THE BALANCES

Under the regime of fixed exchange rates, foreign monetary authorities were required to intervene in foreign exchange markets to maintain the value of their currency within a narrow band. A deficit in the official reserve transactions balance of the United States then indicated that foreign central banks had purchased dollars, because at the parity rates (plus or minus a narrow margin) the private demand for dollar holdings by foreigners had been less than the available supply. The accumulation of these assets by foreign monetary authorities was taken as a gauge of pressure on the dollar in foreign exchange markets.

The net liquidity balance, which takes into account the net change in liquid liabilities to private parties as well as to official agencies in other countries, was designed as a broader indicator of potential as well as actual pressures on the U.S. currency.

The trend toward flexible exchange rates has made these two measures of the balance of payments unsuitable for analyzing exchange rate pressures. Since intervention has become discretionary, pressures on exchange rates are in large part allowed to move the exchange rates instead of being reflected in reserve movements. While official intervention under managed floating can be used to dampen exchange rate fluctuations, the balances do not serve as acceptable indicators even of these limited actions to remove pressure.

Because of the huge surplus of investable funds accruing to the oil-exporting countries, a large negative shift in the U.S. official reserve transactions balance can now result on account of the preference of the oil-exporting countries for placing their funds in the United States. Moreover, the net liquidity balance is far less significant than under the regime of fixed exchange rates, since the foreign central banks are not obligated to acquire dollars from private holders. Finally, the distinctions between liquid and nonliquid assets and liabilities and between private and official foreign exchange assets have become increasingly blurred.

Thus, reliance on these balances could lead to serious analytical misjudgments. The question of how the organization of our balance of payments data can be made more useful is currently under review.

SUPPLEMENT

The Eurocurrency and Eurodollar Markets

The discussion of the international financial aspects of the "energy crisis" brought into public focus the Eurodollar market as an important channel for moving funds from the oil-exporting countries to borrowers. The recycling of "petro-dollars" has been merely one of many functions performed by the Eurodollar market over the years of its existence.

The Eurodollar market, as such, has no specific location. Its physical dimension is a network of international telecommunications media which link financial centers around the world and through which Eurodollar transactions are conducted. Eurodollars are dollar-denominated claims on commerical banks located outside the United States, largely but not exclusively in Europe. They are dollar funds placed with foreign banks by either U.S. or foreign residents, and maintained on the books of these banks as dollar-denominated liabilities to the depositors. Dollars deposited with the foreign banks may be in the form of U.S. currency, but they seldom are. In virtually all instances, they are dollars held on deposit in U.S. banks. In establishing a Eurodollar deposit, the depositor, in effect, transfers the ownership of his deposit in a U.S. bank to the receiving foreign bank. When the foreign bank lends these dollars, it transfers their ownership to the borrower. Finally, when the original depositor "withdraws" the deposit, he in effect exchanges the dollar-denominated claim on the foreign bank for a dollar-denominated claim on a U.S. bank.

Eurodollars, while by far the largest, are merely one of several types of foreign-currency denominated deposits maintained by commercial banks around the world in currencies other than that of the country where the bank is located. Deposits denominated in British pounds (Eurosterling), German marks (Euromarks), Swiss francs (Eurofrancs), and others are also held and traded by banks domiciled outside the countries issuing these currencies.

The emergence and growth of the Eurodollar market may be viewed as a classic example of free market forces at work, overcoming obstacles created by regulations, and responding to market incentives to accommodate various needs. After World War II, when the dollar emerged as the major trading currency, the initial impetus to the growth of the Eurodollar market was given by certain Eastern European countries. Anxious to hold dollars to finance their badly needed imports from the West, but concerned that their dollar balances might be blocked or confiscated in retaliation for their expropriation of American-owned properties if such balances were held in banks under U.S. Government jurisdiction, these countries began placing their dollar balances with commercial banks in Western Europe. Since the late fifties, when most major countries removed restrictions on the holding of foreign exchange (including dollars) by their residents, higher interest rates offered by foreign banks, relative to interest rates offered by the U.S. banks, provided the main incentive for holders of dollar funds to place these with foreign banks rather than banks located in the United States.

