

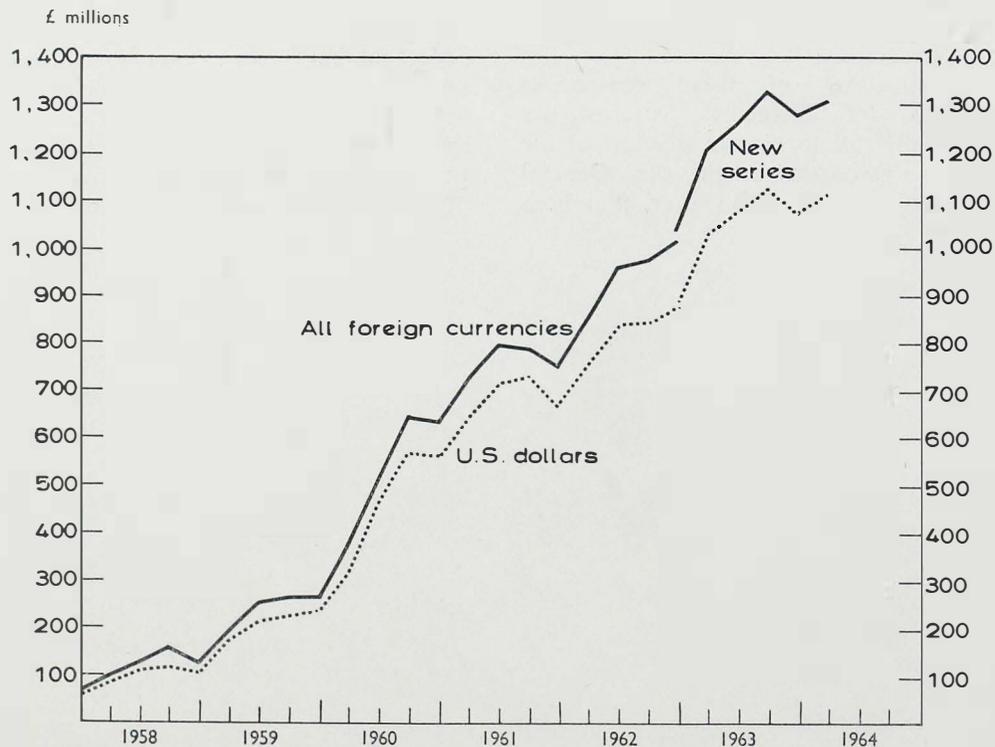
U.K. BANKS' EXTERNAL LIABILITIES AND CLAIMS IN FOREIGN CURRENCIES

Introduction and background The last few years have seen a remarkable expansion in foreign currency deposit business in London, as shown by the growth of U.K. banks' liabilities and claims in foreign currencies. The purpose of this article is to give some account of this development and, also, to introduce a new statistical series of these liabilities and claims, collected as from December 1962, which it is intended to publish quarterly in future. In this article the term "U.K. banks" refers to

domestic banks, accepting houses, and the London offices of British overseas banks and foreign banks, and the term "foreign currencies" means currencies of countries outside the sterling area.^(a)

U.K. banks ordinarily have foreign currency balances with their correspondents abroad, in order to carry on their day-to-day foreign business. They may, in addition, hold balances on behalf of U.K. customers who have Exchange Control authority to retain foreign

EXTERNAL LIABILITIES OF U.K. BANKS IN
U.S. DOLLARS AND ALL FOREIGN CURRENCIES



^(a) U.K. banks' liabilities and claims in currencies of overseas sterling area countries are relatively quite small and mainly arise for reasons of internal book-keeping between U.K. banks and their branches in overseas sterling area countries. The amounts of U.K. banks' liabilities and claims in overseas sterling area currencies and in non-sterling currencies at the end of 1962 were included in an article entitled "An Inventory of U.K. External Assets and Liabilities: end-1962", in the March 1964 issue of this *Bulletin*.

