

London Dollar Certificates of Deposit

The present article is by way of being an interim report about the latest institutional change in the sphere of international finance. Its subject, the new market in London dollar certificates of deposit, came into existence only in May 1966, and its development has been very slow so far. It is therefore impossible at the time of writing (October 1966) to form very definite conclusions about its scope, techniques and broader implications. Nevertheless it is essential to examine already at this early stage the new device, and the facilities available for dealing in it, on the basis of the limited experience that is at our disposal. For I am convinced that we are witnessing the early phases of a major innovation which is likely to affect extensively the Euro-dollar system and the whole system of international finance.

I doubt if there had ever been any previous ten years' period in international financial history during which so many important institutional changes had occurred as during the past ten years. During the late 'fifties we saw the evolution and spectacular expansion of the Euro-currency markets which have revolutionised the foreign exchange markets and money markets (1). Systematic official intervention in forward exchanges and close collaboration between Central Banks for the mutual defence of their currencies have created a new foreign exchange system during the 'sixties (2). The operation of the support points mechanism — the present-day equivalent of the gold points mechanism under the gold standard —

(1) For a detailed description the reader is referred to PAUL EINZIG, *The Euro-dollar System*, 2nd ed., London, Macmillan & Co., 1965.

(2) ARTHUR I. BLOOMFIELD, "Official Intervention in the Forward Exchange Market", *Banca Nazionale del Lavoro Quarterly Review*, March, 1964. PAUL EINZIG, "Some Recent Developments in Official Forward Exchange Operations", *Economic Journal*, June 1963. There is a wealth of first-hand information and official comments in a series of articles by Mr. CHARLES COOMBS in the *Monthly Review*, Federal Reserve Bank of New York.

came into full effect towards the end of the 'fifties (3). The emergence of credit cards is yet another institutional change whose international implications have yet to be ascertained. Although the new markets for certificates of deposit and for Federal funds in New York, and for inter-bank sterling, for Local Authority loans and for hire-purchase finance house deposits in London, concern primarily the two money markets, they have created important new scope for international arbitrage. There is also the new European market for bonds issued in terms of dollars or of composite units of account.

The initiation in London of a market in dollar certificates of deposit is the most recent in this series of innovations. It is a combined outcome of two separate institutional developments which converged into one another in May 1966 — the development of the Euro-dollar market in London and the almost simultaneous development of the market for negotiable certificates of deposit in New York.

One of the disadvantages of Euro-dollar deposits — as indeed of any kinds of time deposits — from the depositor's point of view is that he has to relinquish the use of his money for a definite period. Since Euro-dollar rates are almost always higher for longer periods, it is tempting for owners of liquid funds who do not expect to need their money for some time, and who do not anticipate a rise in interest rates, to commit themselves for longer periods. In doing so they of course run the risk that they might need their money before their deposit matures, or that they might be unable to take advantage of more profitable investment opportunities that are liable to arise.

Attempts to deal with this dilemma by means of option contracts under which the depositor is entitled to reclaim his money at any time after a certain date, or by means of break clauses under which he can withdraw his deposit at any time at the cost of a penalty — usually of the order of $\frac{1}{4}$ per cent — have failed to satisfy requirements. For one thing, the cost of such provisions usually wipes out most, if not all, of the additional yield obtainable on long-term deposits. Moreover, the device is rather involved and

(3) PAUL EINZIG, "The Support Points Mechanism", *Banca Nazionale del Lavoro Quarterly Review*, September, 1966.

is usually available to favoured clients only. It is too clumsy to be convenient from the point of view of the speedy transaction of business as a matter of routine, which is one of the great advantages of the Euro-currency system.

In any case, the Euro-currency market is an inter-bank market in which individual transactions are too large for non-banking clients. The standard amount is \$1,000,000, and single transactions under \$250,000 are relatively infrequent. Rates quoted by banks to non-banking clients for smaller transactions are usually distinctly less favourable than those quoted in the market.