The ability and willingness of foreign banks to offer a more attractive return than U.S. banks has been predicated on several factors. The U.S. banking authorities do not allow commercial banks in the United States to pay interest on deposits of less than 30 days, and they regulate the rate of interest that may be paid on deposits of longer maturity. Commercial banks abroad are mostly exempt from such restrictions. Also, unlike U.S. banks, commercial banks in countries where the growth of the Eurodollar market has been the most spectacular are not subject to reserve requirements on their dollar-denominated liabilities. As a result, the net cost of such funds to these banks is reduced, and they can offer a higher yield. On the other hand, the willingness of foreign banks to offer a higher return has been predicated on the strong demand for dollar loans that has not been fully met by the U.S.-based banks, particularly when such lending was impeded by the existence of the Voluntary Foreign Credit Restraint Program and the Interest Equalization Tax.

Given these constraints, the U.S.-based banks were able to compete for dollar deposits with foreign-based banks through foreign subsidiaries and branches that were not subject to the same restraints as their parent institutions in the United States. Through these media, the U.S. banks have maintained significant participation in the Eurodollar market. The elimination or suspension of certain U.S. regulations in 1970 and 1974 has removed most of the impediments to the direct participation of U.S. banks in the global trade in dollars. By this time, however, the Eurodollar market had acquired a momentum of its own that assured its continued existence for years to come.

MEASURING THE SIZE OF THE EURODOLLAR MARKET

For a number of years, the Bank for International Settlements (BIS) in Basle, Switzerland, has been providing the most comprehensive set of statistics on the Eurodollar market, based on reports of foreign-currency denominated assets and liabilities of commercial banks in Belgium-Luxembourg, France, Germany, Italy, the Netherlands, Sweden, Switzerland, the United Kingdom, Canada, and Japan. The original reports include all foreign-currency denominated liabilities to residents (banks, individuals, and corporations) of countries other than the country in which the reporting bank is located, that is, all external liabilities. These totals are published as gross Eurocurrency positions.

Table 50 shows the size of the external Eurocurrency liabilities by the individual reporting countries. For the end of 1973, the BIS reported that total external liabilities in foreign currencies of banks in the reporting European countries identified in the table amounted to $191 billion; roughly two-thirds of these liabilities were denominated in dollars.

TABLE 50.—*External liabilities denominated in foreign currencies of banks in selected countries, 1970–73*

[Billions of U.S. dollars; end of period]

Country	1970	1971	1972	1973
Selected countries	85.8	110.8	147.5	215.7
Reporting European countries	75.3	97.9	131.9	191.4
Belgium-Luxembourg	6.8	10.5	14.8	24.0
France	9.2	13.9	19.2	27.2
Germany	2.9	3.1	4.0	5.8
Italy	9.4	12.4	18.8	24.1
Netherlands	4.0	4.9	6.4	9.6
Sweden	.5	.6	.7	.9
Switzerland	6.1	6.5	8.5	9.2
United Kingdom	36.4	45.9	59.8	90.7
Canada	5.5	6.3	8.1	11.5
Japan	5.0	6.6	7.5	12.8

Note.—Detail may not add to totals because of rounding.

Source: Bank for International Settlements.

