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The Eurodollar and the Risk of Currency Restrictions

In our age the interest of the general public in natural sciences and technology is so great that progress in those fields is reported regularly in newspapers and non-scientific periodicals. When it comes to changes or new phenomena in finance or banking, the public—and those writing for it—shy away. The Paris edition of *The New York Herald Tribune,* speaking of the Eurodollar market, referred to "that complex financial market fully understood only by the financial brotherhood who deal in it." [1] Indeed, the subject has a growing literature for both professionals and the intelligent public.[2]

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[1] *New York Herald Tribune,* European Edition, April 7, 1965, page 11, Col. 4.

[2] *Cf.* Johnson, N. O., "Eurodollars in the New International Money Markets," First National City Bank, New York, 1964. Altman, O. L., "Foreign Markets for Dollars, Sterling, and Other Currencies," VIII. 3. Staff Papers, Internat. Monetary Fund, Washington, D.C., Dec. 1961, pp. 313-352 (referred to in this article as "Foreign Markets for Dollars"). Altman, O. L., "Recent Developments in Foreign Markets for Dollars and Other Currencies." Document of Internat. Monetary Fund, Washington, D.C., Nov. 30, 1962, also: I.M.F. Staff Papers, Nov. 1962, pp. 297-316. Altman, O. L., "Canadian Markets for U.S. Dollars." Staff Papers, Int. Monet. Fund, Washington, D.C., Nov. 1962; Reinhardt, E., Problèmes actuels de l'exportation des capitaux (Zurich, 1963); Lademann, J., "Struktur und Auswirkung des Euro-Dollar Markets," Neue Züricher Zeitung, Handelsteil, Aug. 17, 1963, No. 3253, and Aug. 19, 1963, No. 3271. Koszul, J.-P., "Eurodollar Market Risky but likely to last," European Community, August 1964, No. 74, p. 9. Nahum, J. G., "Les Marchés Monetairs Internationaux," Banque. Paris, Vol. 40, Apr. 1965, p. 227. Bank for International Settlements, Thirty-Fourth Annual Report, Basel, June 1964 (pp. 127-141).

The Eurodollar

The confusion connected with the Eurodollar is due largely to misleading terminology which, in turn, has a historical explanation.

In the early Fifties, the U.S.S.R. possessed substantial funds of U.S. dollars which, in the atmosphere of tension then prevailing, it did not wish to deposit with U.S. banks for fear of blocking or vesting. The funds were held by the Banque Commerciale pour l'Europe du Nord, a bank in Paris which redeposited these dollars with various European banks at attractive interest rates. The receiving banks passed on again the funds to other banks, and a market of a certain volume was created. The cable address of Banque Commerciale pour l'Europe du Nord, Eurobank, gave the name "Eurodollar" to the funds which were thus traded among the foreign exchange dealers.

A few years later, it was observed in the United States that in view of higher interest paid by European banks on dollar deposits, funds in substantial amounts were transferred from American to European banks. The term Eurodollar was then applied also to these deposits. It was soon realized that these funds of American origin are but a fraction of the dollars deposited with banks in Europe, and outside Europe, and that there existed a vigorous market among non-American banks giving and taking dollars as short-term loans. This has been referred to as the Eurodollar market. Similar, although smaller, markets have developed in pounds sterling, Swiss francs, Italian lire, and other currencies. It has been rightly pointed out [3] that it is misleading to refer to all these various moneys traded in and outside Europe as Eurodollars.

The deposits in the Euromarket are made for short periods of time: 48 hours, 30 days, 90 days, and only exceptionally for longer periods. It is one characteristic of the market that the deposit which is originally made with, say, bank A in country X, is very often passed on to bank B in country Y at a slightly higher interest rate, and frequently even to a third bank in a third country again at an interest rate a fraction higher before it reaches the borrowing public.[4] The market has operated very smoothly until now and the marginal profits made by the banks are economically well justified in bringing the funds to where the effective demand is the greatest.[5]

[3] *E.g.*, editorial in Neue Züricher Zeitung, No. 4289, Dec. 4, 1960.