EXTERNAL LIABILITIES AND CLAIMS OF U.K. BANKS IN FOREIGN CURRENCIES
ANALYSIS BY COUNTRIES FOR U.S. DOLLARS AND BY AREAS FOR ALL CURRENCIES

£ millions

End of period	U.K. liabilities						U.K. claims					
	1962	1963				1964	1962	1963				1964
	Dec.	Mar.	June	Sept.	Dec.	Mar.	Dec.	Mar.	June	Sept.	Dec.	Mar.
U.S. Dollars :												
Austria	78	78	76	88	80	72	3	1	3	2	3	1
Belgium	36	76	63	42	25	27	19	32	56	54	69	62
Denmark	4	3	7	6	5	7	25	17	25	29	33	28
France	40	32	28	32	34	26	50	61	62	53	54	42
Western Germany	39	53	47	37	18	47	36	34	35	45	65	38
Italy	55	51	48	48	52	33	127	124	172	187	173	118
Netherlands	21	32	22	23	29	25	21	18	28	32	26	30
Norway	7	11	7	9	11	14	15	15	14	15	18	15
Sweden	12	7	13	13	7	15	11	6	15	22	28	25
Switzerland ⁽¹⁾	129	166	181	211	223	263	19	19	22	26	31	24
Other Western Europe ...	28	31	38	37	36	41	10	11	17	18	19	24
Total Western Europe ...	449	540	530	546	520	570	336	338	449	483	519	407
United States	103	104	114	128	137	114	323	455	379	360	284	383
Canada	160	198	188	189	127	134	9	8	7	24	25	19
Japan	2	2	2	5	4	4	66	84	81	97	88	99
Other	170	184	241	260	284	285	69	63	78	99	109	97
Total U.S. dollars	884	1,028	1,075	1,128	1,072	1,107	803	948	994	1,063	1,025	1,005
Swiss francs	62	77	85	83	76	87	} 207	64	72	68	71	74
Deutschemark	38	57	45	64	65	61		67	63	79	68	89
Other currencies	54	47	53	53	67	53		85	105	105	105	94
TOTAL ALL CURRENCIES	1,038	1,209	1,258	1,328	1,280	1,308	1,010	1,164	1,234	1,315	1,269	1,262
Of which :												
Overseas sterling countries	18	21	28	32	41	45	2	1	1	1	3	3
North America	273	311	309	325	286	262	355	478	406	404	327	419
Latin America	48	51	59	64	67	77	27	27	31	30	29	27
Western Europe	552	674	668	690	652	707	471	492	624	663	692	590
Other	147	152	194	217	234	217	155	166	172	217	218	223

(1) Including the Bank for International Settlements.

currency. But the large growth in their external claims and liabilities in foreign currencies during recent years has come about as a result of their on-lending abroad of currency funds which have been deposited with them by overseas residents. This is not an entirely new phenomenon. A good deal of such business was done in the late 1920's but it ended in the 'standstill' of 1931. It did not recur on any scale in the 1930's because exchange rates were unstable and the international political situation was too disturbed.

After the war, the London foreign exchange market was not reopened until December 1951

and again, initially, little in the way of currency deposits was taken from abroad. There was some rise in 1955 but the total was still only in the region of £50 million and much of this was converted into sterling by the banks concerned. It was not until after the restriction of credit in the United Kingdom in September 1957, and, in particular, the banning of re-financing in sterling, that the amount of overseas borrowing and lending really began to expand.

From the graph it can be seen that U.K. banks' external liabilities in all foreign currencies, which at the end of 1957 amounted to

some £70 million and were little higher than in 1955, rose to just over £1,300 million by the end of March 1964. This growth has been predominantly in liabilities in U.S. dollars, which at the end of March 1964 amounted to just over £1,100 million.

