange risk is modest. The flows are already measured in tens of billions of marks — even while exchange controls are still applied to the bulk. Based on last year’s behaviour, the potential for enormous, and stabilising, intra-EMS flows is crystal clear.

Other countries have shown the courage necessary to abandon such outmoded restrictions, even where the influence on the demand for Government debt is uncertain. The Netherlands has a large public deficit and one of the higher ratios of accumulated public debt to GNP. Yet, a year ago, the Dutch Government changed the law for the Civil Servants’ Pension Fund — which accounts for half of Dutch pension assets. This fund will now be allowed to invest 5% of its assets abroad. This may not be complete freedom, but it is a courageous start.

I have highlighted West Germany's covert "exchange controls" because of the importance of the Deutschemark as the anchor of the EMS and the strains created by West Germany's trade imbalance with the rest of the EC. From the trenches, exchange controls are a particularly obvious landmine for the financial services infantry. However, some of the generals who are most enthusiastic about the grand strategy have yet to demonstrate to the infantry a corresponding enthusiasm for the removal of their national landmines. Unless they do, the advance may turn out to be very half-hearted, no matter how glittering the prize on the other side of the minefield.

Step Two: Sterling should be excluded from the ECU

In my initial comments on the Delors Report, I made the point that "trying to promote the ECU as a common currency is already damaging the Community." I would like to elaborate on that comment and propose a remedy — principally, that sterling should be excluded from the ECU.

What is the ECU? It is a weighted basket of the member states' currencies. The enthusiasts wish it to become, indeed, believe it is already, a parallel currency and therefore several steps down the road to monetary union — a quasi "common currency." But there is a logical flaw in this process: membership of the ECU follows from the political act of joining the Community — as we are about to see when the Spanish and Portuguese currencies are included later this year.

Whatever the future hopes may be, current economic convergence is *NOT* a condition of membership. As the Delors Report itself notes, "monetary union without a sufficient degree of convergence of economic policies is unlikely to be durable." Self-evidently, that degree of convergence does not presently exist. So, that symbol of monetary union — the ECU — only endures because, for the overwhelming majority of the Community, it is economically non-existent! In short, the ECU is a severe case of putting the cart before the horse. The structure is nothing more than a political gesture rather than a market-driven response to real economic needs.

What is required to get the horse in front of the cart? Why aren't people prepared to hold their savings in ECU financial assets? These are perfectly reasonable questions. I believe the root of the problem lies in the ECU's composition, which is set out in Figure 5.

Figure 5. Composition of the ECU

	Weighting (Apr 25, 1989)
In Exchange Rate Mechanism	
Plus or minus 2¼% fluctuation band	
Deutschemark	34.6%
French Franc	18.6
Dutch Guilder	10.9
Belgian Franc	8.5
Luxembourg Franc	0.3
Danish Krone	2.7
Irish Pound	1.1
Subtotal	76.7%
Plus or minus 6% fluctuation band	
Italian Lira	9.2%
Outside Exchange Rate Mechanism	
British Pound	13.4%
Greek Drachma	0.7
Subtotal	14.1%
Total	100.0%

As is very well known, not all of these currencies — sterling, to name the obvious — participate in the Exchange Rate Mechanism (ERM). Even within the ERM, the Italian lira has wider margins of fluctuation than the plus or minus 2¼% bands. This composition permits a significant degree of volatility in the ECU relative to its constituents. This situation will only get worse in September 1989, when the routine recomposition takes place and the peseta and escudo are likely to be included in the ECU.

To state the obvious: for a financial transaction to take place, both borrower and lender must feel that it satisfies their economic needs. Continuing the focus on the sources of long-term funds, is there any advantage to an investor who holds a bond in the lowest interest rate currency — the Deutschemark — in switching into a corresponding ECU bond? This will be the question facing the portfolio managers of the West German insurance companies I discussed earlier — ONCE they are legally allowed to hold such assets.

Figure 6. Relative Performance of DM and ECU Bonds, Dec 84-Mar 89

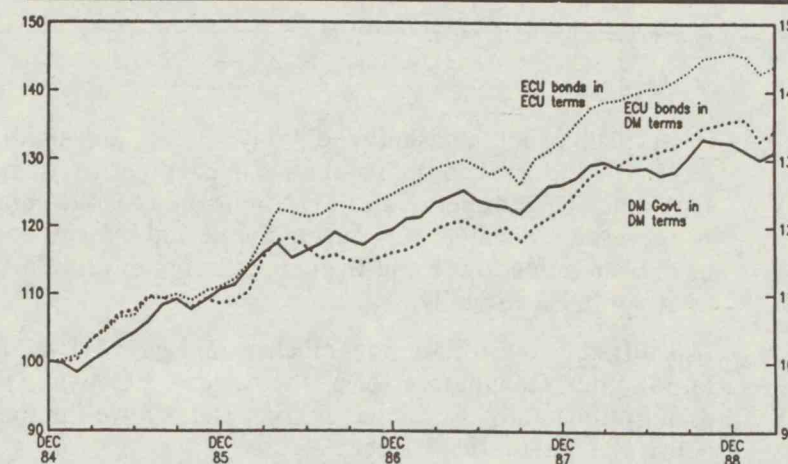


Figure 6 sets out the results such an investor would have achieved since the end of 1984. In summary, the return of the ECU bonds in ECU terms was 10% higher than West German Government bonds, but most was lost by the 7% depreciation of the ECU versus the DM. Even worse, there was a significant degree of currency volatility, making the whole exercise less predictable. This is not a picture that one would expect to induce large-scale flows out of DM into ECU and, not surprisingly, they did not occur.

