

# Reasons behind the growth of eurocurrency markets finance essay



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The Eurocurrency market consists of banks, which are called Euro banks that accept deposits and make loans in foreign currencies. Eurocurrency is a deposit held in the bank outside the country in whose currency the deposit is dominated. The deposit can be placed in a foreign bank or in the foreign branch of a domestic US bank. For example, dollars deposited in a bank in Switzerland are Eurodollars, yen deposited at a US bank are Euro yen, etc. The Eurocurrency market is dominated by US dollar or the Eurodollar. The deposit need to be held at a European bank or in Europe. Eurocurrency is used for lending and borrowing. The Eurocurrency market often provides a cheap and convenient form of liquidity for the financing of international trade and investment. The main borrowers and lenders are the commercial banks, large companies, and the central banks. By raising funds in Eurocurrencies it is possible to secure more favorable terms and rates of interest, and sometimes to avoid domestic regulations and taxation. The deposits and loans were initially on a short-term basis but increasing use is being made of medium-term loans, particularly through the raising of Eurobonds. This has to some extent replaced the syndicated loan market, in which banks lent money as a group in order to share the risk. The Eurocurrency market is dominated by US dollar or the Eurodollar. Occasionally, during the 1970s and 1980s, which were a weak dollar period, the Euro Swiss Franc and the Euro Deutsche Mark markets increased in importance. The Eurodollar market originated post Second World War in France and England thanks to the fear of Soviet Bloc countries that dollar deposits held in the US may be attached by US citizens with claims against communist governments. A Eurocurrency is a freely convertible currency deposited in a bank located in a country which is not the native country of

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the currency. Restrictions on convertibility take many forms - limiting the amount that can be exchanged, the currencies into which exchange is possible, the uses for which foreign exchange can be obtained, or the range of holders who are allowed foreign exchange.

The Eurocurrency market has grown rapidly mainly due to the existence of various US regulations that have raised costs and lowered returns on domestic banking transactions. In other words, the Eurocurrency market has become popular because of the absence of restrictions from the government which have led to attractive deposit rates for savers and attractive loan rates for borrowers. This means that banks can offer higher interest rates on Eurocurrency deposits than on deposits made in the home currency. Similarly, banks can also charge lower interest rates to Eurocurrency borrowers than to those who borrow the home currency. The spread between the Eurocurrency deposit and lending rates is less than the spread between the domestic deposit and lending rates giving Eurocurrency banks a competitive edge over domestic banks.

The Eurocurrency market began to develop in the 1950s, when the Eastern Bloc countries were afraid the United States might seize their holdings of dollars. It means that instead of depositing their dollars in the United States, they deposited them in Europe. Additional dollar deposits came from Western European central banks and companies that exported to the United States. The other long-running disadvantage was a "Regulation Q". This prohibited the payment of interest on demand deposits, as well as authorising the Federal Reserve to set a maximum interest rate payable on savings and time deposits in US banks. The level of interest rates in the

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money supply was raised through slowing down the growth of the money supply. However, while money market interest rates rose, the interest rates payable on time deposits, were held down by the ceiling. Investors moved their time deposits from the banking system, causing the banks to experience a shortage of funds. The banks then looked to the Eurodollar market for funds, and in 1966, when money was tight, borrowing from European Branches of US banks by their head offices rose by \$2.5 billion. Nevertheless, banks began to regard the market as a substitute source of dollars even when "Regulation Q" was not effective as in 1967. Funds raised through this method were then used to continue lending to customers in the US. "Regulation Q" stimulated the growth of the Eurodollar market in two ways: firstly, it reinforced the market's ability to offer higher interest rates on deposits. Two other reasons why they could offer higher interest rates were that Euro banks operated on lower margins; and the effect of domestic reserve requirements. Secondly, the growth of the market was stimulated because of the demand for dollars from commercial banks in the US in order to go around domestic credit restraint policies.

In 1957, the market surged again after changes in British laws. In the 1960s, the market grew once again when, after changes in US regulations discouraged US banks from lending to non-US residents, would be borrowers of dollars outside the United States turned to the Euromarkets a source of dollars. The next big increase in the Eurocurrency market came after the 1973-74 and 1979-80 oil price increases. OPEC (Organisation of the Petroleum Exporting Countries) members avoided potential confiscation of their dollars by depositing them in banks in London. The dramatic growth of

flight capital to Swiss and other banks, encouraged by the development of financial centres such as Luxembourg in which regulations ensured the protection of the anonymity of lenders. The growth in supply of funds to the market was the use by central banks of the market in order to increase returns on their holdings of international reserves. However if there had not also been a large demand from borrowers for Eurodollar, the market would not have grown so rapidly. The reasons for the large demand from the borrowers include a US government discouragement from 1963 of borrowing by foreign companies directly from the US market through the imposition of a tax that increased the cost of borrowing in the US for borrowing in most of the industrial nations. The fact that the euro banks were free of the reserve requirements imposed on domestic banks, allowed them to maintain a lower spread between borrowing and lending rates. Another important reason of a large demand is a US government limitations on the amount of capital that US transnational corporations could shift out of the US to invest abroad, forcing them to borrow outside the US and providing the market with a major group of very creditworthy borrowers.

The domestic and the international markets have two major components: the inter-bank mechanism, and the channelling of funds from initial depositors to ultimate borrowers. However, in the Euro-markets, the former plays a far more important role, with respects to the latter, in which the markets introduced important innovations.

The general efficiency of the inter-bank mechanism in allowing banks access to funds at very short notice, as well as allowing them to place funds in the market for very short periods to earn some interest, helps to reduce the

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transactions and information costs in the Eurocurrency markets. This also allows them to operate on smaller margins. Two innovations, which are associated with lending to non-banks, and which have facilitated the expansion of the Euro-currency markets, are roll-over credits and the syndicated loan system.

The introduction of roll-over credits reduces the risk of interest rates moving against a bank when it tends to borrow short and long-term. It enables banks to offer higher interest rates on short-term deposits, whilst at the same time being able to commit these funds long-term, through reducing the risk of making losses if deposit rates should rise again. On the borrower`s side of the market, such roll over credits imply that interest rates at the time of borrowing are less important, because if they should fall over the course of the loan, the borrower should reap the benefits.

The second innovation is that of syndication of loans. A syndicated credit is a loan in which a group of financial institutions makes funds available on common conditions to a borrower. It allows credits of larger sizes sometimes over \$1 billion, to be put together, a factor that was especially important in the financing of national balance of payments deficits.

In the lender`s point of view, it reduces the risks of international bank lending , through diversification of loans to political entities. It also provides more protection against selective defaults: unwillingness of a nation to repay its debts will be met with pressure from several countries, whose banks are involved. Negotiations were also feasible, because at the same time, there are few enough creditors involved. On the other hand, a possible danger of

the process, which has become increasingly recognised, is that in the event of a default, the repercussions will be spread over a wide part of the Euro-currency system. This has raised questions regarding the stability of the international banking system.

There are certain important consequences of the rise of the Eurocurrency markets. The first is the shift in the financial system from one depending on a state to manage the flow of international liquidity, to a system where liquidity is provided by private banks. The international financial systems were threatened with a lack of credit, there is now, excess international liquidity, and private bank lending provides this. In 1980, the US inter-bank loan market stood at \$74 billion, this almost doubled to \$170 billion by 1995. The international inter-bank lending market by contrast had grown to \$5.8 trillion by June 1995.