Sources of information Two sources of information have been used. Figures of external foreign currency liabilities for the period end-1957 to end-1962 have been derived from returns of their foreign currency position made by those banks having permission, under the Exchange Control Act, 1947, to deal in foreign currencies. As from December 1962 there is a new series of figures, relating specifically to the banks' external liabilities and claims in U.S. dollars and other foreign currencies, and covering all banks and similar institutions in the United Kingdom known to have such liabilities and claims.^(a) It also shows the countries from which funds have been directly borrowed and to which funds have been directly lent. Total liabilities, and the U.S. dollar component, from both series are plotted on the graph, and some details of both liabilities and claims for each end-quarter from December 1962 to March 1964 are given in the table. As is indicated by the graph, the two series differ only to a very minor degree; this difference is explained in the further notes on sources and definitions at the end of this article.

London as part of an international market The development of a market in foreign currency deposits in London is part of a wider development, namely, the creation of an international market in short-term money, chiefly centred in Western Europe. The U.S. dollar, being of international importance as a reserve and trading currency and also in plentiful supply, is the currency mainly dealt in. Hence the market has come to be known as the 'Euro-dollar' market. The term Euro-dollar, although a convenient one, is nevertheless something of a misnomer, for the market is not exclusively in dollars, nor are the centres involved all within

Europe, while the lenders and borrowers of funds are by no means all European.

The essential reasons for the development of this market after 1957 were :

- (i) the greater freedom which banks were allowed in the conduct of their foreign exchange operations as a result of external convertibility in Western Europe at the end of 1958 (the ability to arbitrage funds between dollars and European currencies is an integral part of Euro-dollar activities);
- (ii) other exchange control relaxations in West European countries, which have given commercial banks and business firms more freedom to conduct foreign capital operations;
- (iii) Regulation Q (see below) which limits the rates of interest that U.S. banks may pay on deposits; and
- (iv) reasonably stable international exchange rates.

There were other important factors, notably :

- (i) the balance of payments deficit of the United States which has provided the rest of the world, and especially Western Europe, with increasing holdings of dollars seeking the most profitable form of investment;
- (ii) the practice adopted on occasions by certain central banks of offering their commercial banks special inducements to hold dollars in order to reduce internal liquidity; and, to a lesser extent,
- (iii) the tendency of East European countries to hold dollars through West European intermediaries.

Some initial impetus was given to dollar deposit business in London by the ban imposed late in 1957 on U.K. banks' overseas lending in sterling to finance trade between countries outside the sterling area and on the extension of other sterling credits beyond normal limits. Thus deprived of part of their normal sterling acceptance business, the banks made up by offering dollar loans against dollar deposits from overseas residents. By the time the

^(a) This series is parallel with the series of external liabilities and claims in sterling which was discussed in the June 1963 issue of this *Bulletin*. It does not, however, include liabilities in foreign currencies arising from Basle arrangements, which, at the 31st March 1963, amounted to £89 million.

restrictions began to be removed in early 1959 the Euro-dollar market was firmly established.

The important role of London banks, especially the accepting houses and overseas banks overseas banks, with their wide overseas connections and long experience of international business are well equipped to play an active part in this market. Figures showing the foreign currency element of the deposit liabilities and advances of the accepting houses and overseas banks in London are published for the first time in Table 14 of the Statistical Annex. The figures in Table 14 are not exactly comparable with those in this article,^(a) but they show nevertheless the dominant role of these banks in the Euro-dollar market. Through their foreign exchange departments, London banks are constantly in touch with banks abroad and with one another, either directly or by means of foreign exchange brokers. It was, therefore, an entirely natural development that they should become the centre of a market in dollar, and other foreign currency, deposits, where, for large amounts, placers of funds can obtain a better return than if they put their money in its native home, and borrowers can obtain funds more cheaply than in the centre of the currency concerned or in their own currency. This market is highly organised, with large amounts being dealt in, at any time, for a variety of maturities, and with the minimum of formality. The number of banks involved is in the region of one hundred and thirty, but the bulk of the business is in the hands of about forty of them.

