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Eurodollar and the World Economy

by George F. Ray, London *

The Encyclopaedia Britannica contains, in its "Book of the Year", a useful section for defining those new words which have recently become accepted as expressing a new concept. In 1966, the word "Eurodollar" was described there as "a US dollar held (as by a bank) outside the US and especially in Europe".

This came rather late in the day: by 1966 the Eurodollar was fully established. From small beginnings it has grown into one of the most important markets in the world for short-term credits and more recently also for long-term financing.

The Concept of "Eurodollar"

If you are the owner of an amount of Eurodollars, some bank owes you this sum in dollars; the bank can be anywhere in the world (not necessarily in Europe) but it must be outside the United States. There are other "Euro-currencies" for which the case is similar. Euro-marks are Deutschmark deposits with a bank anywhere outside Germany. Dollars, however, account for four-fifths of the Euro-currencies; hence the importance of Eurodollars. (Swiss francs account for perhaps 9-10 p.c., Deutschmarks some 6-7 p.c., sterling and other currencies for the rest.)

"Eurodollar" market is something of a misnomer. This market is neither limited to Europe, nor to dollar—but both Europe and the dollar are by far the most significant in the transactions in this international money market. There is not much genuinely new in the concept: there was an active market in dollar deposits in Europe in the 1920s but because of the collapse of the gold standard, the instability of the 1930s, and the wartime and postwar restrictions there was no such business transacted between 1931 and the mid-1950s (apart from special deals of a few Swiss and London banks). The present Eurodollar market may not be new in concept but it is certainly new in its proportions. According to several independent estimates the size of the Eurodollar market exceeded \$ 30,000 mn early in 1969¹. Its rise has been just as phenomenal; the

same figure was "only" \$ 12,000 mn two years ago. These enormous proportions make the present role of Eurodollar different in kind, and not only in degree, from any earlier monetary operations.

The Start and the "Supply"

The Eurodollar market took off in the early 1960s but its roots go back to the late 1950s. Eurodollar's basic condition is a relatively free movement for the main currencies—which was not achieved after the war before the mid-1950s. Since American interest rates have almost always been traditionally lower than those in most money markets in Europe, London banks found themselves in a position of being able to offer loans in dollars at cheaper rates of interest than in other currencies including sterling. These dollars they obtained from non-American holders; because of the higher interest rates in Britain higher earning could be achieved this way for these dollar-holders as compared with depositing their dollars in the USA.

The two factors which gave further considerable stimulus to Eurodollar were the full convertibility of the major European currencies around 1960, making transactions considerably easier, and the difficulties of sterling. As from the first major restriction in 1957, sterling's traditional part played in the financing of international trade has gradually been declining and other media were required to replace it. Eurodollars offered such a medium. The huge and annually recurring balance of payments deficits filled European central banks with dollars. They sold these to the commercial banks of the country who again re-sold them to practically anyone who wanted to buy these Europeanised dollars, which earned higher (often considerably higher) interest rates in Europe than in the States. Normally Eurodollar interest rates have moved above the American and below the European money rate levels. International corporations, finance houses, insurance companies have always had spare cash; this they gladly turned into Eurodollars. Another advantage of the new medium was a holding in dollars without being fixed in America: there are investors who prefer the dollar to any other currency but for a number of reasons would not

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¹ Euromoney, June 1969, p. 4; The Economist, August 30, 1969, p. 40; "Index" Svenska Handelsbanken Economic Review, No. 7, 1969, p. 1-2.

invest in America. This helps to explain why East European central banks were among the first on the Eurodollar market. Eurodollar is available to exporters in many countries (though not in all countries because of restrictions) who sell for dollars: they just have to transfer their dollar earnings to a dollar account with a Swiss, Belgian, or other European bank.

The "Demand" Side

What is happening to the Eurodollar when the commercial banks sell them, and who is using them? Nobody has ever seen a Eurodollar, physically changing hands—how is the mechanism working?

Eurodollar is no legal tender; no Eurodollar banknotes are being printed; Eurodollar is a backstage actor, in fact not much more than an accountancy item. There are certificates of deposits nominated in dollars and if the deposit is with a bank outside the US, the certificate de facto refers to Eurodollars (without saying so); there is a market of certain magnitude in these certificates. This, however, is not the main form of Eurodollar's operations.

Practically every borrower can, in principle, obtain finance ultimately originating in Eurodollars. Municipalities are great borrowers; a British city corporation borrows sterling from a bank or finance house; the latter obtained these funds from the Eurodollar market (i.e. bought Eurodollar deposits), switched them into sterling, and lent this sterling to the borrower. In this example the borrower was a British city corporation — but practically it can be anybody. Foreign traders, and international companies are among the largest users but it is impossible to be accurate in this field. Banks in Europe, indeed anywhere outside the US, may use their Eurodollar deposits for backing their normal domestic operations, by converting the dollars into their national currency; in this way each of their clients may become a "second-hand" user of Eurodollar, and the banks themselves become the first-hand borrowers of Eurodollar. American bankers can of

course do the same. Indeed, they have been doing this on a large scale more recently, especially since credit restrictions in the States were intensified.

Eurobonds are loans for five years or more, denominated, paid for, and yielding interest, in dollars outside the United States. They can be traded at the major stock exchanges. Their origin goes back to President Kennedy's interest equalisation tax in 1963. The purpose of this legislation was to prevent, or at least discourage, Europeans from raising long-term loans in the States; this drove them to the Eurodollar market. Another filip came from President Johnson's administration which in 1968 prohibited Americans from financing overseas projects by investing abroad US domestic capital; as a consequence, the Eurodollar market was used for these purposes as well. From small beginnings the Eurobond business has taken significant proportions, exceeding \$ 2,500 mn in 1968.