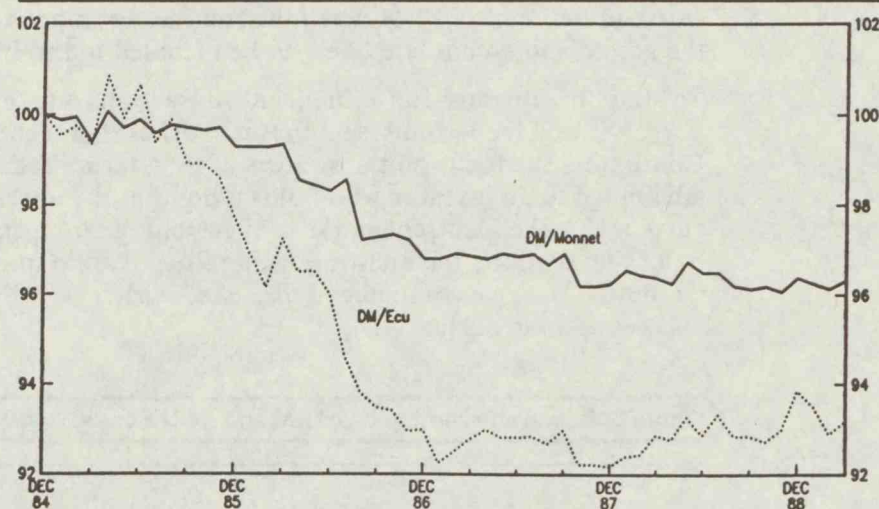
The key failure to create an attractive investment occurred because of (i) currency volatility, and (ii) depreciation. Both problems are inherent in the composition of the ECU. Perhaps the solution would be the creation of a new basket of the currencies with a "sufficient degree of convergence."

Many people advocate the greater use of ECU as a prelude to a "common currency," and *The Economist*, for example, has been suggesting that it should be renamed the "Monnet." This would honour one of the Community's founding fathers. It also has the pragmatic advantage of sounding to the man-in-the-street more like the word for cash — rather than conjuring up visions of some peculiar Australian bird called an emu. But perhaps the name "Monnet" *should* be given to this new basket of currencies, because it really could be the horse which pulls the cart towards a common currency.

This "Monnet" would only consist of the currencies within the narrow, plus or minus 2¼%, ERM band. Presumably, Italy will match its enthusiasm for the ideal of monetary union with the practical step of giving up its wider fluctuation band. The "Monnet" would then account for 86% of the present

ECU. By definition, the volatility will be slashed and the depreciation risk eliminated — to the extent that the EMS is not realigned.

Figure 7. Deutschemark Exchange Rates of ECU and Monnet



Historically, such a basket would have functioned significantly better than the ECU. Figure 7 compares the Deutschemark exchange rate of both the ECU and the Monnet. Naturally, the Monnet would not have been perfect — there were devaluations during the period. Nonetheless, volatility would have been much lower and the depreciation about half that of the ECU — at about 0.9% annually.

It is difficult to estimate how much would have flowed through to a bondholder. Calculations of a "theoretical" ECU yield require a number of assumptions and, in practice, market yields have fluctuated significantly below the "theoretical" levels.

Starting from today and looking forward, ten-year ECU bonds — of mixed credit quality — yield 8.6%. This is about 1.9% above corresponding West German Government bonds and identical to corresponding French Government bonds, for example. Theoretically, a Monnet Government bond would also yield 8.6%. To the extent that the Delors Report is accepted and implemented, a West German investor could look for an extra 1.9% annually of yield in a basket of currencies ever more firmly committed to stable exchange rates.

If that turns out to be true, the gain is the entire 1.9% annually. If the history of the last four years or so is repeated, the yield is still 1% above the 6.8% available on Government bonds, whereas if the ECU's history is repeated, the gain will be virtually nothing. Worse, one quarter or more of the ECU's members are not even prepared to commit themselves to reasonable "stability."

This is the type of scenario that should cause rational West German investors to shift large sums of money into the Monnet. I established earlier just how rational they are, and how large the potential funds. For a borrower, these calculations apply in reverse: the greatest advantage will accrue to borrowers in higher yielding currencies — Danish krone or Italian lira, for example — where the lower interest cost, but diminished currency risk, will be major attractions. This natural arbitrage process would tend to drive long-term interest rates in all the constituent currencies together. When issuers and investors become convinced of the likelihood of monetary union, the only remaining differences in rates would reflect credit preceptions — just as they still do in the monetary unions of Canada and the Federal Republic of Germany.

The Monnet — defined in this way — could make a major contribution to monetary union, even though it would superficially emphasise the existence of a two-speed Europe — those outside the ERM and those who are fully committed. However, the Monnet membership would be open to any country that wished to commit itself — credibly — to the *full* rigours of the ERM. If all EC member states joined, then the ECU and Monnet would become identical. Once this had occurred — or perhaps even before — the permitted margins of fluctuation within the ERM could be tightened progressively. The Monnet would then approach, correspondingly, the definition of a parallel currency. Once the fluctuation margins had been narrowed to zero and the constituent currencies were, as the Werner report put it, "free from fluctuations and with immutable parity rates," monetary union would, at that distant time, have been achieved and the Monnet could be the "sole Community currency."