Relative rates in London and New York Scope for the development of the Euro-dollar market was provided by the wide spread between deposit and lending rates in the United States. Regulation Q of the Board of Governors of the Federal Reserve System helped to formalise this situation by setting limits to the interest U.S. banks could pay on deposits, thus no interest could be paid on deposits for less than 30 days, not more than 1% could be paid on time deposits of between

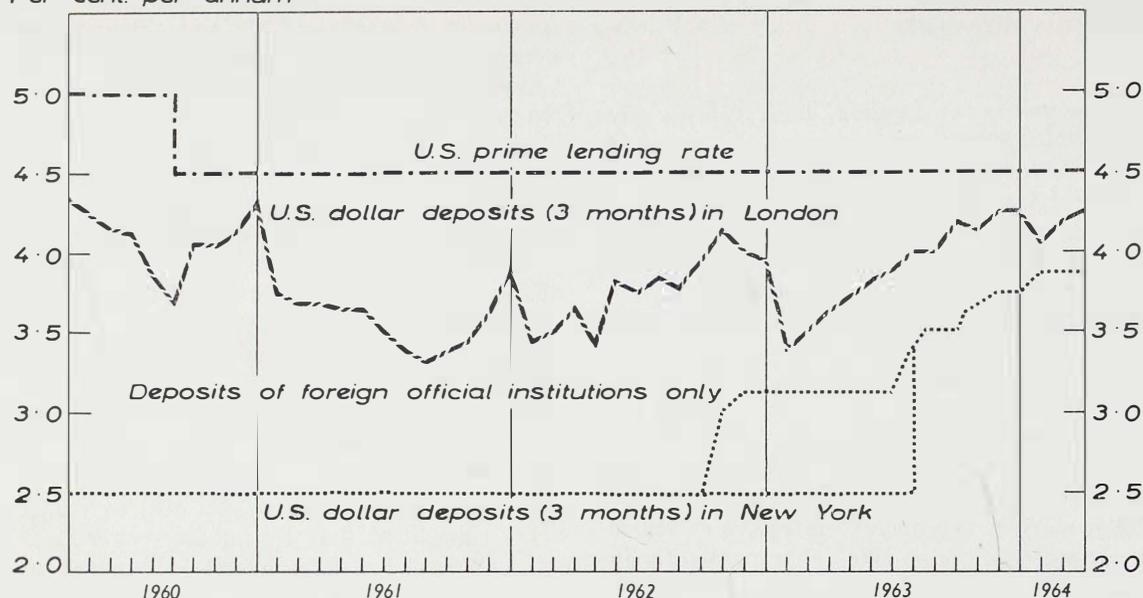
30 and 90 days, and, until July 1963, the maximum rate allowed on time deposits of between 90 days and six months was $2\frac{1}{2}\%$. (In October 1962 these limits ceased to apply to deposits of foreign official institutions) For short-term loans, the prime rate charged by banks in the United States since August 1960 has been $4\frac{1}{2}\%$. The average rate for loans is about 5%, but the effective rate is usually somewhat higher because the borrower is generally required to leave a proportion of the loan on his current account. Another reason why the real cost of borrowing is higher in the United States than it seems, is that it is done by term loan rather than by overdraft, and interest has to be paid for the whole of the loan for the whole of the period.

Banks in London have been able to attract large sums in dollars by quoting better rates for deposits, including interest on money at call and very short notice—categories which earn nothing at all with New York banks—and have employed them at less than the U.S. lending rate and still made a worthwhile turn. They are able to operate on a fairly small profit margin because the additional overhead expenses of conducting their Euro-dollar activities are minimal. Since July 1963, when the Regulation Q ceiling on time deposits of more than 90 days was raised to 4%, U.S. rates have moved upwards and are now close to that level. Moreover almost 4% can be earned on three months' money which, if placed in negotiable certificates of deposit, is liquid to the holder. London rates have hardened in consequence, as is shown in the graph on page 104. With no increase in U.S. lending rates, there has clearly been some narrowing of the margin within which banks outside the United States may operate.

