

Euromarkets

– the currency of international financing?

Euromarkets is the generic term used in international capital markets for currencies and securities held outside the country of origin. These markets allow institutions to invest in international securities such as foreign bonds and currencies, in the form of eurobonds, eurocredit and eurocurrencies, and are not to be confused with euro denominated instruments.

The basic idea behind these markets is the facilitation of cross border transactions – in other words, international financing. There is a wide range of institutions raising funds in these markets, from sovereigns to corporates. It is widely accepted that the markets were developed in the 1950s in response to the Cold War. The Soviets feared that holding their dollar deposits – oil revenues – in the US could lead to an asset freeze, and decided to switch them to a European bank outside the control of US regulators. At the same time, US banks were operating under restric-

tions which led to them holding dollar balances in Europe, through merchant banks.

Arguably, London is now the unofficial centre for euromarkets. These markets are attractive because they are unregulated and offer higher yields. In effect, this is undomiciled money' whose volition has accelerated through recent advances in technology. At present, it is difficult to establish the exact value of the Euro-market because there are many private placements that are issued from the Cayman Islands and Luxembourg. However in the Euro syndicated loan market the total issuance is estimated at over \$2 trillion and the fixed income market total issuance stands at an estimated \$3 trillion plus. The message is that this market provides a significant tool in supporting globalisation, foreign exchange trading and, of course, global liquidity. Some say it is the purest example of a liberalised and self regulated market.

Investment Week's Technical page aims to offer clear explanations of some of the more complex areas of financial advice. Not only will this page explore business issues, such as depolarisation, it will also offer explanations on subjects ranging from trivial commutation in pensions to tips on how to mitigate inheritance tax. If there's a subject you'd like to see explored on this page, please email: james.smith@incisivemedia.com

WHAT IS A EUROCURRENCY?

The prefix Euro denotes a convertible currency deposited outside of its country of origin, for example, US dollar denominated securities traded outside the US. Eurocurrencies also include the Eurosterling, the Euroeuro and the Euroyen.

Typically, these are short-term deposits of less than one year. The rise of the Eurodollar – a dollar denominated time deposit located in a bank outside the US – was probably the most important development. Indeed, it is widely considered to be the parent of the global financial system in so far as it marked a notable divergence from post war international banking restrictions.

Research shows that in the 1950s the world witnessed an expansion of free flowing and unregulated global money markets. Alongside this, trade and capital inflows were growing rapidly, and the dollar was also gaining prominence as an internationally accepted mode of



payment and as a reserve asset. The free convertibility of most western currencies soon followed. In the proceeding decades banks started to use dollars for foreign trade and payments, US companies started to expand into western Europe, and the US balance of payments deficit continued to grow. These factors, among others, conspired to seal the origins of the Eurodollar.

EUROCREDIT

Unlike eurocurrency deposits, eurocredits are medium-term loans, typically with a maturity of between one and 15 years. Because of the unregulated nature of this market, only highly rated borrowers can gain access to this lending. The loan, the interest or the principal can be denominated in one or several of the eurocurrencies. For floating rate credit, the interest rate is fixed at a specific margin over Libor – London Inter Bank Offered Rate. Fixed rate credit is normally at a margin above a swap – a form of derivative – or the government rate.

EUROBONDS

This is an international debt market. A eurobond is a tradable instrument usually launched by means of a public offering and listed on a stock exchange. It is a form of unsecured, therefore risky, debt. Other important features

of these bonds are that they are issued in bearer form, as opposed to in registered form, and are exempt from withholding tax. Most eurobonds are redeemed at one specified date in the future or bullet form, and their issuance is identical to those of other corporate bonds. The settlement of eurobonds is conducted by Euroclear and Clearstream. Issuers that have raised money this way include The World Bank, the European Investment Bank and the European Bank for Reconstruction and Development, as well as other government agencies.

M&As AND DERIVATIVES

With the introduction of the euro, borrowers now have an alternative to dollars at a low interest rate. What impact has this capability had in the last few years? High levels of liquidity have undoubtedly fuelled asset prices, particularly in property, as well as helped to turbo charge cross border corporate activity and overseas listings, as evidenced by the Alternative Investment Market (Aim). The boom in derivatives instruments has also fuelled euromarkets. In bond markets, for example, demand for collateralised debt obligations (CDOs) and constant proportion debt obligations (CPDOs), has resulted in a high demand for eurocredit.

LONDON

By default or design, London has become the pre-eminent financial centre for these transactions. In the 1980s, it became the key centre in the Eurodollar market when British banks began lending dollars as an alternative to Sterling. London is also a convenient geographical location, not only sitting physically between the Americas and Asia, but also being well positioned in terms of operating between the two time zones. So far, London has resisted the temptation to impose controls that could effectively shift this epicentre in one fell swoop. Should it do so, other nascent financial centres lie waiting. However, few governments would wish to disrupt this intricate apparatus, potentially causing problems to their domestic banking and credit systems.

At present, credit spreads are historically tight, driven by high levels of money supply, strong earnings, low interest rates and relatively low leverage. Also, the infiltration of increasingly innovative derivatives has meant the volatility of underlying credit has reduced. So long as rates remain at relatively low levels, then it is likely that people will continue to use euromarkets to raise funds, and London will continue to be the dominant player.