Conclusion

This step-by-step approach, while lacking the glamour and immediate appeal of a dramatic declaration of political theory, instead offers a practical and concrete approach. It will build on the foundations already laid by the successful aspects of the EMS — its stability is a prerequisite for the Monnet to become widely accepted. Corresponding steps simply require the savers of Europe to be allowed, through their financial intermediaries, the freedom to express their wishes with their own money. If they are moved to use this freedom and make rational decisions, then they will, by their own individual and practical decisions, propel us towards the goal of monetary union.

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When Will Sterling Join the ERM? — Domestic Versus European Timetables

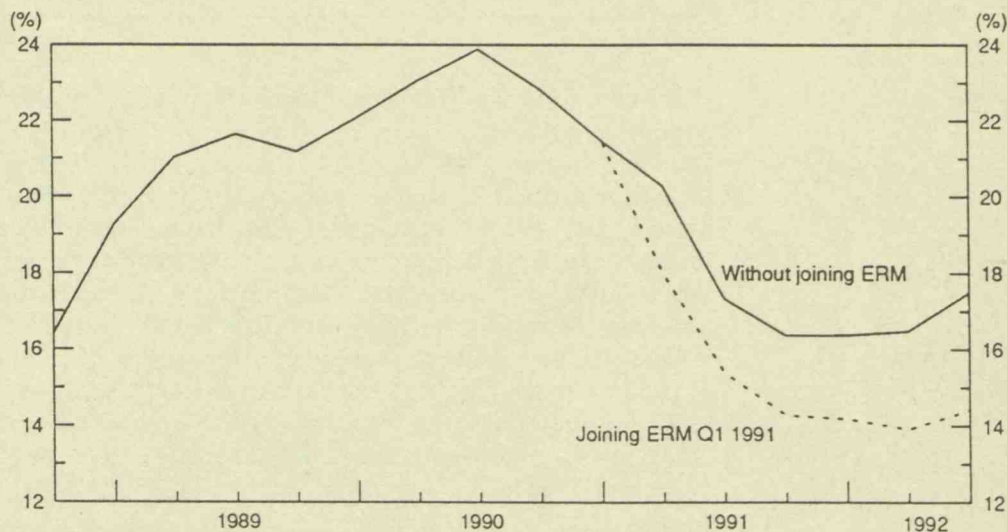
Introduction and Summary

ERM an Escape Route From UK Political and Economic Woes...

Chancellor Major reaffirmed the UK's commitment to join the Exchange Rate Mechanism (ERM) in his Budget speech, but stated that "progress on reducing inflation is a vital precondition." The UK Government, beset by problems, may focus solely on its own electoral timetable, governed by the June 1992 deadline. We believe the Government's chances for reelection rest on its ability to create a combination of mortgage rates below 10% and an inflation rate no higher than 5%. However, it is doubtful that this can be achieved by the election deadline, on present policies. But joining the ERM could dramatically raise the odds on reaching this goal in time. We believe the preferred route — on UK grounds alone — would be:

- entry at the beginning of 1991;
- with a 2¼% central rate band; and
- with the lower end of the band fixed at the current market rate.

Figure 1. Mortgage Plus Inflation Rates and the Exchange Rate Mechanism, 1989-92E



E Estimate. ERM Exchange rate mechanism.

...But EC Plans a Common Currency Soon

The European Community (EC) timetable is different. The just-completed European Commission report on how EMU is to be achieved — being debated this weekend by EC finance ministers — involves a rapid move to a single currency. **The dilemma looming for the UK concerns more than ERM membership: it is nothing less than a commitment to accept a common European currency by the mid-1990s.**

In this report, we analyse these two timetables separately, given the UK's conditions for entering the ERM. **We conclude that the risk of an historic split between the UK and Europe is significant.**

The UK Timetable

On present trends, the Conservative Party is set to lose the next election. The outcome will be determined by the ability of Mrs. Thatcher's Government to reduce inflation and interest rates sharply, and time is running out. Recent events have reinforced fears that wage inflation in the UK can only be reduced if the economy is tipped into recession. However, it will be hard to engineer a cycle of recession and recovery in which a post-recession combination of rising activity and subdued inflation can be established ahead of the June 1992 election deadline. There is no indication, either in likely budgetary or current monetary developments, that the Government is willing to take stern action to reduce near-term wage expectations.

Political and Economic Conundrum

Furthermore, the Government faces a policy dilemma very different from past experience. Whereas the economy reached cyclical troughs in January 1981 and January 1986, some 40 months and 24 months before the end of the five-year parliamentary term, respectively, the next election is already no more than 26 months away, and there is no sign that the trough in the present cycle has been reached. One key characteristic of this cycle is that it has been extended by official policy, thereby allowing insufficient time for a recovery in both economic and political fortunes.