Typical London rates for dollar deposits at the end of March 1964 were $3\frac{7}{8}\%$ at call and for seven days, $4\frac{1}{8}\%$ for one month, $4\frac{1}{4}\%$ for three months and $4\frac{3}{8}\%$ for six months. Business, of course, would have been done at rates either side of these quoted rates. Those placing funds with first-class London banks may have to be content with slightly lower rates. Euro-dollar loans being normally unsecured,

^(a) The primary purpose of the division into sterling and foreign currency in Table 14 is to provide information about the sterling business of these banks. In that table, therefore, "foreign currency" comprises all currencies other than sterling, including those of overseas sterling area countries which are omitted from this article. Table 14 also covers slightly fewer banks, and there are some other minor technical differences.

Per cent. per annum



'names' are all-important and the rate charged varies with the credit-standing of the borrower. Some borrowers may have to pay an appreciable margin over the quoted rate. Banks in countries which are heavy borrowers may also be required to pay a relatively high rate.

The graph above shows that the three months' dollar deposit rate in London has moved within relatively narrow limits. Since the early part of 1960, when the rate was kept up by the high rate on U.S. Treasury Bills, and until the very recent climb to over 4%, it has generally been around 3 $\frac{3}{4}$ %. For a short time at the close of each year it has tended to rise to around 4% in the face of large temporary withdrawals, and some borrowing, by continental banks to switch into local currencies for making up their end-year balance-sheet positions. Exceptionally it exceeded 4% during the Cuban crisis in October 1962, and it continued to do so in November on account of a sudden surge of demand from Italian banks which had been allowed by the Banca d'Italia to become net borrowers abroad. These and other large-scale changes, such as the running-down by the Deutsche Bundesbank in 1962 of its substantial dollar swap commitments with West German commercial banks, appear to have been taken by the market in its stride, without undue fluctuations in the rate.

Currencies other than dollars

Although the U.S. dollar is by far the most important foreign currency handled on the London market, significant amounts of other currencies are also held: at the end of March 1964 liabilities in such currencies amounted to £200 million. A large proportion was in Swiss francs and deutschemark. Some of these funds may be placed in London by residents of Switzerland and Western Germany as a profitable short-term investment; some may be placed here by other foreigners as a result of restrictions imposed on the payment of interest on foreign-owned deposits in Switzerland (from mid-1960) and Western Germany (during June 1960–April 1962 and again from the 1st April 1964) in order to discourage inflows of 'hot' money. Deposit rates for these currencies in London are normally a reflection of the rates on dollar deposits and of the dollar forward exchange margin against these currencies.

Recent experience

The graph of external liabilities on page 100 shows an almost continuous rise until the third quarter of 1963, apart from the effect of the seasonal outflow in December for 'window-dressing' purposes, which is reversed in January. Since then, however, there has been a levelling-off, the

total of £1,308 million at the end of March 1964 being £20 million less than it was at the end of September 1963. It remains to be seen whether this is just a temporary check, perhaps brought about by the shock of one or two failures abroad in the latter part of 1963, or whether perhaps the increased competitiveness of New York banks is making some impact on the market. Another possible influence is the limit imposed by the Italian authorities in September 1963 on Italian banks' overseas borrowing.

The problem of double-counting The total of external liabilities reported by U.K. banks inevitably includes some duplication of deposits. Given the differences of standing among banks engaged in this business and also their varying specialised interests, it often happens that several intermediaries may come between the original depositor and the final borrower. During this process it is possible for funds deposited with a U.K. bank by an overseas resident to be on-lent to a bank abroad and then redeposited with another U.K. bank. In this way the same funds can be counted twice. The extent of such double-counting is not known. On the other hand, there is no question of the banks being able to create international credit on any scale by making foreign currency advances unsupported by foreign currency deposits, because of the limits imposed by U.K. Exchange Control on the extent to which banks may run open positions in foreign currencies.

