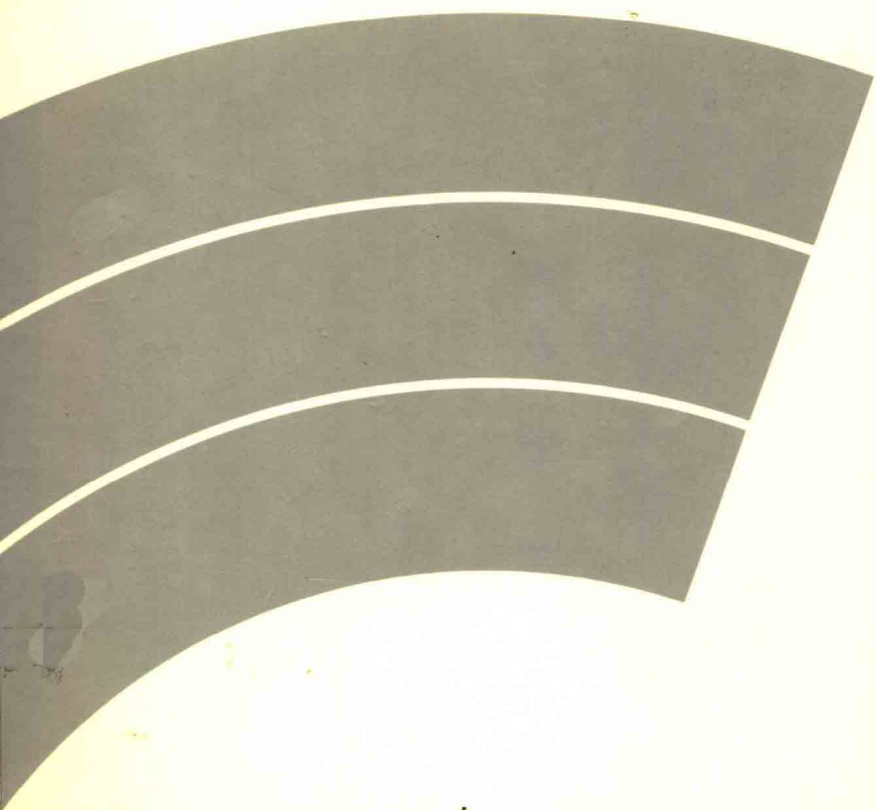


THE INCREDIBLE EURO~ DOLLAR



W.P. Hogan and I.F. Pearce

The Incredible Eurodollar

W. P. HOGAN

Professor of Economics, University of Sydney

and

I. F. PEARCE

Professor of Economics, University of California (Irvine)

London

GEORGE ALLEN & UNWIN

© W. P. Hogan and I. F. Pearce, 1982

This book is copyright under the Berne Convention. No reproduction without permission. All rights reserved.

George Allen & Unwin (Publishers) Ltd,
40 Museum Street, London, WC1A 1LU, UK

George Allen & Unwin (Publishers) Ltd,
Park Lane, Hemel Hempstead, Herts, HP2 4TE, UK

Allen & Unwin Inc.,
9 Winchester Terrace, Winchester, Mass 01890, USA

George Allen & Unwin Australia Pty Ltd,
8 Napier Street, North Sydney, NSW 2060, Australia

First published in 1982

British Library Cataloguing in Publication Data

Hogan, W. P.

The incredible Eurodollar

1. Euro-dollar market

I. Title II. Pearce, I. F

332.4'5 HG3897

ISBN 0-04-332081-3

Set in 12 on 13 point Garamond by Preface Ltd, Salisbury, Wilts
and printed in Great Britain by Biddles Ltd, Guildford, Surrey

Acknowledgments

The authors wish to thank numberless friends, and friends of friends in banking and academic circles, who listened patiently to our arguments and enquiries and gave freely of their expertise. Needless to say we accept full responsibility for any errors which may nevertheless remain.

Above all we owe a debt to the University of California at Irvine and to Barbara Sawyer who *magically transformed* our illegible scrawl into a magnificent manuscript which could only be described as perfect.

Quis Custodiet Ipsos Custodes

. . . *nobody* really understands the international monetary system . . .’ H. Johannes Witteveen – former managing director of the International Monetary Fund and finance minister of the Netherlands.

quoted by ‘Adam Smith’, *Paper Money*
(New York. Summit Books, 1981), p. 109.