Figure 2. Election and Policy Cycles, 1979-90E

Election	May 79	June 83	May 87
Economic Peak	May 79	Aug 84	Aug 88
• Months From Last Election	0	14	15
• Months to End of Parliamentary Term	60	46	45
Economic Trough	Jan 81	Jan 86	May 90E
• Months from Last Election	20	31	36
• Months to End of Parliamentary Term	40	29	24
Monetary Policy Easing	July 80	Mar 85	Sept 90E
• Months from Last Election	14	26	40
• Months to End of Parliamentary Term	48	34	20

E Estimate.

If the current cycle had been "normal," monetary policy would already have been eased. As Figure 2 shows, interest rates were lowered from July 1980 and March 1985, some 14 and 26 months, respectively, after elections. This time around, monetary policy has yet to be eased, and it is already 34 months after the last election. It is far from clear whether rates will be brought down within the next six months, and even possible that the next move will be upward. In fact, the previous Chancellor attempted to ease policy in the standard cyclical fashion, but the move was hidden within the framework of exchange rate policy: short-term rates were reduced sharply in the first half of 1988 as the exchange rate surged, but the policy shift extended the boom in a rapidly-overheating economy, sowing the seeds for an almost-unprecedented period of monetary tightening that has persisted since mid-1988.

Perhaps the closest parallel is the enforced relaxation of monetary policy in 1977 as the authorities attempted to curb a sharp rise in sterling. That attempt had to be reversed, and the subsequent spike in interest rates in 1978-79 may have contributed to the Labour Government's defeat in 1979.

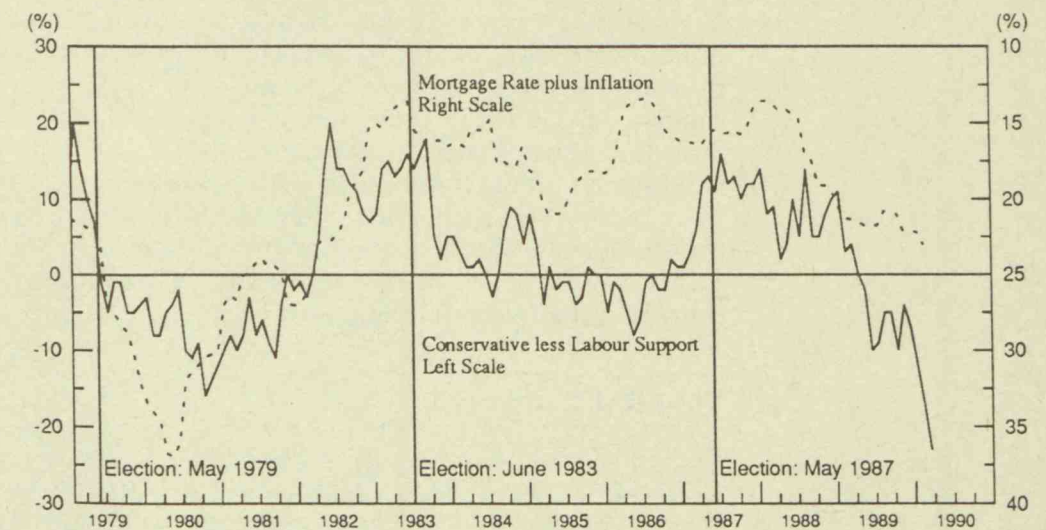
Mortgage Rates Will Erode Party Support

Essentially, Chancellor Major's problem is that past policy errors have desynchronised the economic and political cycles, and there is no easy way that domestic economic policy can resynchronise the two cycles before the next election.

The Government faces a conflict between economic and political goals. If winning the election depends on lowering interest rates and sustaining rates at lower levels for a significant period, then the economy should already have cooled off sufficiently to allow the process of monetary easing to begin, without incurring excessive inflation or currency risks. However, demand pressure is still high, wage settlements show no signs of coming down, and European central banks could tighten policies further in the near term: monetary easing will be too risky for the Chancellor. Such a move might push sterling down and wages up and have to be reversed in the run-up to the election in the most politically damaging fashion. On this basis, we predict that mortgage interest rates will remain at current levels for an uncomfortably long time and are likely to further erode support for the Conservatives.

Although the absolute level of support for the Conservatives is not as low as in 1985-86, it may be wrong to dismiss the 1989-90 Party losses as no more than a symptom of "mid-term blues." Opinion polls show that the Conservative Party faces the largest shortfall in popular support versus the Labour Party since 1971. Prospects for reelection appear bleak, given the fall in support for the Alliance, which may have been the repository of protest votes in 1985-86. The resolution of internal differences within the Labour Party may have provided a more solid underpinning for the Labour vote, perhaps suggesting that the Government will have greater difficulty regaining support ahead of the election than prior to the last two elections.

Figure 3. Mortgage Plus Inflation Rates and Opinion Polls, 1979-90E



E Estimate.

Against this backdrop, the UK economy will not provide the essential conditions in 1991 or first-half 1992 that would give Mrs. Thatcher a good chance of winning the election: a combination of inflation no higher than 5% and mortgage interest rates below 10%.

Economic performance is likely to be improving relative to the dismal 1989-90 experience, but inflation will only briefly dip below 5% — and underlying inflation, stripping out mortgage interest rates, will stick at 6%. Thus, monetary policy easing of sufficient size to reduce mortgage rates to desired levels will risk a sterling crisis that would then threaten a reversal of policies. Similarly, the maintenance of an extremely tight monetary stance might succeed in reducing inflation to desired levels, but at the expense of an election-losing mortgage rate well into double digits.