In order to attract into Euro-dollars additional funds which have hitherto been deterred by the considerations indicated above, bankers in London had been considering for some time the possibility of issuing Euro-dollar certificates and creating a market in them. The idea was inspired by the outstanding success of the market in certificates of deposit that developed in the U.S. during the early 'sixties and has been expanding uninterruptedly ever since. Such certificates have been in use for a long time in several countries, but they had no adequate markets. An experiment in New York in 1960 to offer them to foreign holders of dollar deposits without providing for them a secondary market met with scant response (4).

In 1961, however, the First National City Bank of New York initiated the issue of certificates of deposit to corporations and other depositors, while at the same time the Discount Corporation of New York created a secondary market in these certificates by buying and selling them out of its own holdings. The First National City Bank's example was soon followed by a large number of American banks, and the Discount Corporation's lead was followed by several firms of Government security dealers. In a short time the new device became very popular, and today it is regarded as the largest sector of the New York money market, overshadowing in importance the markets in U.S. Treasury bills, commercial paper and bank acceptances. The amount of outstanding certificates of deposit rose to \$17 billion by March 1966.

The temptation to emulate the New York experiment in London became increasingly stronger with the sharp increase of American demand for dollar deposits in the London Euro-dollar market. As

(4) RICHARD FIELDHOUSE, *Certificates of Deposit*, Boston, Bankers Publishing Co., 1962, p. 39.

a result of the official limits imposed in 1965 on credit expansion in the U.S., American bank branches in London became in 1965-66 the largest borrowers of Euro-dollars. They borrowed for the purpose of financing foreign trade hitherto financed out of dollars allotted to them by their head offices, but also for assisting their head offices to meet the domestic credit requirements of their local clients, and even for assisting their banks to improve their liquidity. Several American banks opened branches in London during the last year or two mainly because of their desire to have direct contact with the Euro-dollar market. Even though banks in New York or in other American cities have access to that market through their London correspondents, there are obvious advantages in being on the spot.

American branches in London are anxious to increase the borrowing of Euro-dollars without bidding up unduly the rates which were rising in any case as a result of the rising trend of interest rates in New York. One of the ways to that end is to attract depositors from outside the market and for that purpose the idea of issuing negotiable certificates of deposit has obvious advantages. American banks had, therefore, been exploring the possibilities of initiating that device. The First National City Bank of New York, which, as we saw above, was responsible for the initiation of the New York market for certificates of deposit, was first in the field also in London. Apart from dealing with legal problems, technical problems and taxation problems, it had to obtain the consent of the British authorities to the introduction of the new device.

Fortunately for the success of the scheme, the Bank of England adopted a very liberal attitude towards the proposed innovation. This was in keeping with its enlightened policy in respect of the development of the Euro-currency market itself which, so far from being hampered, was actually encouraged in official quarters. Although the use of Euro-dollars for international financing was bound to reduce sterling's role as an international currency, the Bank took the line that the advantages of having another important international market in London would more than outweigh the disadvantages of a decline in the international use of sterling. Thanks to this attitude, and to the enterprise and technical knowhow of London banks, London has succeeded in increasing her importance as an international banking centre through the expansion of the

Euro-dollar market, in spite of having been handicapped by the need for defending sterling against frequent attacks.

The Bank of England's willingness to extend this broad-minded treatment also to the proposed London dollar certificates arose logically from its original favourable attitude towards the Euro-dollar market. Limitations arising from exchange control regulations that are applied to the certificates of deposit are by no means too severe. They are substantially identical with those applied to Euro-dollar deposits in general. U.K. residents are under the same restriction in respect of acquiring and holding such certificates of deposit as they are in respect of acquiring and holding Euro-dollar deposits. Neither deposits nor certificates can be acquired against sterling on resident account. They can only be acquired by U.K. residents with the aid of dollars which they are authorised to hold for limited periods and for specific approved purposes, or with the aid of investment dollars. It is evidently not worth their while to buy investment dollars — whose premium ranged between 15 and 28 per cent during the last two years — for the purpose of acquiring dollar certificates of deposit. But if they want to hold investment dollars in any case, the certificates offer the highest yield compatible with liquidity. As the attractions of the certificates cannot increase selling pressure on sterling through U.K. demand for dollars, and does not even increase the demand for investment dollars, the Bank of England felt it could afford to be liberal in authorising their issue even during the difficult year of 1966 when the trend was towards a tightening of exchange control.