In addition to gross figures, the BIS publishes data on net Eurocurrency liabilities. The net liability measure is an estimate of the amount of credit outstanding in the Eurocurrency market, after an adjustment to exclude interbank deposits. Deposits by one Eurobank at another are made for several reasons. First, banks usually observe limits on loans to particular borrowers or markets. When limits are reached, many banks will lend to another bank which wants to increase the supply of loans to its nonbank borrowers. A second reason is that many banks whose lending is specialized by either function or region will supply funds to another intermediary for more general operations. The redepositing gives rise to double counting when the same funds pass through several banks on their way to final borrowers. The practice of the BIS has been to net out of the gross figure all interbank deposits within the reporting area, on the assumption that they result in duplication along the credit chain. Interbank deposits between this area and the areas not covered by the BIS reports, however, are assumed to derive from actual credit flows initiated by nonbank market participants and carried out by the banking intermediaries. Thus, interbank deposits between banks within the European countries comprising the reporting area are excluded, while deposits of banks outside the area are included in the net measure. Also included in the net measure are Eurocurrency liabilities of the area banks to the residents of the country in which the bank is located. On this net basis, the BIS had estimated the size of the Eurocurrency market at $132 billion in the reporting European countries at the end of 1973. Of that total the Eurodollar component was estimated at $97 billion.

In recent years banks in other financial centers such as Singapore and the Bahamas sharply increased their Eurocurrency deposits. Data on these liabilities are not included in the BIS figures. However, the Morgan Guaranty

Trust Company of New York, utilizing published national banking statistics of various countries, has been compiling data on the world Eurocurrency market. According to their estimates, the gross foreign currency liabilities of banks around the world (including interbank deposits and foreign-currency denominated liabilities to residents) amounted to $295 billion at the end of 1973. Of the world total, $215 billion were Eurodollar deposits; about $80 billion of these were held at foreign branches of U.S. banks. After an adjustment for double counting resulting from interbank deposits, the net size of the world Eurocurrency market at the end of 1973 was estimated by Morgan Guaranty at $155 billion, of which $115 billion consisted of liabilities denominated in U.S. dollars.

In the first 3 quarters of 1974 the world Eurocurrency market expanded considerably. On a net basis it has been estimated that the deposits rose globally by some $35 billion, from $155 billion at the end of 1973 to $190 billion at the end of September 1974. A large portion of that increase apparently took place at banks in the United Kingdom where gross Eurocurrency deposits rose by $16 billion to $106 billion.

Receiving foreign currency deposits and establishing foreign-currency denominated liabilities is, of course, only one side of the Eurobanks' activities. Lending the funds received and establishing foreign-currency denominated claims represents the other phase of their operations. The BIS also collects and publishes data on the asset side of the balance sheet of Eurobanks for the European countries comprising the reporting area. Table 51 shows the distribution of such assets around the world.

TABLE 51.—*Foreign-currency denominated claims of banks in reporting European countries, 1973*

[Billions of dollars [1]; end of 1973]

Area and country	Foreign-currency denominated claims		
	Total	Dollars	All other currencies
Claims on residents of			
Reporting European countries [2]	106.6	67.3	39.3
Other areas	81.3	66.5	14.8
Other Western Europe	11.4	6.6	4.8
Eastern Europe	7.8	4.9	2.9
Canada	5.1	4.4	.7
Japan	8.1	7.5	.6
Latin America	11.3	10.3	1.0
Middle East	2.5	2.0	.5
United States	14.5	13.8	.7
Other	2[illegible].6	17.0	3.7

[1] Foreign currencies expressed in billions of U.S. dollars.
[2] Belgium-Luxembourg, France, Germany, Italy, Netherlands, Sweden, Switzerland, and United Kingdom.

Note.—Detail may not add to totals because of rounding.

Source: Bank for International Settlements.

Eurodollars are not included in the U.S. monetary aggregates (M_1, M_2, M_3); only dollars held by foreigners as currency or as deposits in U.S. banking institutions are included. Indeed, Eurodollar deposits must first be "converted" into deposits in U.S. banks before they can become means of payment in the United States. In general, such "conversion" has no impact on the U.S. money supply. On the other hand, owners of Eurodollar deposits undoubtedly consider them highly liquid dollar-denominated assets, and some degree of arbitrariness inevitably enters into distinctions between such assets and money.