The Market Place

Except for the United States for Eurodollars (and the "home country" of any Euro-currency) banks and all types of lenders and borrowers in the whole world are, or can be, involved and operate on the Eurodollar market. Even this exception is only true in the very restricted geographical sense. By definition, there is no Eurodollar within the USA, but American banks, as well as companies and citizens, have been involved in huge transactions indeed in Eurodollars outside the States.

"Involvement" is not identical with the actual place of the market, which is limited to the world's great financial centres. The Eurodollar market is concentrated to a high degree in London which "is the unchallenged centre, a natural consequence of the traditional role of British banks in handling international credits". This is a neutral Swedish view quoted from one of the leading Scandinavian bank reviews²—and it can be supported by some simple statistics:

² "Index", Svenska Handelsbanken, No. 7, 1969.

Foreign Banks in London

Headquarters	1889	1918	1940	1949	1959	1964	1968	1969
EEC countries	3	7	11	16	18	21	22	22
Other Western Europe	1	3	5	5	9	11	16	18
Eastern Europe	—	—	2	2	2	2	2	3
USA	1	3	7	7	8	12	24	31
Commonwealth / Sterling Area	7	14	16	18	25	31	35	36
Japan	1	2	4	4	9	10	12	12
Rest of world	—	1	3	4	10	12	14	15
Total	13	30	48	56	81	99	125	137

□ Banks in London (British and London-based foreign banks) are responsible for more than 50 p.c. of the total (world) Eurodollar operations.

□ At the end of 1969, there were 137 non-British banks³—leading banks in their home countries—maintaining at least one branch, or representative office, in London. (Many of them have two London offices.) In no other financial centre of the world does the number of foreign banks come anywhere near this number. (And it is already known that several newcomers will be added to this list during 1970.) 56 (of the 137) foreign banks opened their London branches in the last ten years and it is reasonable to assume that their main incentive for doing so was London's already established leading place, as well as the unique facilities offered by the City of London. The rise of the foreign banks in London has been spectacular indeed: their number almost trebled since the end of the war.

Among these, the American banks deserve special attention—after all, dollar (even if “Euro”) is primarily their business. An inquiry among the 31 American banks was organised; these can be supposed to be the “outward-looking” banks of the United States. In 27 of the 31 cases London was the first place where these banks opened a European office (in the rest of 4 cases London was the second). 18 of the 31 banks have just one office in Europe—in London. As compared with the 31 American banks settled in London, not more than 10 of them have offices in Frankfurt and Paris; 7 in Brussels; 6 in Milan; 5 in Amsterdam, Düsseldorf, Geneva and Madrid; 4 in Antwerp, Athens, Munich, Rome, Rotterdam and Zurich, and 3 in Vienna.

The Advantages of Eurodollar

It is a frequently mentioned fact that the world economy, and especially world trade, have been facing an international shortage of liquidity in the last 10-15 years. Euro-currencies have helped to ease this shortage; their enormous growth provided the world money markets with freely convertible, liquid and mobile funds. These were available not only for financing trade but also for investment. When US capital became scarce and its export restricted, investment abroad of US companies was to a large degree financed by Eurodollars; British companies—in both the public and the private sector—also availed themselves of this possibility, as did investors and other borrowers elsewhere, including Germany.

³ The statistical information concerning foreign banks in London is based on the October 1969 issue of *The Banker* (London), with the permission of the editor of this journal. The data concerning American banks are based on author's special inquiry.

There is no doubt that without Euro-currencies the recent tensions in the international money market would have been more severe.

A certain amount of risk is undeniably stemming from the free flow of the huge Eurodollar funds. A recent example was provided as the outcome of the tightening of the home money supply by the US administration: American banks raised funds at the Eurodollar market (in a sense “repatriating” the dollar) at such a rate that the outflow of dollar from Europe took alarming proportions—until the US government was forced to act under pressure from European central banks.

It is conceivable that any country could deny the free convertibility to Euro-currencies; this would create a barrier and soon the country's trade, or trade balance, would suffer.

The vast transactions in Eurodollar are almost entirely without collateral, they are unsecured loans exclusively based on trust. Huge funds change hands in complicated dealings and a long chain of banks, brokers and dealers can be involved at both the lending and the borrowing end; just like any chain—this is as strong as its weakest member. Similarly, a danger can be seen in the free movement of funds of spectacular magnitude without any central control. The intricate market mechanism is the main controlling organism.

Merits versus Risks

So far major troubles, which can possibly stem from these and other danger points, have not arisen. Or perhaps they have but smooth operators bridged them by quick actions behind the scenes. It remains to be seen whether the merits of Eurodollars outweigh the risks involved, but Euro-currencies have certainly come to stay with us for the foreseeable future.

Finally, it is appropriate to quote Dr F. E. Aschinger of the Swiss Bank Corporation who concluded an address given in London⁴ on the subject of the “Eurodollar market in times of crisis” as follows: “The Eurodollar market fulfils such important functions in the world economy that it would be a mistake to curtail its working by restrictive measures just because it contains some dangers which become acute in international monetary crises. We have got to live with the Eurodollar market, and must therefore make every effort to pursue sound economic and monetary policies which will minimise its dangers and maximise its positive effects.”

⁴ *Euromoney*, November 1969, p. 14.