Contents

Acknowledgments

page ix

1 The Eurodollar Introduced

(i) An Inevitable Improbability	1
(ii) The Market	2
(iii) What is New?	3
(iv) Inflation and the Eurodollar	3
(v) Exchange Rates and the Eurodollar	4
(vi) The Eurodollar Market and Risk	5
(vii) How Much Debt is Tolerable?	6
(viii) Who is Liable?	7
(ix) Is the System Understood?	9
(x) The Heart of the Matter	10

2 Why It All Happened

(i) Balance of Trade Identities	12
(ii) The Balance of Payments in the Past	14
(iii) The Balance of Payments in the Mid-Twentieth Century	17
(iv) A Multiple 'Equilibrium' Diagram	19
(v) Multiple 'Equilibrium' – World Markets Cleared	24
(vi) Multiple 'Equilibrium' and the Market Mechanism – Excess Consumption by Forgery	26
(vii) The Rise and Fall of the International Monetary Fund Reference	35 37

3 The Chronicles of the Planet HTRAE

(i) Htrae	38
(ii) The Beginnings of the Namyac-Bal Market	41
(iii) The Stock of Money in Deficitia	44
(iv) The Astonishing Expansion of the N.B. Market	45
(v) Was the N.B. Market Inflationary?	47
(vi) The Role of Balancia in the N.B. Market	48
(vii) Controlling National Money Supplies	49
(viii) The First Great Crisis on Htrae	50
(ix) Aftermath	54
(x) The End of the First Crisis	56
(xi) The Final Collapse	57
(xii) Diagnosis	59
Reference	62

4 Eurofinancing in Practice.

(i) The Beginnings	63
(ii) Necessary Distinctions	66
(iii) Market Growth	67
(iv) Market Structures	75
(v) Sources of Finance	80
References	84

5 Market Instability: Risk and Speculation

(i) Eurodollar Market Efficiency?	85
(ii) Elements of Risk	88
(iii) Experience with Risk	90
(iv) General Features of Risk	96
(v) Exchange Rates	98
(vi) Eurocurrencies and Market Behavior	100
(vii) Dollar-Deutschmark Exchanges	102
(viii) A Final Comment	104
References	105

6 Some Euromarket Folklore

(i) An Official View	106
(ii) Domestic Monetary Management	111
(iii) US Reserve Requirements Proposals	115
(iv) A Challenge to National Sovereignty	120
(v) The Euromarket and Lenders of Last Resort	123
(vi) The European Approach	125
References	128

7 Prognosis and Prescription

(i) What of the Future?	129
(ii) Atrophy	134
(iii) Or Dramatic Collapse?	134
(iv) Overhang?	135
(v) Special Drawing Rights (SDRs) in Lieu of Overhang?	136
(vi) Repudiation of Debt	138
(vii) Prescription	139
References	142

Index	143
-------	-----

1 The Eurodollar Introduced

(i) *An Inevitable Improbability*

Economic events, viewed in retrospect, generate no surprises. Each follows the other in a succession at all times logical, inevitable and predictable. Looking back it is easy to show why that which happened had to happen and why nothing else was ever possible. Looking forward, however, is a very different matter.

Economists of the Middle Ages enjoyed, in some ways, a deeper and more extensive understanding than their modern counterparts of the true and many-sided nature of money. They were able easily to distinguish between 'real' money and 'imaginary' money and indeed explicitly used these terms. It is certain, however, that they could never have thought, even in their most outrageous flights of fancy, that there might one day exist a world, unbelievably more complicated than the one they knew, operating apparently without real money at all. Imaginary money, they would have said, is simply the unit in which real money is measured. The one cannot exist without the other.

Nevertheless it remains true, paradoxically, that, had our learned predecessors actually lived to see the world that was to come, they would have found nothing surprising. The principles remain always the same. The realizations of those principles, on the other hand, exhibit infinite variety leading to unimaginable consequences.

The rise of the Eurodollar market, from very small beginnings some fifteen years ago to a collective institution with monetary assets, almost certainly exceeding in value the annual total of all world international trade put together, is just such a realization. The event was predictable but not predicted, unthinkable beforehand but not surprising *ex post facto*. At

2 *The Incredible Eurodollar*

the time of writing it has not reached its full flowering, though we know already that it cannot survive. We do not know what will be the manner of its collapse; or whether indeed it will truly 'collapse', or simply wither away. When it is gone however it will seem obvious why it came about and why it ended as it did.