Sterling an Important Policy Constraint

In addition, the impact of a (politically) necessarily expansionary budget in 1991 will — while providing the mechanism for a welcome upturn in demand — eat into the budget surplus and erode the trade balance. Sterling may prove to be a more important constraint on policy than we have concluded. Certainly, the risks are all on one side, suggesting that sterling's downside will be tested by the markets during the critical run-up to the election.

There appear to be two options for the timing of the election — autumn 1991 and spring 1992. Without external support, neither date is attractive. In each case, a policy of resisting an excessive fall in sterling will leave the mortgage rate at a floor of 11%, too high for electoral comfort and above the 10% level ruling ahead of the last two elections. Taxes will likely be cut in the 1991 budget to support demand ahead of the election, resulting in a rise in the trade deficit from the second quarter of next year, immediately cutting away one of the props for the pound. An alternative stern strategy, in which fiscal policy is held tight, would break the pattern of every preelection budget since 1969, and appears almost inconceivable for a Government lagging badly in the polls. Taking risks with the exchange rate has featured in recent election strategies, but the difference between 1991 and the years in which the last two elections were held is that the economy will be operating with much greater demand pressure — measured by the trade deficit. Hence, inflation and exchange rate risks will be higher.

Conservative Party tacticians are likely to conclude that the mortgage and inflation rates will need to show a better performance than prior to the previous two elections, since the shortfall in popular support versus the Labour Party is far larger. Without external support, however, easing monetary policy sharply to encourage a reduction in mortgage interest rates will founder on the rocks of lower sterling and higher inflation. A tight policy aimed at driving inflation down will leave mortgage rates stranded and may encourage a politically debilitating rising unemployment trend. Either way, Mrs. Thatcher's Government looks unlikely to meet the critical economic conditions for reelection.

The ERM Escape Route

This conclusion may already be leading to a reconsideration of alternative strategies. In particular, the requirement that sterling be supported through a period of falling interest rates will draw attention to the external support offered by membership of the ERM.

Recent discussions of possible ERM membership have focussed on: (1) the need to enter at a highly competitive exchange rate to help cut the trade deficit; and (2) the potential instability of UK policy as a result of joining

Timing of ERM Entry

a system centred on lower inflation, lower interest rate economies, which might lead to a switchback in UK interest rates. We contend that longer-term policy conflicts will take a back seat in attempts to secure possible short-run benefits of membership ahead of the election. Our concern is therefore with the period up to mid-1992.

If managed carefully, ERM membership ahead of the next election will permit interest rates to be lowered significantly without generating increased inflation pressure over the relevant time horizon. Entry into the ERM may take place at the current exchange rate, or at a rate significantly higher or lower than the current market rate. The advantages of a low rate lie in its sustainability over a longer period, given high UK inflation, and in a relatively low level of associated interest rates. The advantages of a high rate are tied to the more immediate dampening effects on inflation. Thus, the critical influences on the choice of entry rate are:

- the relative priority attached to the long and short term; and
- the relative priority attached to lowering inflation and cutting interest rates.

Figure 4. Table of Simulation Results, 1991-92E

	1991E				1992E			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Outside ERM								
RPI	6.9%	5.4%	5.5%	6.0%	5.6%	5.6%	6.1%	6.4%
Mortgage Rates	13.0	11.5	10.5	10.0	10.5	11.5	11.0	11.0
DM/£	DM2.65	DM2.62	DM2.59	DM2.54	DM2.54	DM2.50	DM2.47	DM2.44
GDP	1.4%	2.0%	3.1%	4.1%	4.3%	3.9%	3.1%	2.7%
Low Entry Rate								
RPI	6.6%	5.1%	5.0%	5.3%	5.1%	5.4%	6.5%	7.3%
Mortgage Rates	11.0	10.5	7.5	7.0	8.0	9.5	10.0	11.0
DM/£	DM2.59	DM2.57	DM2.55	DM2.52	DM2.50	DM2.47	DM2.47	DM2.47
GDP	1.7%	2.5%	3.9%	5.1%	5.4%	4.6%	3.3%	2.4%
High Entry Rate								
RPI	7.0%	5.6%	5.5%	5.7%	4.9%	4.5%	5.0%	5.6%
Mortgage Rates	14.0	12.5	11.5	10.0	10.0	11.0	11.5	11.5
DM/£	DM2.77	DM2.74	DM2.70	DM2.69	DM2.65	DM2.67	DM2.69	DM2.70
GDP	1.22%	1.4%	2.3%	3.3%	3.6%	3.8%	3.3%	2.6%
Current Entry Rate								
RPI	6.6%	5.0%	4.9%	5.2%	5.0%	5.0%	5.6%	6.0%
Mortgage Rates	11.0	10.0	9.0	8.5	8.5	9.5	10.0	10.0
DM/£	DM2.69	DM2.65	DM2.64	DM2.64	DM2.64	DM2.64	DM2.64	DM2.64
GDP	1.6%	2.3%	3.5%	4.5%	4.4%	4.0%	3.0%	2.4%

E Estimate. GDP Gross domestic product. RPI Retail price index.