Sources of funds Statistical information about the type of overseas supplier is limited to a breakdown of external liabilities into those to banks and those to customers other than banks. At the end of March 1964 liabilities to overseas customers other than banks were a little over 20% of the total. This information is of limited value when looking at the London market in isolation, because some of the foreign currency deposited here by overseas banks would be held by them on behalf of customers other than banks. Liabilities to overseas banks will, in fact, comprise overseas central bank funds, placed in

London either direct or via overseas commercial banks, and funds of overseas commercial banks either held by them against foreign currency liabilities to their customers or acquired by them through exchanging domestic currency.

It is known that there have been changes in the relative importance of these sources. In the past the Deutsche Bundesbank, the Banca d'Italia and the Swiss National Bank have encouraged the banks in their own countries, either by means of favourable swap arrangements or by making deposits, to hold substantial amounts of dollars, many of which would presumably have reached the Euro-dollar market. But central banks are now relatively less important as an original source. The emphasis has shifted to commercial banks and companies. The relative importance of the two is somewhat uncertain, but it is safe to say that business concerns have been becoming more important. In particular, it is thought that companies resident in the United States, and also U.S. subsidiaries abroad, may have been putting funds into the Euro-dollar market.

As regards geographical sources, the table gives an analysis by countries of U.K. external liabilities in dollars, and one by areas of liabilities in all foreign currencies. Of the £1,300 million of liabilities in all currencies in March 1964, approximately 55% was to Western Europe, 20% to North America and the remaining 25% to countries in Eastern Europe, Latin America and the Middle East. The largest individual suppliers of funds were Switzerland (which includes the Bank for International Settlements), Canada and the United States. Besides placing dollars direct in London, U.S. residents are known to deposit U.S. dollars with Canadian banks on a large scale, and some of these dollars are transferred to London and therefore appear in U.K. statistics as liabilities to Canada. This underlines the danger of reading too much into figures for individual countries; they will not always accurately reveal where the beneficial ownership lies. To give another example, dollars placed by (say) an East European country with a bank on the Continent may be redeposited in London; they would then be included in U.K. figures as a liability to a country in Western Europe.

Employment of funds It is evident from the figures of U.K. banks' external claims in the table that a very high proportion of the foreign currency funds coming to London are lent overseas. In other words, the banks do comparatively little switching into sterling (but see "The net external position" below).

At the end of March 1964 the total of external claims in all foreign currencies was about £1,260 million, of which about £1,000 million was in U.S. dollars. Some idea of the direction in which the dollars flow can be derived from the analysis by countries, but here, as with the liabilities, the figures for individual countries will not necessarily accurately reflect the residence of the ultimate borrowers. Although the banks individually set themselves lending limits both for 'names' abroad and for countries, funds can reach a large overseas borrower by more than one route.

On the evidence of the latest figures about £400 million in dollars and nearly £200 million in other currencies have been lent to West European countries. Almost £400 million of dollars is employed in the United States, consisting of a variety of types of claims. They include, first and foremost, dollars acquired by the London offices of American banks and re-deposited by them with their head offices in the United States; secondly, correspondent balances with U.S. banks, and U.S. Treasury Bills and other U.S. money market paper, including assets held as cover for deposit liabilities to U.K. residents; thirdly, direct loans to U.S. business concerns; and, fourthly, dollars which Japanese banks in London are understood to lend to Japan through their offices in New York. After the United States, the countries which are the largest recipients of funds are Italy, Japan and Belgium. There is a sizable two-way traffic with Eastern Europe and Latin America.