[4] Solmssen, H. K., Eurogeld geht durch viele Hände. Börsen-Zeitung, Frankfurt a.M., No. 223, 20. Nov. 1964.

[5] For a brief description in non-technical language of the way a foreign ex-

The dimensions of this market are beyond the imagination of the outsider, 9.5 billion dollars according to one recent estimate.[6] The market would probably continue to grow but for certain perils instinctively felt by the operators. In analyzing what these intrinsic dangers are, specifically in connection with the Euromarket operations, one finds that they are to some extent legal in nature: (1) the debts of the participating banks in various countries are assumed to be governed by the same legal rules, whereas they often are not, and (2) supervenient currency regulations (including blocking or vesting of the funds) may affect transferability from country to country.

The present analysis deals with the risks of currency restrictions inherent in the Euromarket.

Currency Restrictions and the Euromarket [7]

What particularly concerns bankers as well as their clients is not so much the existing but the potential currency restrictions, because if a certain transaction is not permitted under existing regulations, if acceptance or repayment of a foreign money deposit or loan is prohibited, the business will not be concluded. Hence, the impending regulations are of more concern, those which at the time of contracting of the agreement are not in force but which might be enacted before repayment. Prospective enactments will not be reviewed here, but some remarks will nevertheless be useful on how future currency restrictions may affect currency operations.

Potential currency regulations * can attack Eurodollar and other Eurocurrency claims on two fronts: it maybe the country of the debtor bank which imposes the restrictions (*lex debitoris*), or again the country whose currency is used and where ultimately the funds are deposited (*lex monetae*). In an example where an Egyptian national deposits Swiss francs with a London bank, the creditor might not receive payment if restrictions enacted in Great Britain after the deposit was made prohibit payment, or if Swiss regulations—*horribile dictu*—block or vest the funds, or prohibit transfers.

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change dealer operates in Europe *cf.* Pelli, G., "Foreign Exchange," Swiss Bank Corporation, Zurich, 1964.

[6] Bank for International Settlements, Annual Report for 1965. Neue Züricher Zeitung, July 1, 1966, No. 2901, p. 4.

[7] This part has been adapted from the author's "Legal Nature of the Eurodollar," 13 *American Journal of Comparative Law* 30, 1964, and is included here by the kind permission of the Journal.

* This term is used here in the broadest sense and includes, for example, provisions for the blocking and vesting of foreign assets.

(a) Restrictions of *Lex Debitoris*. When the law of the debtor bank regulates the contract and imposes restrictions on the bank, these restrictions will be part of the applicable law and need not, it seems, be stipulated beforehand. It is interesting to note that some banks nevertheless go out of their way to do so. The General Terms of Italian banks for instance, as will be seen,[8] contain the express provision that "any lien, restriction charge or loss due to . . . regulations issued by authorities *in Italy* or abroad . . . are to be borne by the holder of the account" (emphasis added). It is possible that the inclusion of Italian regulations was deemed necessary in drafting because it was believed that if the foreign, but not the Italian, restrictions alone were mentioned, the latter could be regarded *a contrario* as not applicable. The uniform General Terms of German banks also contain an express provision that the owner of foreign money accounts bears the results of, and damages deriving from, regulations issued domestically as well as abroad.[9] The examples could be multiplied.