In our view, the Government's poor support will compel Mrs. Thatcher to take a short-term view. This will bias the decision towards a higher entry rate. A commitment to stabilize the pound against low interest rate currencies — backed up by bilateral support arrangements — will lead to a reduction in the risk premium attached to sterling for a comparatively short period of time.

ERM Entry at a High Exchange Rate

Consider the example of sterling entering the ERM at a rate set 5% above the current market rate. A reduction in sterling's risk premium might generate the conditions for a 100-basis-point reduction in short-term interest rates, but a higher entry rate will offset about half of this effect. Our simulations suggest that interest rates would, in this case, be brought down more rapidly than if sterling stayed outside the ERM, but progress would be slow. In addition, the favourable effects on inflation of lower import costs would be outweighed for four quarters by the negative impact on retail price inflation of the relatively high level of mortgage interest rates.

Thus, a high entry rate policy might yield relatively large benefits in the second year after entry, but not until then. This option therefore rules out the possibility of holding an election in the autumn of 1991. The restricted timing options might well prove the critical negative factor for such a policy, because of the nightmare threat of the need to hoist interest rates to defend an uncompetitive currency ahead of the election. In addition, our model suggests that the combination of lower interest rates and a somewhat firmer pound could only be sustained if wages react downward to reductions in interest rates and retail price inflation, and to the implied firmer discipline of the ERM.

ERM Entry at a Low Exchange Rate

We also consider the case of the Government adopting a low exchange rate, for example, 5% below the current rate. Our model-based simulations suggest that short-term interest rates might be brought down to a low of 7% within a year of entry, easily meeting the criterion of a 10% mortgage rate prior to the election. Retail price inflation would fall, but only because of the artificial impact of lower mortgage rates. In contrast, underlying inflation would turn up six months after the devaluation and accelerate over the following year. Eventually, then, such a stance would sow the seeds of its own failure. The best time to hold an election, in this environment, would be within a year of entry into the ERM.

The best outcome would reflect a downward adjustment to wage growth in response to lower interest rates: the benefits in terms of lower inflation and interest rates would be considerable. The worst outcome would be an upward reaction in wages to higher underlying inflation (i.e., to the fall in sterling), but our simulations suggest that the overall impact on headline inflation would still be downward for six quarters from the date of ERM membership.

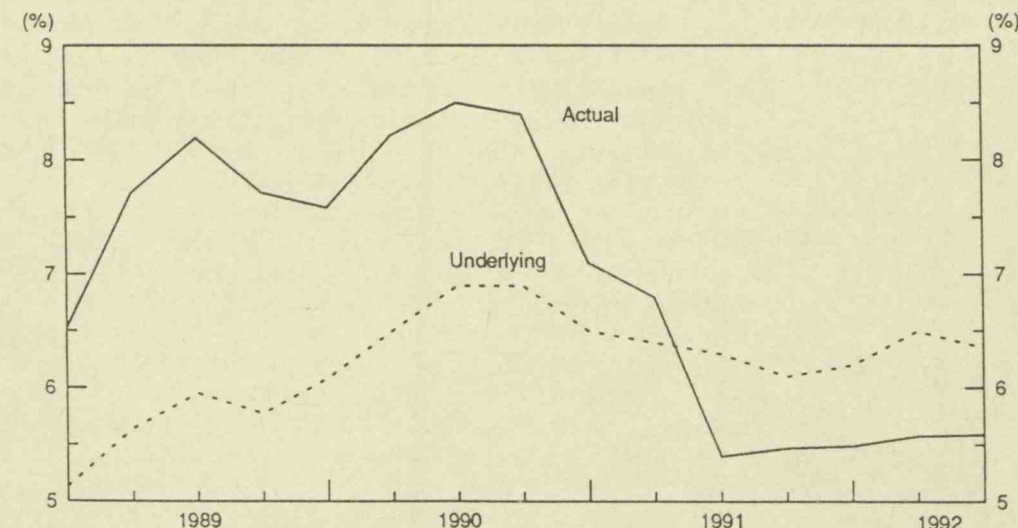
The key conclusion, therefore, is that entering the ERM at a somewhat lower exchange rate will secure temporary benefits to interest rates and retail price inflation, unless wages react violently upwards. Entry at the beginning of 1991 at a lower exchange rate cannot be ruled out, but the Conservative Party would require a sharp improvement in the opinion polls to permit entry on such terms, as it would raise too many inflation threats if the election was delayed until 1992.

ERM Entry at Current Exchange Rates

The compromise option of entering the ERM at close to the current exchange rate may offer the best balance between lowering inflation dangers and reducing interest rates, while avoiding restrictions on the timing of the General Election. As with all options, the benefits flowing from a reduction in the risk premium attached to sterling are likely to prove transitory, but would get the Government past the election. We calculate that setting the lower end of a 2¼% band at the current market rate would

permit short-term interest rates to be cut to a floor of 8½%-9% well within a year of entry and held close at that level for another six months. Critically, this could be the best option for headline inflation: if sterling enters the ERM at the beginning of 1991, the combination of a stable currency and lower interest rates will bring retail price inflation down to 5% by mid-year and hold the rate at that level throughout the following 12 months.

Figure 5. Underlying and Actual Inflation, 1989-92E



E Estimate.