The idea of creating yet another international market in London must have been looked upon with favour in Threadneedle Street. The fact that London alone was chosen by the First National City Bank and by the seven other American banks (5) that followed its lead as the only centre for the issue of their certificates of deposit implies a recognition of the importance of the role the City still plays in international finance in spite of the chronic troubles of sterling.

At the time of writing eight out of the thirteen American bank branches in London are engaged in issuing certificates of deposit. One British bank, the Bank of London and South America, which

(5) The Chemical Bank New York Trust Company, Bankers Trust Company, Continental Illinois Bank and Trust Company, First National Bank of Boston, Morgan Guaranty Trust Company, First National Bank of Chicago, and Irving Trust Company.

has always been a large user of Euro-dollars, adopted the new device soon after its initiation. Its example was followed later by the Midland and International Banks (a subsidiary of the Midland Bank) and by the Moscow Narodny Bank (a Soviet Bank established in London). Other London banks, too, are considering the idea.

London dollar certificates of deposit are issued in multiples of \$1,000, with a minimum amount of \$25,000 with the exception of one bank which fixed the minimum at \$100,000. Although many certificates of between \$25,000 and \$100,000 are in circulation, units of \$500,000 and \$1,000,000 are not infrequent. As far as I know the largest single certificate issued to date was for \$5,000,000. Certificates are mostly for standard maturities — 30, 60, 90, 120, 150 and 180 days — but there have been instances for issuing certificates for odd dates. Nor is the limit of 180 days absolute. In fact in October 1966 several issuing banks decided to issue certificates up to one year. Beyond one year there would be disadvantages from a taxation point of view.

The certificates are issued by London branches of American banks against the payment of their dollar amounts to their offices in New York. Upon receiving advice from their New York offices that payment has been effected the London branches issue the certificates to banks nominated by the depositors. In a great many instances the certificates are left deposited with the issuing bank itself. Maturing certificates are repaid with interest at the New York office of the issuing bank concerned, upon the surrender of the certificates by the depositor to the London branch. Payments are made through the medium of a bank representing the depositor. All certificates are bearer certificates unless otherwise stipulated by the depositor.

No taxes are charged or deducted by the issuing bank. Certificates are not subject to any U.S. taxes, unless depositors are citizens of, or residents in, the U.S. The only U.K. tax is the 2d. stamp duty on each certificate, which is paid by the issuing bank. There is no U.K. stamp duty on the transfer of certificates or on their presentation for repayment. If the certificates are actually held in the U.K. at the time of the owner's death, however, they are treated as part of the U.K. estates of non-residents for the purpose of death duties.

The text of the certificates makes it clear that the obligations of the issuing bank are subject to the laws of the U.K. This provision

may become important in the event of the adoption of new exchange control measures that would place a ban on the repayment of these dollar liabilities. The ban would then apply to American branches in London in the same way as to British banks, in spite of the fact that the head offices of the former would be well in a position to meet the liabilities of their London branch. However, that contingency is so remote that it may safely be ignored at present.

That the U.S. Government recognises the special status of London dollar deposits — or, for that matter, Euro-dollar deposits in general — is shown by the fact that they are not covered by Federal Deposit Insurance (6), and neither Regulation Q fixing maximum interest rates for deposits nor the statutory reserve requirements apply to them.

The issuing banks fix the interest rate on certificates every morning before 10 a.m. They fix their rates independently of one another. Once fixed, the rate is usually left unchanged for the day, in spite of the fluctuations of Euro-dollar rates in the course of the day. This practice has been adopted to attract non-banking depositors who are not in sufficiently close touch with the market to follow its fluctuations. It is not an absolute rule, however. While it is observed for small transactions, when large amounts are involved or when Euro-dollar rates decline sharply during the day, the basic rule that no quotation is binding unless it is accepted immediately is apt to be observed.