(ii) *The Market*

The so-called Eurodollar market is a market in international debt. It accepts deposits and makes loans, which may, in principle, be designated in any currency of any country, provided only that the named currency is sufficiently 'safe' to be internationally acceptable. The named currency would have also to be convertible to other main currencies at exchange rates not subject to too violent or too unpredictable changes. In practice today (1980), the most likely currencies to be designated are US dollars, Sterling, Deutschmarks, Swiss francs, or Japanese yen, with US dollars still the most favored by a very large margin.

Banks that operate in the Eurodollar market are of course, like all banks, highly respectable and respected. Some however are more respectable than others. They range from specially created but independent subsidiaries of major world commercial banks, sometimes operating in the great financial centers and sometimes in small countries with conveniently lenient financial legislation, to so-called 'fringe' banks, called into being by the necessities and opportunities of current world monetary convolutions. All that it is necessary to know at this stage about Eurobanks is that they are able to offer favorable rates of interest on deposits of acceptable currencies and that they are highly experienced in the art of finding borrowers in all parts of the world for all of the funds so deposited. These two facts are of course not unconnected. The one makes possible the other.

It should be understood also that the function of a Eurobank is to underwrite risk. A will not lend to B direct if he does not

trust B to repay. But he might very well be happy to deposit funds with a respectable bank, despite the declared intention of that bank to lend to B; for A then enjoys not only B's promise to pay but the bank's promise also if B should default. The likelihood exists a fortiori if A does not know of the bank's lending plans.

Finally it is of crucial importance to emphasize that Euro-dollar deposits are *not* checking accounts. They cannot be used to pay bills without first being withdrawn. They are *time* deposits of varying maturities which cannot ordinarily be spent until they are repaid on the due date.

(iii) *What is New?*

The reader might now ask, 'if all this is the case, what is new?' Banks have always accepted deposits and made loans. International loans are commonplace, and have been for many hundreds of years. What is it about the Eurodollar which calls for special explanation?

Part of the answer lies in the astonishing magnitude of current operations, both in absolute size and rate of growth. According to figures published by The Bank for International Settlements (see Chapter 4 below), the total of outstanding Eurodollar deposits amounted, in June 1980, to something of the order of US\$ 1,200,000,000,000, which is three to four times the entire money stock of the whole of the USA. More remarkable still is the fact that this total has grown sixfold in eight years, from less than \$200 billion in 1972 to the present \$1,200 billion in 1980. Furthermore there is every sign that it will have risen between June 1980 and June 1981 by an amount greater than the whole of the *stock* that existed in 1972.

(iv) *Inflation and the Eurodollar*

It is tempting of course to wonder whether the rise of the Eurodollar market is due simply to world inflation or, con-

4 *The Incredible Eurodollar*

versely, whether or not the world inflation is due to the increased 'money' stock now deposited in Eurobanks; but neither of these conjectures bears close examination. There is little correlation between the rise in world prices and the increase in the stock of Eurodollars, nor should we expect there to be. Eurodeposits are not money in the sense that cheques can be drawn upon them. In fact the stock of Eurodollars has risen much faster than the total nominal value of world trade for reasons which need have nothing *directly* to do with inflation.

(v) *Exchange Rates and the Eurodollar*

This does not mean that there is no cause for concern. We have already noticed that the total stock of Eurodollar deposits is today of the same order of magnitude as the annual value of all world trade of all countries put together. This in turn suggests that explicit or implicit transactions in Eurodebt each year might very well equal in value all world commodity trade transactions in the same period. This would be the case if the average maturity time for Eurodollar deposits were twelve months or less as it well might be. Each time a deposit falls due for repayment a decision has to be made whether the debt should be repaid or continued (rolled over) and whether the designated currency should be retained or changed. Debt repayment or roll over may or may not involve the passing of currency across exchanges, but whether it does or not, exchange rates must be affected by the mere fact that the *opportunity* to redesignate the currency exists. Eurobanks deal in currency exchanges and their view of the proper rates must depend as much upon the demand or implied demand for currency to buy and sell debt as upon the demand for currency to buy and sell internationally traded goods.

In the normal way the price of one currency in terms of another (the exchange rate) will settle so as to equate the supply and demand for traded commodities, that is, to balance trade. But if at the same time there is a demand to change the

currency designation of significant quantities of maturing debt, according to expectations of future exchange rate changes based upon extrapolation of past observations or other cause, then it seems likely that a free market in currencies will fail in its primary function, namely, to balance trade. The existence of the Eurodollar market may very well serve to sustain the very forces which cause the Eurodollar market to grow. This is a classical case of economic instability.