We conclude that wage uncertainties rule out ERM entry at an aggressive exchange rate, while devaluation would risk another twist in the wage/price spiral. Entry at the current exchange rate offers large electoral benefits. Persistent wage pressures might suggest that the UK should enter the system with a wider Spanish-style 6% central rate band, but such a policy would leave currency risk at a higher level and thereby reduce the Government's ability to cut interest rates. Once again, longer-term stabilisation goals might well be sacrificed in the interest of reducing rates ahead of the election.

As for timing, the domestic inflation rate adds to the other arguments for a narrow window of opportunity early next year. Inflation will remain close to 8% throughout the second half of 1990, and underlying inflation will drift up over at least the next six months. The real threat of currency instability if entry takes place while underlying inflation is rising should rule out that route this year. Similarly, entry needs to be no later than the early months of 1991, if the option of holding a late-1991 election is not to be ruled out. So the preferred option is likely to be entry:

- at the beginning of 1991;
- with a 2¼% central rate band; and
- with the lower end of the band fixed at the current rate, thereby permitting a very modest appreciation in the market rate in response to currency inflows.

The "Madrid Conditions"

At the Madrid Summit of the EC Heads of Government in June 1988, the UK Government reaffirmed its intention to join the ERM but imposed conditions. One condition — reducing inflation — is an entirely internal UK problem. The others — completion of the internal market, abolition of exchange controls, a free market for financial services and the strengthening of competition policy — relate to the EC and essentially involve the implementation of Stage One of the Delors Committee Report.

Progress on Competition Policy...

Much has been achieved since that summit. Competition policy has been strengthened substantially by the passage of the Merger Regulation in December 1989. This gives the European Commission power to vet large mergers that have an EC dimension. The Commission has announced a major toughening of its attitude to state subsidies, and the proposed Directive on Public Procurement opens up 15% of the Community's gross national product (GNP) to competition.

...Exchange Controls...

Even more dramatic strides have been taken in the monetary field. Exchange controls have been falling like dominos in France and Italy, and the trivial controls remaining in Italy should be abolished by the June deadline. Exchange controls impeding the movement of substantial capital flows remain only in Spain and are obvious candidates for progressive relaxation well ahead of Spain's 1992 deadline — as the counterpart to Spain's bold and successful joining of the ERM at the time of the Madrid Summit.

In a strongly *communautaire* gesture, Belgium and Luxembourg abolished their two-tier exchange rate system on March 1, 1990, rather than resist until their 1992 limit. Belgium also cut its withholding tax rate from 25% to 10% and drastically simplified the reclaim procedure to help capital mobility. Italy voluntarily gave up its wide fluctuation bands within the ERM in January, as proof of its commitment to monetary union.

...ECU Issuance...

Both France and Italy have continued to expand their issuance of debt dominated in European currency units (ECU). France now has ECU 1.6 billion of long-term bonds outstanding and Italy has ECU 11.3 billion of bills and bonds in issue. The UK's ECU 2.8 billion of bills pales in comparison. Even West Germany, in the form of the State development bank, Kreditanstalt für Wiederaufbau (KfW), has just issued ECU 200 million of five-year bonds — targeting them specifically at West German savers.

...and a Single Market for Finance

Corresponding strides have been made in the liberalisation of financial services. The keystone of the new structure is the Second Banking Directive that gives banks a "European passport" to do business throughout the EC. This directive, and its associated measure on prudential supervision, was passed in December 1989. The measure allowing the free sale of mutual funds — the UCITS Directive — came into operation in October 1989, even though some states have lagged in passing their domestic enabling legislation. EC Commissioner Brittan has promised a "framework Directive" for life insurance and pension funds.

The Community component of the UK's conditions for ERM membership can now be regarded as satisfied, as was recently recognised by both Chancellor Major and Deputy Prime Minister Sir Geoffrey Howe. Only the UK's internal condition of lower inflation remains, and the Chancellor has now refined that to an inflation rate "proximate" to that of the rest of the EC.

German Reunification — Is it Cause for Delay?

While the deadline for a decision on UK membership of the ERM draws nearer, the system itself is now being questioned due to uncertainty about the implications of German reunification. It seems likely, however, that the West German authorities will try very hard to adjust policy to enable the Deutschmark to maintain its current EMS parity. In such a powerful and political context, the implications of any scenario other than an unchanged Deutschmark are profound, extending well beyond economic topics and perhaps even serving as a test for a reunited Germany's intentions towards the rest of Europe. German reunification is not, therefore, a reason to delay UK entry into the ERM.

The European Timetable

The Madrid Summit "asked the competent bodies to adopt the provisions necessary for the launch of the first stage [of EMU] on July 1, 1990." This has been done. The proposal on cooperation between central banks, which amended a 1964 decision, extends the role of the committee of central bank governors and provides for it to be consulted in advance of national decisions on monetary policy. The proposal on the "attainment of progressive convergence of economic performance during Stage One of EMU," which replaced a 1974 decision, provides for the Council to undertake "multilateral surveillance [of] all aspects of economic policy in both the short-term and medium-term perspectives." These proposals completed the approval process when passed by the European Parliament in February 1990.