The interest rates are based on the current Euro-dollar rates for corresponding maturities. Broadly speaking they are about $\frac{1}{8}$ per cent lower, which is justified on the ground of the extra advantage of marketability. Actually the differentials vary between $\frac{1}{16}$ and $\frac{3}{16}$ per cent. They tend to be wider for longer maturities than for shorter maturities, but this depends on the issuing bank's view on future tendencies of interest rates, on its relative commitments in Euro-dollars for various maturities, and on the relative demand for certificates for various maturities. If a bank has over-lent Euro-dollars it may be anxious to offset its commitments by borrowing more, in which case it may reduce the differential in order to attract more deposits. Conversely, if it has over-

(6) In any case the maximum covered by Federal Deposit Insurance is \$25,000, which happens to be the same as the minimum amount for certificates of deposit.

borrowed Euro-dollars it would widen the differential because it has no immediate desire to attract more deposits.

Interest rates are also affected by the day of the week on which the certificates are issued and on which they fall due. Issuing banks are naturally anxious to receive deposits on Thursdays or Fridays, and even more so on the eve of window-dressing dates, and are prepared to reduce the differentials for the sake of attracting more deposits for such dates. But then the basic Euro-dollar rates themselves are already affected by such considerations.

On the basis of the New York experience of 1960, the First National City Bank deemed it essential to ensure the creation of a secondary market simultaneously with the initiation of the issue of certificates. It would not have been sufficient to rely on the spontaneous development of a natural market. The new London device came, so to say, out of the blue, because the scheme was kept a closely-guarded secret until the moment of its public announcement. In order to attract deposits, it was essential to be able to give positive assurance that depositors would encounter no difficulty if and when they should wish to dispose of their certificates.

As in the case of certificates of deposit issued in the U.S., there can be no question of redeeming the certificates before maturity. This would merely have amounted to an option clause or a break clause in a new form. The alternative was to make a definite arrangement, following on the precedent of New York in 1961, for a financial house to be prepared to buy and sell securities of its own account, playing a part similar to that of firms of jobbers on the London Stock Exchange. This was in fact done. The announcement made by the First National City Bank on June 23, 1966, that as from June 26 it was to issue London dollar certificates of deposit, was followed immediately by the announcement by the international financial house White, Weld & Co., of New York, that its London branch was prepared to deal in such certificates (7).

If White, Weld & Co. had merely offered its services as brokers it would not have helped very much, for the certificates were bound to have a very limited market during the early phases of their exist-

(7) While the Euro-dollar system came into existence very gradually, and was for a long time hardly noticed by anyone except those directly concerned (who went out of their way to avoid publicity), the system of Euro-dollar certificates was initiated with the maximum of publicity. This difference was due to the fact that while Euro-dollar dealing was between banks, certificates were intended to appeal to a wider public.

ence. Until their circulation attained fairly substantial proportions would-be sellers could not be expected to rely on the chance of finding a counterpart at reasonable rates. But White, Weld & Co. was prepared to act as principals and to buy on their own account certificates offered for sale. It was prepared to retain them and to meet demand for certificates out of its own supply.

Before very long several other firms were also prepared to provide a secondary market in certificates — the First Boston Corporation, Nesbitt Thomson & Co., Merrill Lynch, Pierce, Fenner & Smith, etc. Attempts were also made by some firms — Cater Ryder & Co., and Feba Ltd., (the firm owned jointly by the nine foreign exchange broker firms) — to act as brokers, but owing to the smallness of the initial turnover this has proved to be rather difficult. Nevertheless, several firms of bill brokers applied for, and received, permission from the Bank of England to operate in London dollar certificates of deposit.