Knowledge of the ultimate uses to which funds are put is rather sketchy. A mere 10% of the total lent abroad goes direct to overseas residents other than banks. Of the remaining 90%, what is lent to banks outside the United States is partly used by these banks for making foreign currency advances to their nationals, presumably to finance foreign trade, and partly converted into local currency for use internally. Among the large borrowers, the Italian banks were borrowing heavily last year to finance foreign trade, while Japanese banks borrow

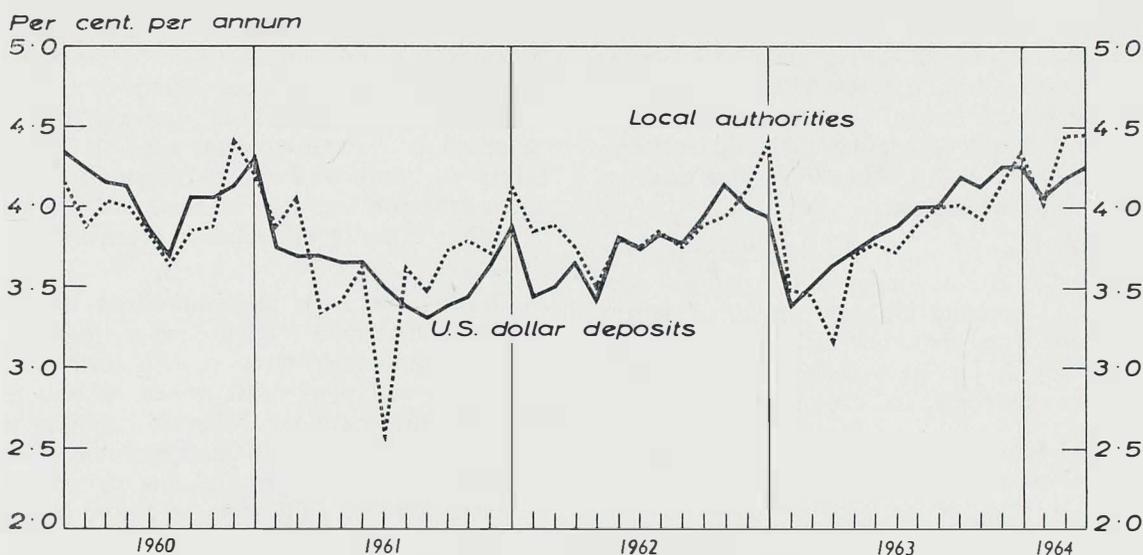
both to finance their country's foreign trade and also to switch into yen for employment in Japan. Belgium is a special case; in addition to placing two three-year loans, each for U.S. \$20 million, in London during 1963, the Belgian Government, through the medium of the Belgian commercial banks, are also an extensive borrower of short-term dollars from London. The Government exchange the dollars with the National Bank of Belgium for francs, in order to help finance their domestic requirements.

A new development in 1963, since the virtual closing of the New York capital market to foreign borrowers as a result of the Interest Equalisation Tax proposal, has been the issue through various syndicates of banks in London and abroad of a series of loans to foreigners, denominated (except for one in Swiss francs) in U.S. dollars. With the exception of the two Belgian Government loans mentioned above, these were long-term loans. Virtually all the funds subscribed came from abroad. U.K. banks do not normally take up long-term loans themselves in cover of their dollar deposit liabilities. Euro-dollars, being mainly short-term funds, are unlikely to be used to any extent to subscribe to these issues, which are largely taken up in what might be described as Euro-capital, albeit frequently denominated in U.S. dollars.

The net external position It was mentioned at the beginning of the previous section that U.K. banks lend abroad almost the equivalent of the foreign currencies they receive from abroad. In fact, the excess of liabilities over claims, or the net external liability in foreign currencies, at the 31st March 1964 was £46 million. This figure, however, understates the degree to which U.K. banks have borrowed foreign currencies abroad and switched them into sterling, because the figure of external claims which is deducted from external liabilities will include the minimum balances of U.K. banks with their correspondents abroad, as well as certain other balances held for U.K. residents which are, for the most part, regarded as outside the Euro-dollar field. But having said this, the amount switched into sterling is still modest in relation to the total of external liabilities; at present it is about 10%.