Initiating EMU

Thus, the condition laid down by the Madrid Summit for the start of Stage One on July 1, 1990, has been fulfilled. The key steps in Stage One — "the initiation of the process" of creating EMU — are:

- "In the economic field... a complete removal of physical, technical and fiscal barriers ...completion of the internal market would be accompanied by a strengthening of Community competition policy."
- "In the monetary field the focus would be on removing all obstacles to financial integration. Firstly, through the approval and enforcement of the necessary Community Directives, the objective of a single financial area in which all monetary and financial instruments circulate freely, and banking, securities and insurance services are offered uniformly throughout the area would be fully implemented. Secondly, it would be important to include all Community currencies in the EMS exchange rate mechanism. Thirdly, all impediments to the private use of the ECU would be removed."

As we have noted, considerable strides have been taken in these areas in recent months, and the completion of Stage One looks inevitable. Nonetheless, the timescale is likely to be lengthy. The "full implementation" of all the liberalisation measures by means of national enabling legislation may take a couple of years from the dates stated in the Directives — often January 1, 1993. Regrettably, but realistically, it may be 1995 before Stage One can legitimately be declared complete.

Completing EMU — The IGC

However, the EC timetable is already focussing on the next step. At the Strasbourg Summit in December 1989, "following a discussion on the calling of an Intergovernmental Conference (IGC) charged with preparing an amendment of the Treaty [of Rome] with a view to the final stages of

EMU, the President of the European Council noted that the necessary majority existed for convening such a conference,“ that is, Mrs. Thatcher’s dissenting voice was outvoted. It was agreed that the IGC would meet before the end of 1990.

The previous Madrid Summit stipulated the carrying out of “full and adequate preparation” for the organisation of an IGC. To this end, the Commission has drawn up a report on how EMU is to be achieved. This report, which is to be discussed at an informal meeting of EC finance ministers at Ashford Castle in Ireland this weekend, calls for the creation of a new independent Community institution, EuroFed, which would direct monetary policy and be subject to democratic scrutiny. EuroFed would also control the issuance of a single currency, the ECU. The report recognises that the “binding budgetary rules” proposed by the Delors Committee have met serious political objections. In a very welcome move, it states that “there is virtual agreement on two rules which could appear in the Treaty” — no “bailing-out” of fiscally imprudent Member States and no monetary financing or priority access to the market for public authorities. Budgetary cooperation would take the form of medium-term financial strategies, combined with mutual surveillance. As this surveillance is already occurring, these cooperation procedures must be acceptable to the UK Government. Moreover, the commitment to a “no bail-out” approach may represent a decisive turn towards an acceptance of market discipline — thereby shifting significantly towards the philosophy of the UK Government and raising the chances of agreement on the budgetary issues.

The report recommends “that the Community prepare for a relatively rapid passage from the beginning of Stage One to the definitive EMU, including a common currency.” This would correspond to Stage Three of the Delors Committee proposals, but with a crucial distinction: a market-driven approach to the regulation of public finances. If the technical discussions of the finance ministers do not uncover any major obstacles, then the process moves to the foreign ministers’ meeting on April 21. Inevitably, the agenda for such a meeting will be broader and could include the question of institutional reform of the Community to hasten the original, though ultimate, goal of political unity. Already, there are proposals to hold an IGC on this topic. These aspects will undoubtedly surface at the special Summit in Dublin on April 28 on Eastern Europe, as well as at the European Council Summit in June.

The Strasbourg Summit specified that the IGC, which meets “under the auspices of the Italian authorities,” should draw up its own agenda and timetable. Creation of the complex language of a Treaty could take a year, although both France and West Germany are pressing for a faster resolution. Based on the experience of the Single European Act, ratification of the Treaty by each of the 12 national parliaments could take another two years. The completion of Stage One could thus coincide with the ratification of the Treaty, followed by a formal decision to move rapidly through Stage Two to Stage Three, complete with a common currency. The enhanced cooperation envisaged by Stage Two will, in practice, be in operation from now on.

However, changes to the Treaty of Rome have to be unanimous, so the Treaty making process can only begin once there is an agreement in principle to proceed. As hosts, Italy will have a particular influence on drawing up the IGC agenda, so it is very likely that such an agreement in principle will be put before the December 1990 Summit in Italy — presenting the UK with a major dilemma.

Rapid Passage to Definitive EMU

Agreement in Principle by Year-End?

Conclusion

The UK Government may debate ERM membership purely in terms of its own internal electoral and economic timetable. However, the EC has *its* timetable *and* a powerful commitment to EMU. The 11 other states seem set on proceeding to EMU with, or without, the UK, even if they have to leave the door open — as they have done with ERM membership. The dilemma looming for the UK is thus much bigger than ERM membership: it is nothing less than a commitment to accept a common European currency by the mid-1990s.

UK objections to Stages Two and Three of the Delors Committee proposals centre on the loss of budgetary powers and thus economic sovereignty; taking account of this, the EC has now moved some way towards an acceptance of market discipline. If the UK can make a commitment in December to an ultimate common currency — aided by the EC’s move towards the acceptance of market discipline instead of binding budgetary rules — early ERM membership would be a natural consequence. If such a commitment remains unacceptable, it would be inconsistent to join the ERM at the very moment that it acquires this new and unacceptable objective. Presumably, UK membership could only be temporary, undermining the idea that ERM membership will add credibility to counter-inflation policy.

We conclude that the risk of an historic split between the UK and Europe is significant and will rise rapidly in the second half of this year.

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