Firms which provide a secondary market quote regularly their buying and selling rates at which they are prepared to deal, with a spread of $\frac{1}{8}$ to $\frac{3}{16}$ between them for short maturities and up to $\frac{1}{4}$ for longer maturities. As in the case of issuing banks, the rates quoted vary not only in sympathy with the corresponding Euro-dollar rates but also according to supply and demand and according to the commitments of the firms for the various dates. While issuing banks issue mostly certificates for standard dates, most of the turnover in the secondary market consists of certificates for odd dates sold by depositors some time after having obtained them. But since the market houses have a wide international clientele they also receive orders for certificates for standard dates, in which case they buy new certificates from the issuing banks.

The terms of settlement are identical with those applying in the foreign exchange market and the market for Euro-dollar deposits — delivery and payment two clear business days after the conclusion of the transaction. Payment is to be made in clearing house funds in New York. The certificates are delivered free of charge in London, and a charge is made for delivery costs if the depositor prescribes delivery outside London.

As most deposits reach the issuing banks through the intermediary of banks, they have no means of knowing whether the depositors act as agents or as principals. The size of the individual amounts is practically the only indication. If it is large, the assumption

is that banks buy the certificate for their own account, though large corporations or Middle East oil millionaires are well in a position to deposit \$1 million or more. If the demand is for certificates of small amounts then it is safe to assume that the depositors are non-banking clients of the intermediary banks. Although the original intention behind the scheme was to be able to secure hitherto untapped non-banking sources of dollar deposits, there is reason to believe that a high proportion of the deposits are held by banks. They find the certificates very useful liquid assets whose yield compares usually favourably with that of Euro-dollars at call, even though the marketable certificates are just as liquid.

Switzerland is one of the main sources of demand for certificates. Holders of foreign accounts with Swiss banks may want to employ their liquid balances in that form. In particular, if they are awaiting a favourable moment for investing in Wall Street they naturally prefer to acquire certificates which during 1966 secured for them yields usually $1\frac{1}{2}$ to $1\frac{3}{4}$ per cent above those obtainable through investment in U.S. Treasury bills or bank acceptances.

Having regard to the advantages offered by the certificates, during the five months' existence of the new market the increase of their volume has been remarkably slow. Estimates of the outstanding total varied, but even the highest figure did not exceed \$150 million at the beginning of October 1966, compared with the estimated total of Euro-dollar deposits of \$10 billion. The turnover in the secondary market is not very active. There is a great deal of inquiry because all issuing banks are anxious to keep in touch with the market, but actual transactions are few and far between. The main reason for this, apart from the novelty of the device, is that during most of the time of its existence Euro-dollar rates have been rising. If depositors anticipate a further rise in interest rates the marketability of the certificates offers no attraction for them, since they assume that, should they wish to recover their deposits before maturity, they would only be able to do so at a loss. For this reason they may prefer to employ their funds in Euro-dollars at call. It seems reasonable to assume that the market will expand during a period of declining interest rates.

In the absence of a large turnover the range of the types of operations in certificates has been limited. There has been no buying for forward delivery, nor time arbitrage which plays a very important part in the New York market for certificates of deposit.

"Playing the yield curve" is a much favoured type of operation by dealers in New York wishing to take advantage of discrepancies between yields for long and short maturities and of changes in such discrepancies. As and when the London market will expand such transactions will become a familiar feature, and so will arbitrage transactions with other centres after they too have developed similar markets.

I am convinced that the expansion of the market is only a question of time. For one thing, American depositors are at present prevented by the existing unofficial ban from taking an active hand — though I suspect that some of them at any rate circumvent the ban. Although none of the American bank branches are prepared to issue certificates to American citizens, whether they are resident in the U.S. or abroad, it is always possible to secure them through the intermediary of some non-American bank. But once the present ban is removed Americans are bound to take a very active interest in the certificates. And once the dollar has ceased to be subject to suspicion, holdings of such certificates are likely to become widely favoured all over the world, in preference to ordinary time deposits or Euro-dollar deposits, or any other kinds of market paper, and even in preference to gold hoarding. Central Banks are likely to acquire a taste for it, as they did for Euro-dollar deposits. Another important permanent source of demand will be created by the banks' desire to spread their liquid assets over a wide variety of easily realisable investments.

