# 8th session

3rd April 2014

## Eurocurrencies



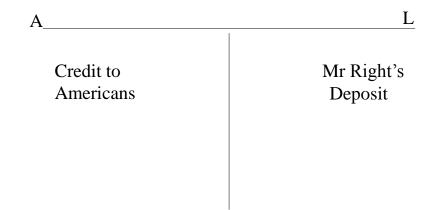
Pugel, Chap 18
Pilbeam, International
Finance, Chap 12

- Definition
  - Eurocurrency is a currency that is deposited outside the issuing country (offshore).
- What matters to be considered a eurodeposit is the location of the bank that accepts the deposit. Both the bank nationality and the location or the nationality of who provides the funds, are irrelevant The bank that accepts deposits in Eurocurrency is a EUROBANK.
- Thus, a US dollar deposit by a US manufacturing firm in a branch of a US bank in London is considered a eurodollar, while a US dollar deposit by a French company in a German bank in New York is not.

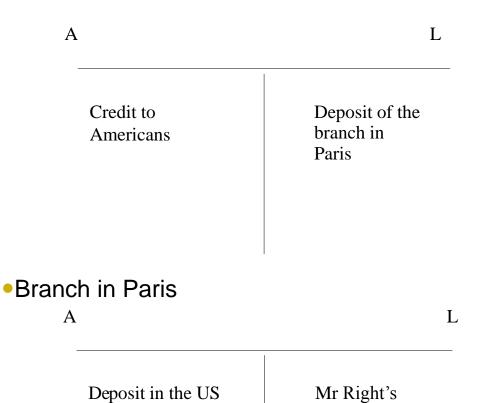
## Creation Process

Mr Right has a deposit in dollars in a NY bank. Mr Right goes to Paris to work during a year and transfers his account to a branch of his bank in Paris, a eurobank, an offshore bank. Eurodollars were created.

US Bank before the transfer of dollars



## • US Bank after the transfer of dollars

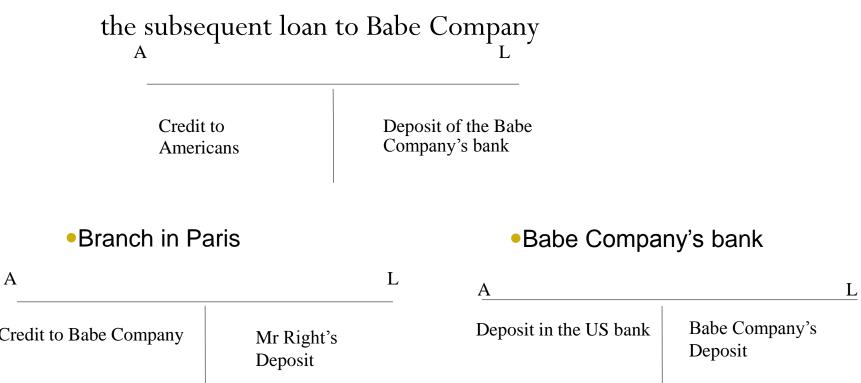


Deposit

bank

- The eurodollars are an indirect way of Mr Right owning a deposit in the USA.
- The branch in France now has an asset and can lend it on to people outside the USA, creating eurodollars. There must be an initial deposit in the USA, but the value of the eurodollar liabilities outside the USA do not have to be fully matched by the initial deposit inside the USA.
- The eurodollar market (offshore) does not exist without onshore dollar deposits in the USA.
  - "Offshore markets in a currency can flourish if offshore financial institutions are able to maintain and to access freely clearing balances in the currency with onshore banks (Dufey and Giddy (1978))"

 US Bank after the transfer of dollars to the branch in Paris and the subsequent loan to Babe Company



Credit to Babe Company

- The *offshore* market does not belong to any national banking system. It is is outside the control of any single country and is largely unregulated.
- A eurobank is not necessarily a separate physical entity, it corresponds to a separate accounting in a bank different jurisdiction, different regulatory regime.

- The Eurocurrency market is different from the foreign exchange market, although participation in any of the markets may be motivated by the need to make payments in foreign currency or interest in making investments.
- Foreign exchange market: one currency is exchanged for another at a price that is foreign exchange rate.
- International currency market (Eurocurrency market): banking market where amounts are invested or borrowed at an interest rate International Money Market.
- The Euromarkets allow the distinction between currency risk and country risk: a deposit in dollars in London has the foreign exchange risk associated with the dollar, but the country risk associated with the UK.

- The Eurocurrency market is largely an inter-bank or wholesale market deals only in large amounts, usually of \$1 million or more.
- Usually short maturities: from overnight to 12 months. Similar time structure of assets and liabilities
- Needs of borrowers for loans of longer time periods (eurocredits) development of rollover loans with a floating interest rate: the borrower receives a six-month credit with a guarantee that it will be renewed (rolled over) every six months for the life of the loan, which may be for ten years or longer. The interest rate may be adjusted at each roll over.

#### ORGANIZED IN TIERS

- The interest rate on Eurocurrency loans or deposits is fixed by reference to LIBOR (London InterBank Offer Rate).
  - The contract defines the maturity of the loan or deposit and the interest rate as a percentage margin over LIBOR.
  - The difference between the LIBOR and the eurobank rate depends on the credibility of the borrowing entity. It may range from 15 basis points (b.p) to more than 300 b.p, most often between 100 and 200 b.p. [ If the LIBOR is 4%, a 75 p.b. margin corresponds to a rate of 4,75%].
  - 1st tier banks pay the least expensive rates for deposits from other banks and borrow at the lowest rates, too.
  - In the interbank market, dollar-based institutions are typically in the 1st tier.