The situation of overseas branches of American banks is of particular interest. When the higher interest rates paid in Europe in 1958 and following years lured American funds to Europe (in the beginning particularly to London), one of the factors that slowed the stream of transfers was the fear of future currency restrictions: the European banks pay higher interests, it was said, but is the money safe there? The obvious thought was to deposit the funds with the European branches of American banks because the branch, it was believed, has no legal personality of its own, its debts are those of the American bank, and if currency restrictions in one of the European countries were to prohibit payment or retransfer to America, the bank in the United States would honor its obligation. It is very much to the credit of American banks that, eager as they have been to increase the dollar deposits with their European branches, "they try to make it very clear to dollar depositors in their overseas branches that the withdrawal of these dollars is subject to local currency regulations, and that they are not obligated in the event that local laws restrict or prohibit payment. Depositors of dollars in their foreign branches are generally required to sign an understanding to that effect." [10]

(b) Restrictions of *Lex Monetae*. The laws of a country regulating its monetary system affect generally any monetary obligation

[8] Example No. 4 in note 11, *infra*.

[9] See *infra*, note 11, Example 3.

[10] Altman, "Foreign Markets for Dollars," *supra* note 2, p. 322.

contracted in the money of that country, whether the parties are nationals of that country or not; but as respects payment restrictions in a given country, blocking or vesting assets, the situation is different. Thus, if the monetary unit of a country is devalued, all debts contracted in the money of that country will usually be automatically affected; what is owed is a given number of a given monetary unit, whatever that unit may be under the laws relating to that particular money; but if the country whose money is involved imposes restrictive measures on debts, those usually do not affect the obligations of outsiders. Were the United States to block the assets of, say, Swiss banks, this by itself would probably not relieve the Swiss banks of their obligations to pay the dollar debts which they might owe to their depositors.

This would impose a disproportionate risk on banks which usually stipulate therefore that the supervenient risk of currency restrictions of the *lex monetae* are to be borne by the depositor.[11]

[11] A few examples of such relevant stipulations follow:

Example 1: A Swiss Bank in Zurich: "It is understood that your dollar deposit is redeposited with one of our correspondents in the United States in our name and at our disposal, but at your risk and is subject to all present and future laws, decisions, measures, etc. in that country." German original text: "Es ist verstanden, dass Ihr Guthaben auf Dollar-Konto zwar auf unserem Namen und zu unserer Verfügung, jedoch auf Ihr Risiko bei einem unserer Korrespondenten in den USA deponiert ist und allen bestehenden und zukünftigen Gesetzen, Entscheidungen, Massanahmen, usw. in diesem Land unterliegt."

Example 2: Branch of a United States Bank in Geneva: "Because a customer's non-Swiss currency account has its counterpart at the Bank's correspondents or branches in the country of the currency involved, all of the regulations of the country of the currency of the account are applicable to the customer's account with the Bank, particularly as regards the availability of holdings in that currency."

Example 3: German banks, uniform text, Article 3(2): "The owners of foreign money deposits participate in all economic and legal disadvantages and damages which affect the total deposits of the Bank held abroad in the respective currency as a result of *vis major,* war, civil commotion or similar events, or due to acts of third persons, not attributable to the Bank, abroad or in connection with regulations enacted by the domestic or foreign authorities." German original text: "Die Inhaber von Währungsguthaben tragen anteilig alle wirtschaftlichen und rechtlichen Nachteile und Schäden, die das im Auslande unterhaltene Gesamtguthaben der Bank in der entsprechenden Währung als Folge von höherer Gewalt, Krieg, Aufruhr oder ähnlichen Ereignissen oder durch von der Bank nicht verschuldete Zugriffe Dritter im Auslande oder im Zusammenhang mit Verfügungen von hoher Hand des In-oder Auslandes treffen sollten."

Example 4: Italian Banks: "Any lien, restriction, charge or loss due to *force majeure,* to fortuitous circumstances or regulations issued by Authorities in Italy or abroad, or however originated from causes not ascribable to the bank,

The Fund Agreement and the Euromarket

With the notable exception of Switzerland, the countries participating in the Euromarket are all parties to the Articles of Agreement of the International Monetary Fund. The Agreement requires the member states to refrain from imposing certain restrictions; Article VIII, Section 2.(a) reads as follows:

> Subject to the provisions of Article VII, Section 3(b), and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions.

