## 3. EUROCURRENCY MARKETS:

**Unit Structure:**

3.1 Objectives
3.2 Introduction
3.3 Factors responsible for the growth
3.4 Characteristics-components-functions
3.5 Euro banking- Advantages- Disadvantages

### 3.1 LEARNING OBJECTIVES:

After reading this lesson you are able to:

- Understand euro currency market
- To understand the features of euro currency market
- Understand Components of euro currency market
- Understand function of euro currency market
- Understand the offshore banking

### 3.2 INTRODUCTION:

During the late 50s, the Russians were earning dollars by selling gold and other commodities and wanted to use them in buying grains and other commodities from the westward countries namely US.However they didn't want to keep dollars by way of deposits in the banks of new York, as they feared that the US government might freeze the deposits if the cold war moves to an intensified state.so they approached the banks in Britain and France who accepted their deposits in the form as dollars. since these deposits were made in Europe , it was termed as euro while the deposits were made in dollars so the term used were 'euro dollars' deposits. since the late 80s these kinds of deposits were carried out only in Europe so it was specifically given name as Euro Yen , Euro Rupee and in general it was termed as Eurocurrency deposits. However since 1990 there has been a great expansion in the market worldwide however the prefix “EURO” has remained as it is. Eurocurrency markets are now global market and it does not only refer to Europe any more. In the modern era it is clearly known as ‘offshore’ and not related to only Europe.

### 3.3 FACTORS RESPONSIBLE FOR ORIGINATION AND GROWTH OF – -EUROCURRENCY MARKETS:

**-Factors related to the USA:**

(1) **Unwillingness to hold dollars in USA reserve Banks**: Countries were reluctant to keep bank deposits in the United States, so they started keeping their dollar earnings deposited in London. Eventually all other Euro dollar holders did the same, which became an obvious case when the United States ran into constant balance of payments deficits.

(2) **Regulation Q in the USA**: The growth of the Eurocurrency market was also regulated by certain monetary regulations in the United States called as 'Regulation Q' which had put a ceiling on the interest rates on domestic deposits. So, such depositors were naturally attracted to Euro banks that were not bound by Regulation Q. By sending off dollar deposits to their offshore branches the U.S. banks were able to avoid tying up so much of their funds in reserve requirements at a zero rate.

(3) **Regulation M in the USA:** Regulation M in the US stipulated reserve to be maintained against deposits accepted by banks in the US. This increased the cost on deposits for bank which broadened the gap between the lending and deposits rate. This feature was mostly exploited by European banks.

**-Factors related to other countries:**

(4) **Curtailment in UK:** Constant balance of payments deficits made the United Kingdom government limit British banks' external use of sterling, so they had a powerful incentive to develop business in foreign currencies.

(5) **Full Capital Account Convertibility adopted by developed countries:** By 1958 most of the important industrial countries had restored full convertibility of their currencies.

(6) **Growth of tax heaven concept and offshore banking :** At the end of the 1960s and during the early 1970s the Eurocurrency markets, expanded to a number of other "offshore" banking centers. These were typically small territories that had, exchange control, tax and laws regulating banking which were favourable to international banks. The business was entrepots in nature, with foreign currency funds deposited by one foreign source and then lent to another.

## 3.4. CHARACTERISTICS OF EUROCURRENCY MARKETS:

The various characteristics of Eurocurrency Markets are:

(1) **Unregulated Market:** It is a market across border. Hence the government does not have full control over the transactions. Hence transacting entities escape from most of the stringent provisions and regulations. Under euro currency government interference is minimal. Thus it is an unregulated market.

(2) **Long Term Loans and Short Term Deposits:** Eurocurrency loans are for longer period of time. Deposits however in Eurocurrency markets are primarily for short term. This leads to asset-liability duration mismatch problem for the banks.

(3) **Massive wholesale market**: Transactions in Eurocurrency markets are huge. They are mostly within Governments and Banks, Public Sector Organizations and large MNCs. This makes the market a wholesale rather than a retail market.

**(4)Time Deposits:** The Eurocurrency market exists for savings and fixed deposits and recurring deposits in banks. There is hardly any space in Euro market for demand deposits.

**(5) Eurodollar and LIBOR based market**: Eurocurrency interest rates are based on a variable rate base such as the (LIBOR).i.e. London Inter bank Offer Rate. Under this interest rate risk is reduced. This market is largely dominated by US Dollars over other currencies.

## 3.5.COMPONENTS (COMPOSITIONS) OF EUROCURRENCY MARKETS:

Composition is broken apart in 3 areas, viz., (I) Market Participants, (II) Euro financial- instruments and (III) transactional structure.

**(I) Market Participants:**

**(1)Commercial Banks:** The institutional core of the market is formed by the Commercial banks. Banks enter the euro currency market both as lenders and as depositors. Around 20 of the world's largest banks play a vital role in the Euromarket. They attract a disproportionate volume of primary deposits which are then re - lent to other Eurobanks. These banks connect the external with the domestic market, taking funds from one market and placing them in another market. The depth of the interbank market enables banks to adjust liquidity positions with great ease.

**(2)Corporate:** Eurocurrencies are mainly borrowed by Corporations whose name, size and good standing enable banks to make loans to them with little more than a superficial analysis of creditworthiness. But during recent times the range of corporate and government borrowers have widened to hold less good names. The main reason for this is the vast amount of funds available for lending.

**(3) Governments and central banks**: Central banks and Governments are also lenders in the Eurocurrency markets. In addition, international institutions such as the World Bank and other regional development banks, and institutions associated with the EU, have been borrowers on regular basis. In the last decade the market has also seen an enlargement in government and government - related borrowers. This is especially true of the medium term Euro Credits market, which has become very famous for infrastructure projects and for financing balance of payments deficits.