## Participants (who demands and who supplies funds)

- Main Depositors:
  - Large firms (American or not) with international activities.
  - Commercial banks located in important financial centers.
  - Central banks, through BIS.
- Main Borrowers:
  - Large firms (American or not) with international activities.
  - Commercial banks located in important financial centers.
  - Governments.

# Factors that promoted the initial development of the eurodollar markets

- <u>Political factor</u>: The creation of Eurodollars in the 50s and the Soviets.
- <u>Suez crisis (1957)</u>: Due to a balance of payments crisis, the British government restricted banks from lending British pounds to foreigners.
  - Too profitable a business for the banks to lose attract dollar deposits in order to continue to finance trade not British, this time in dollars. Because the government did not interfere in this activity, London became the first and still most important centre of Eurocurrency transactions.

- Restoration of the <u>convertibility</u> of currencies in Western Europe in 1958 and exchange controls lifting: surplus countries may invest where returns are higher; deficit countries can borrow where costs are lower. They can use the dollars and easily convert into local currency (financing activities).
- <u>USA deficits:</u> flow of dollars into the hands of non-US residents.
- Petrodollars: pos 1973.
- Regulation Q: EUA- 1963: limits to the interest rates that could be used to remunerate deposits. Prohibition of interest payments on deposits less than 30 days.
- <u>Real integration:</u> international trade, multinationals. Use of Euromarkets instead of hedging using forward contracts, for instance.

- Weight of interbank transactions in Total eurobank transactions:
  - 30% in middle 1960's
  - 50% in 1980
  - In the 1990's the proportion of interbank lending reduced, and lending to non-banks increased. Reasons: reduction of the volume of foreign exchange transactions with the introduction of the euro [McGuire 2004]

- The position of London in the eurodollar market
  - Despite
    - the exponential growth of the Eurodollar market since its inception,
    - globalization,
    - the emergence of competing financial centers mainly in the 90s\* maintains its dominant position. Data from 1994: London 25% of dollar deposits outside the U.S. (almost double the next financial center, the Cayman Islands)
  - London has many international banks.
- \*1968 Singapore launched the Asian Dollar Market

Early 1970's – Europe - Luxembourg, Channel Islands, Isle of Man

Table 1

## The US dollar in the global deposit market

In billions of US dollars, at end-2008

Non-bank depositor	Location of bank	
	<b>United States</b>	Outside the US
US resident	11,7431	1,520
Non-US resident	809	2,580
Total	12,552	4,100

Source: He & McCauley 2010, p.8

### Euro-bonds

- Debt security sold outside the country that issues the currency in which it is denominated.
- The 1st Eurobond was issued in 1963.
- It is a market with long maturities (5 to 10 years).
- These bonds are issued by financial institutions, corporations, governments and some international organizations.
- Those who invest in bonds are central and commercial banks, government agencies, international financial organizations, insurance companies, pension funds and large companies.
- Since market intervenients are well-known, there is no insurance nor governmental guaranties for these loans.

- The interest is paid to the bearer, the eurobond is transferable. It is not registered . No taxes are paid on the interests.
- The eurobonds are printed on a high security paper with the conditions of the contract on the back.
- In recent years, other forms of security have developed.
- The eurobond market is attractive:
  - since companies do not have to adhere to strict regulations, the cost of issuing bonds is lower.
  - it is more favorable from a tax perspective.
  - because of the anonymity.

- Regulation
  - Market outside any country.
  - It is difficult to impose banking regulation to euromarkets, because banks can shift their business between different regulatory jurisdictions.
  - <u>Deposit Insurance</u> The available fund is too small to cover the volume of deposits in the international banking system. The interbank deposits are not protected.
  - Reserve Requirements- If a country imposed them unilateraly, the deposits would shift to unregulated centres. Multilateral cooperation is difficult.

- The\_supervision of the balance sheets of the eurobanks is unclear. If a branch of an Italian bank, operating in London trades basically in eurodollars who should supervise: the Northamerican regulators, the Italian or the English?
- Rediscount: Problem similar to the one of supervision: what central bank should act as the lender of last resort?
   Rediscount increases M<sup>s</sup> → macroeconomic internal objectives may be compromised.
- Offshore banking activity is mainly interbank. A local disturbance may quickly assume a global dimension → need of regulatory international cooperation.

Basel (Switzerland) Committee on Banking Supervision:
 presidents of 11 central banks—agreement in 1975 —
 Concordat — share of information between the supervisors of the "home" country and supervisors of the "host" country. Requires better data on the balance sheets of the multinational banks.

A "home" supervisor - the supervisor of a bank, or banking group's principal place of business, normally where it is incorporated and licensed.

A "host" supervisor is the supervisory authority in any other jurisdiction where the bank or banking group has a presence that requires authorization. (IMF)

• Important change in the international financial relations during 90's: growing importance of new markets as origin and as destination of private capital flows → developing countries that liberalized their capital markets (Brasil, Mexico, Tailand, Indonesia) – 1997 to 1999: financial crises in emerging markets.

• Following the Asian crisis, several countries imposed capital controls, trying to reduce the use of their currencies in *offshore* markets.

#### • Worries:

- to what extent the Eurodollar market feeds worldwide inflationary forces
- whether Eurodollar lenders take greater risks when making their loans than do other lenders