(vi) *The Eurodollar Market and Risk*

More important still is the risk of chaos, of more than one kind, which could be brought about by major default on Euro-debt. The figures quoted above viewed as debt are not especially disturbing. It is everywhere agreed, of course, that there is no way in which existing liabilities could be repaid by the borrowers, except over a very long period of time, and that even long-term repayment would hardly be possible in the present political climate. On the other hand, it is quite usual for an individual to borrow two or even three times his annual income, and few countries have, as yet, taken on international debt of this order of magnitude. These considerations have led some commentators to ask why repayment need ever be attempted. After all, governments do not usually see it as their duty to repay national debt, only to pay the interest.

There are a number of answers to this. It is true that we would think it normal for a person to borrow three times his annual income to buy, say, his home; but no credit company would agree to lend three years' purchasing power to buy non-durable consumer goods. The reason is simple. A home can always be sold to repay debt but that which is already consumed cannot be sold. Consumer credit can be repaid only out of income. Banks which might be willing to lend money to individuals to buy housing would almost certainly be unwilling to lend to the same individual to buy whiskey. But the very same bank will often lend money to governments to finance a trade deficit whether or not that trade deficit was

6 *The Incredible Eurodollar*

generated by the overpurchase of building materials or whiskey.

There is, unfortunately, considerable evidence to suggest that the deficits of some countries are indeed induced by unwise overconsumption. It is *not* true that all international borrowing is matched by a corresponding accumulation of real capital in the borrowing country, implying an increase in its capacity to pay interest appropriately. The reason for this lies quite simply in the fact that governments and/or central banks are frequently the principal borrowers. Neither governments nor central banks are ordinarily required to deposit collateral, particularly when their borrowings are apparently required only to support exchange rates in accordance with international agreements. It is not usual to doubt the capacity to repay of official borrowers if only because of a universal belief that someone, somehow, is bound to come to the rescue of official borrowers in a crisis. This attitude has been reinforced one hundredfold in recent years by the establishment and growth of international institutions and agreements precisely designed to rescue official debtors whenever they are too much embarrassed. One of the great myths of our time finds expression in the universal belief that no kind of economic activity should ever be inhibited by lack of money. The necessity to limit spending to the level of one's capacity to pay has been translated by experts to mean a 'lack of liquidity', easily treated by the creation of credit. Accordingly the automatic mechanism which ordinarily serves to correct imbalances of trade has been replaced by a mechanism which automatically produces the credit needed to sustain unlimited imbalances. Lip service only is paid to the inescapable need for countries to face the facts of life.

(vii) *How Much Debt is Tolerable?*

Debt may be tolerable but whether it is or not depends upon its magnitude. Growing debt not matched by capital growth sooner or later becomes intolerable as interest charges absorb a

growing proportion of the national product. When it does become intolerable debt must be repudiated. What, therefore, is disturbing about Eurodollar debt is, above all else, its 25 percent annual rate of growth. Eurodebt is growing faster than world inflation and much faster than the capacity of debtor nations to pay the growing service charges.

We comment finally in this section upon two further matters of fact. First, it is already clear that banks operating in the Eurodollar market are themselves anxious over possible default. More and more they are creating lending consortia in the belief that this will somehow lessen the risks of which they are conscious. There exists an increasing awareness that it is not just a question of whether the whole structure is sound. Rather it is a question whether part of it is unsound. The repudiation of a relatively small debt which is unsound could lead to a progressive attempt to withdraw even those deposits which are quite safely invested. A large proportion of Eurodollar deposits are short term. It is a matter of concern what might happen if repayment of short-term deposits on a large scale were demanded because of a loss of confidence either in the designated currency or in the likelihood of ultimate repayment by borrowers.

Second, it is the case that significant defaults have already been observed. More than one borrowing country has had its Eurodebt 'restructured', which is the euphemistic term for 'partially written off'. The argument that some default is inevitable is reinforced by the observation that some degree of default has already been observed.

(viii) *Who is Liable?*

Of course nobody minds too much, apart from a limited number of creditors, when a borrower defaults. After all lenders are rich and borrowers are poor! The distribution of income does not begin by being 'fair'. There is nothing new in the repudiation of debt, nor are its consequences necessarily wholly bad. In the case of the Eurodollar market, however,

8 *The Incredible Eurodollar*

there is an important feature which is new, if not in principle at least in its order of importance.

If a loan is made through the good offices of a financial intermediary then that financial institution is liable for the debt as well as the defaulting debtor. It is possible therefore that a Eurobank might find itself in trouble as well as the original debtor. Indeed it could be, and sometimes is, argued quite falsely that dollar debt can come into being only because US citizens import more than they export, and hence that all such debt is ultimately a US liability. This is of course not the case.