The question to be answered is whether the obligations in the Euromarket are of such character that their discharge is "payment for current transactions." Article XIX (i) gives the following indication as to what is to be regarded as current payment:

> Payments for current transactions mean payments which are not for the purpose of transferring capital, and include without limitation:
> 1) All payments due in connection with foreign trade, other current business including services, and normal short-term banking and credit facilities;
> 2) Payments due as interest on loans and as net income from other investments;
> 3) Payments of moderate amount for amortization of loans or for depreciation of direct investments;
> 4) Moderate remittances for family living expenses. The Fund may, after consultation with the members concerned, determine whether certain specific transactions are to be considered current transactions or capital transactions.

This "indication" has been strongly criticized as being too vague to be considered as a definition, and also for other reasons,[12] but for a European banker there can be little doubt that the normal Euromarket transaction—a deposit between banks running up to 90 days—falls squarely under Article XIX (i)(1) as "normal short-term credit facilities."

All this, obviously, gives comfort to a participant in the Euro-

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are to be borne by the holder of the account." The examples could be multiplied in great number.

[12] The difficulty of distinguishing clearly capital movements from current transactions are, indeed, very great. *Cf.* F. A. Mann, *The Legal Aspects of Money,* (second edition) Oxford, 1953, p. 340, also, same author in *Money in Private International Law,* also "Paiement courant et paiement en capitaux," Document No. 107 of the Monetary Law Committee of the International Law Association (1964) passim.

market but does not entirely relieve him from all anxieties. There are four fronts on which currency restrictions can attack the fortress created by Article VIII: the three exceptions referred to in Article VIII, Section (a) itself, and the breach of the Agreement by the member country.

The prohibition to impose restrictions on current payments and transfers does not apply, as can be seen from the text quoted above:

(a) if the Fund approves the restrictions (see text of Art. VIII, Section 2. (a) quoted above):

(b) if the Fund authorizes the temporary imposition of limitations according to Art. VII, Section 3;[13] and

(c) if the restrictions are part of the post-war transitional period within the meaning of Art. XIV, Section 2.[14]

The first two possibilities are, of course, very real ones. To safeguard the monetary system of the world by protecting the currency of one or more of its members, the Fund may grant the required approval. But looking at the problem with an eye on past performance and the spirit of the Agreement, it is very probable that the Fund will extend all necessary help, and call on other countries and organizations for assistance, before it consents to currency restrictions on current transactions.

The third possibility (restriction during post-war transitional period) appears to be academic. The member countries participating in the Euromarket all permit these Euromarket transactions at this time so that even if Art. XIV, Section 2 would apply at this late day because a country argues that it is still in the "post-war transitional period," it could not re-introduce currency restrictions on current transactions already made free.

The last possibility, the introduction of currency restrictions in defiance of the Fund Agreement is, in this author's opinion, a remote possibility. Not because he has such great faith in the ethical standard of all countries at all times, but because the breach of the Agreement would have disastrous consequences for the member. The member would become ineligible to use the resources of the Fund,[15] and might be required to withdraw from membership in the Fund.[16] There would be further immediate practical consequences, however. The banks of

[13] Art. VII, Sec. 3.

[14] Art. XIV, Sec. 2.

[15] Art. XV, Sec. 2 (a).

[16] Art. XV, Sec. 2 (b).

the countries participating in the Euromarket have assets scattered around the world. If a country's currency restrictions which are *not* contrary to the Fund Agreement prohibit the banks of that country to fulfil their obligations, these restrictions are respected by the courts and agencies of the other member countries [17] but would probably be disregarded if the currency restrictions are in the teeth of the Fund Agreement. In this case the assets of the banks of the breaching country could be attached in third countries; this would lead to a complete breakdown of that country's international banking. No country is likely to bring upon itself this disaster.

[17] Art. VIII, Sec. 2 (b).