The switching of currency funds into sterling has not had a significant influence on the credit

THREE MONTHS' DEPOSITS: comparison of U.K. local authority rate⁽¹⁾
and U.S. dollar deposit rate in London



⁽¹⁾ Adjusted by the forward margin for U.S. dollars (3 months).

situation in the United Kingdom. In amount it has varied over the years according to the profitability of short-term lending in the United Kingdom, notably to local authorities and hire purchase finance houses. The banks are perfectly free to arbitrage in this way, but they need to cover the exchange risk involved, so the cost of forward exchange cover is an important consideration. Forward exchange conditions have at times been favourable and at other times not: this is illustrated by the graph above which compares the three months' dollar deposit rate in London with the local authority three months' rate, after adjustment for the cost of forward dollar cover. When such inward interest arbitrage occurs, it would tend to increase the supply of foreign currency in the market and to increase the likelihood of direct benefit to U.K. official reserves and, by the same token, any reversal of the process could have an adverse effect on the reserves. But the gain or loss to the reserves would not necessarily equal the amount switched into or out of sterling.

To date, U.K. banks have not on-lent Euro-dollars to their U.K. customers to any extent. Borrowing of foreign currency by U.K. residents is, of course, subject to Exchange Control permission.

Summary and conclusions

The Euro-dollar market has shown the capacity to adapt itself to changing conditions and has emerged as a truly international short-term money market, providing attractive opportunities for short-term investment and, at the same time, relatively easy and cheap access to short-term finance. Evidence of the advantage of the market to both givers and takers of deposits is provided by the magnitude of the growth of foreign currency liabilities and claims of banks in London, which has become the principal centre. The market has helped to stimulate banking competition and reduce interest rates in the main borrowing countries; and has probably added to the total funds available for the finance of international business.

There are risks involved, but the U.K. authorities have not discouraged London banks from participating in this business, relying on their good judgment in the way they conduct their operations. The market has shown that it has a useful part to play although, if the pause in growth during the past few months reflects a more cautious approach, this may not be wholly a bad thing.

SOURCES AND DEFINITIONS

The figures of U.K. banks' external liabilities and claims in foreign currencies are gross figures, as shown in the reporting banks' books at the close of business on the last working day of the period, foreign currency amounts being calculated in sterling terms at the middle closing rates for the day. 'Forwards' and unsettled spot deals are ignored.

Both sources used, namely, the authorised dealers' returns and the new style returns beginning in December 1962, are similar in content. In both series liabilities include deposits and advances in foreign currencies received from overseas residents, and claims include :

- (i) foreign currency deposits with, and advances to, overseas residents;
- (ii) holdings of foreign currency notes and coin;
- (iii) holdings of treasury bills and similar short-term paper denominated in foreign currency;
- (iv) commercial bills drawn in foreign currency on overseas residents and owned by the reporting institutions; and
- (v) claims on overseas customers arising from foreign currency acceptances.

The new returns also include, in liabilities, some commercial bills drawn in foreign currency on U.K. residents and held by the banks on behalf of their overseas customers and, in claims, some commercial bills drawn in foreign currency on overseas residents and held by the banks on behalf of their U.K. customers; but these items are known to be small and are not a serious cause of difference between the two series.

The returns from the authorised dealers relate to their total foreign currency position, *i.e.*, including their position with their U.K. customers and other U.K. banks as well as their overseas position. Whereas liabilities to overseas residents have always been given separately on these returns, claims on overseas residents were not fully segregated until March 1963.

The definitions of "overseas residents" and "U.K. residents" used for these returns are the same as those described on page 100 of the June 1963 issue of this *Bulletin* in connection with external liabilities and claims in sterling. In particular it must be stressed that branches located in the United Kingdom of overseas registered banks are treated as U.K. banks and that branches of U.K. registered banks located overseas are treated as overseas banks.