The falsity of the argument does not, on the other hand, alter the fact that the first line of defence of any Eurobank short of money may well, in practice, be the Eurodollar market as a whole. In a general way it is possible, at very short notice, to borrow very large sums of money in the Eurodollar market, sufficient for a single bank to secure all the liquidity it needs to handle minor crises. Nor in the case of a major crisis would it matter if a single bank collapsed. There is nothing new in this.

What is new is the extent and complexity of the links which any failing bank will almost certainly have, directly or indirectly, with the central bank in some major financial center. Suppose, for example, that a British subsidiary of an English clearing bank, operating in the Eurodollar market, stood in danger of failure because of a loan default on the US dollar designated debt of some country located, say, in South America. Suppose further that the Eurobank concerned was physically located in the Cayman Islands and had advanced dollars to South America, originally deposited by an oil producing country in the Middle East. When the Eurobank fails, must the parent bank in the UK meet the debt when it had no hand in negotiating it? And if the parent bank is liable and if it too fails in consequence may it then appeal to the Bank of England as lender of last resort? And if the currency required is US dollars and the Bank of England has insufficient US dollars in its reserves can it then appeal to the US Federal Reserve System for help under gentleman's agreements made

for quite a different purpose than that of underwriting trade debts between two countries which have nothing to do with either the USA or the UK? Where does responsibility end? Is the USA after all responsible for debts of non-nationals just because they happened to be designated in US dollars?

(ix) *Is the System Understood?*

Much more serious than anything so far mentioned is the possibility that some implications of the Eurodollar market might not be properly understood either by some who operate in that market or by all whose responsibility it should be to secure a proper environment for efficient economic activity in general.

In particular, the fact that international indebtedness in recent times commonly takes the form of bank deposits and loans, rather than the more familiar nineteenth century government bonds sold direct to private investors overseas, invites modern monetary experts to classify Eurodeposits as 'money' rather than 'debt'. Monetary theory today customarily includes time deposits in its 'M3' measure of the money stock, and many governments think it is more important to control the quantity of M3 than M1. Accordingly we find in the banking literature expressions of concern as to whether a dollar deposit in a Swiss bank should be counted as part of the money stock of Switzerland, the USA or even Turkey to whom the deposit was lent to buy, shall we say, wool from Australia. The deposit in the Swiss bank and the corresponding loan to Turkey remain obstinately recorded in the Eurobank books even though the actual dollars have by now returned to the USA after being used by Australians to buy Virginian tobacco.

The propensity to count Eurodollar deposits as money has led to many curious propositions. It has been supposed that somehow Eurodollar operations create new dollars outside of the control of US authorities, thereby increasing the world stock of acceptable money with inflationary implications. Even those who understand that debt is not spendable wealth until

10 *The Incredible Eurodollar*

someone, willing to save, can be found to buy that debt, frequently take the view that somehow the Eurodollar market raises the velocity of circulation of money and so is inflationary.

At the same time the very considerable literature on the Eurodollar market reveals wide differences of opinion on the very first question, 'how does the debt arise and why does it grow so fast?' Because much of the debt is designated in US dollars it has been thought that the underlying cause must be US trade deficits. But published figures show that, against the total of Eurodeposits, the total of all US trade deficits is microscopic. Other writers have claimed that, by the normal application of fractional reserve banking, the total of US trade deficits can be 'multiplied' to create deposits far in excess of the original deficits and that this is the underlying explanation.

These misconceptions have given rise to proposals echoed by the highest state officials, which, if the object is to check the growth of the market, could not possibly succeed.

It has been suggested, for example, that Eurobanks should be required to hold dollar deposits (i.e. reserves) in US banks equal to some fixed proportion of their total loans. But this would do nothing to check the inflow of funds. It would simply change the form in which Eurobanks hold their assets, raising the ratio of cash to loans. At the same time it would invite participating banks to devise new and even more ingenious ways to flout unnecessary international regulations, leaving the underlying causes of the problem untouched.

(x) *The Heart of the Matter*

The truth is that the Eurodollar market came into being because of a tendency for the *same* countries always to be in trade surplus and the *same* countries always to be in trade deficit. It is not the US trade deficit which creates the debt but the accumulated trade imbalances of the whole world. The market will exist as long as the debt exists and will not go away until it is funded or until those countries, now in trade surplus, engineer a deficit and those in deficit engineer a