**(4)Private Individuals**: Minor participants in the Eurodollar markets are known as private individual. High net worth individuals are no doubtedly been significant participants as investors in the Eurobond market, where the fact that payment of interest is without deduction of tax and securities are bearer securities gives the market anonymity and an most probable attractiveness from a tax point of view.

**(II) Euro financial-instruments:**

**(1) Eurodeposits**: Most deposits in the Eurocurrency market are Fixed deposits at fixed interest rates, whose maturity is of a short period. Around three-quarters of deposits in London Eurobanks have maturities of less than three months. Many of these deposits are on call .i.e. thus they can be withdrawn without notice. These typesof time deposits are mostly made by other bank, but many are made by governments and their central banks as well as Multi-national Corporation. A few are made by very high income individuals, often through Swiss bank. Deposits come in many forms. Other than negotiable Eurodollar certificates of deposit, there are many similar certificates of deposit.

(2) **Euroloans:** Many Eurodollar loans are direct on the basis of formal lines of credit. However, the technique of loan syndication has been developed for larger currencies by the market. Interest on syndicated loans is usually calculated by adding a spread to LIBOR, although the US prime rate is also used as a basis for interest pricing. Interest rates under LIBOR change continuously.

(3) **Eurobonds:** Eurobonds are international bonds denominated in a currency which is different from that of the country in which they were issued. Eurobonds are securities which are easily transferable, and the Eurobond market is a vital factor in international finance as the size of the Eurobond market inthe international market exceeds that of the U.S. bond market.

(4) **Other Instruments**: Other Euro financial instruments consist of Euro certificates of deposits, Euro commercial papers, etc.

**(III) Transactional structure of Euro Markets:**

The Euro currency market is completely a wholesale market. Transactions made are very rarely to be for less than $1 million while at times they are for $100 million and more. Like the foreign exchange markets, the vast bulk is operated to inter - bank operations. The largestnon-banking companies have to deal via banks. Borrowers are the very high goodwill corporate names carrying the lowest credit risks. The market is liked by telephone or telecommunication and is focused upon London, which has a share of around 1/3 of the Eurocurrency market. All Euro currency transaction are unsecured credits in nature, hence the lenders pay a lot of attention to borrowers status and name.

**3.6.FUNCTIONS OF EUROCURRENCY MARKETS:**

Given below are some of the functions of the Eurocurrency markets:

**(1)Cheap Source of working capital**: Lesser interest rate is attracted by Euro currency loans than the loans of the domestic economy. This is due to low overhead costs. Since dealings are between good credit rating and the banks, the costs of credit checking and processing are lesser. Lending rates can thus be fixed lower than domestic market.

**(2)Liquidity:** Financial institutions find it highly profitable to hold their idle resources in Euromarkets. Moreover due to fewer restrictions in the markets, investors can make investments in bearer securities. With the absence of tax withholding on interest there is an advantage in this form. Most of the Euro deposits have varied maturities period ranging from less than a day to couple of months. On an average 80 per cent of these deposits have maturity of 6months.

**(3)Facilitates International Trade:** Eurocurrency markets make easy availability of loans which helps in smoother working of international trade. Most banks prefer this form of financing to traditional forms such as letter of credit. It's mainly for two reasons: (a) Lower interest rate and (b) easy procedural formalities.

**3.7. EUROBANKING / OFFSHORE BANKING:**

Euro banking offers many vital advantages to the various stakeholders. Depositors try to evade from the tax-net of their own country of domicile. Borrowers get liquid money for capital investments as well for working capital at a highly competitive interest rate.

To grab this kind of business, banks offer banking services to nonresidents. Depositors would deposit their own home currency or US Dollar and thus Eurodollar deposit or Eurocurrency deposit is created. This is then lent to an appropriate borrower by the bank.

**3.8.ADVANTAGES OF OFFSHORE BANKING:**

(1) **Access to politically and economically stable jurisdictions**: Offshore banks provide easy access to politically and economically stable jurisdictions. This may turn advantageous for those residing in apolitical turmoil areas where there is a risk and fear of getting their assets frozen, seized or disappear.

(2) **Higher interest on deposits**: Some offshore banks may operate with a lower cost and greater interest rates than the official rate in the home country due to lower overheads and a lack of intervention by the government. Also in most of the offshore banking centers, there is a lack of control in the interest rate. Banks are free to decide their interest rates. This is a great advantage for the banks.

(3) **Evasion of Tax:** Usually Interest is by offshore banks without deducting tax. This is an advantage to individuals who evade the payment tax on worldwide income. Popular Offshore banking centers also save on their own direct taxes.

(4) **Non-conventional Facilities**: Some offshore banks offer banking services which are non-available from domestic banks such as anonymous bank accounts.

(5) **Other advantages to the banks:** In most offshore banking centers; banks get exemption from reserve requirements, entry is easy to establish a branch, license fees are low, etc.

## 3.9.DISADVANTAGES OF OFFSHORE BANKING:

(1) **Crime and illegal activities:** Offshore banking has been associated with the crime economy and organized crime, through money laundering. Following September 11, 2001, tax heavens and offshore banks, along with clearing houses, have been accused of helping various organized terrorist groups, crime gangs, and other state or non-state actors.

(2) **Tax loss to Governments:** Tax evasion is been promoted by Offshore banking, by giving tax evaders with an attractive place to deposit their hidden income.

(3) **Capital outflow and volatility:** Developing countries may suffer due to the speed at which money can be transferred in and out of their economy.

(4) **Widens rich-poor gap:** Offshore banking is usually more accessible to those on high incomes, because of the costs of establishing and maintaining offshore accounts. Middle-income groups suffer the most on account of the tax burden in developed countries.