Other U.S. banks in addition to those already engaged in issuing certificates are likely to take a hand, if only to avoid losing deposits as a result of the acquisition of certificates of other banks by their depositors. British banks, too, are likely to follow the example, apart from other reasons, in order to retain their lead in the Euro-dollar market, a lead which might be threatened by a spectacular expansion of the market in certificates issued by American banks. Nor is London likely to remain the only centre in which certificates will be issued or dealt in.

The Bank of England is watching closely the development of this market, not only owing to its possible implications from the point of view of foreign exchange policy, but also in order to discourage any tendency towards over-trading by individual issuing banks. All banks engaged in issuing certificates have to declare the amounts issued in their weekly returns to the Bank. Houses operating

in the secondary market, too, have to make weekly returns on their total turnovers. The Bank intends to publish the total of these returns in an early issue of its *Quarterly Bulletin*. The fact that it pays so much attention to the new device in spite of the smallness of the amounts involved at present seems to indicate that authoritative quarters share my belief that an expansion of the issue and turnover of certificates is only a question of time.

Once the advantages of the new device over alternative facilities come to be widely realised its use is bound to be increasingly popular. The extent of its popularity, like that of the Euro-dollars themselves, will have of course its ups and downs. Conceivably certificates in other currencies will also appear (8) and, in given circumstances, they might overshadow the dollar certificates from time to time. Once the knowhow and the mechanism exist and the use of the device is firmly established, it is likely to be used increasingly, subject to temporary declines followed by further expansions, as in the case of the markets in Euro-currencies.

Our next step is to examine the broader implications of the new device, postulating that it has come to stay and that its market will assume considerable dimensions. How is it likely to affect banks within and outside the U.S.? Is it liable to affect the dollar and other currencies? Will it contribute towards an increase in the volume of liquid resources, and if so to what extent? Is it a potentially disturbing influence in the foreign exchange markets and in the national economies? At the present stage any answer to these questions must necessarily be tentative and must rest very largely on sheer conjecture. Nevertheless it is advisable to give some thoughts to the problems involved, even at this early stage.

Assuming that certificates amounting to billions of dollars come to be issued, how is it likely to affect American banks? The effect on individual banks will depend largely on whether they will participate in the issue of certificates. If so, the question is whether the amount a bank issues attracts more deposits from other banks than the amount it loses through the issue of certificates by its rivals. This question has been considered in great detail by American banking circles and in American financial literature in connection with the issues of domestic certificates of deposit in the U.S. As the amount

(8) In fact, a small Swiss bank in Basel is actually engaged in issuing certificates of deposit in Swiss francs.

of London certificates likely to be issued is bound to remain a small fraction of total American bank deposits, or even of domestic certificates of deposit, the problem is one of secondary importance, though not negligible.

Taking the American banking system as a whole, it stands to increase its proportion of time deposits. From this point of view, too, the difference that the issue of London certificates is likely to make is merely one of minor degree.

Even if British and other non-American banks should engage in the issue of dollar certificates it would not materially affect the American banking system. The basic fact of the situation that is often overlooked is that dollar deposits against which certificates are issued, as Euro-dollar deposits or ordinary foreign-held dollar deposits, are dollars which *must* be held with some American banks in the U.S. No matter how many times they change hands as a result of their change of status and change of ownership, they must remain dollars held with American banks in the U.S. Changes may result in transfers to other accounts or to other American banks but, unless they lead to withdrawals of deposits in cash and the hoarding of the notes thus withdrawn, they must remain within the American banking system. So the issue of certificates by non-American banks merely results in transfers of dollars from one account to another, or from one American bank to another.

An active turnover in the secondary market for certificates is liable to increase the frequency of transfers of deposits between American banks. Each time the certificates change hands the buyer's bank loses the deposit and the seller's bank gains the deposit. Under the law of averages such gains and losses are liable to cancel each other out in the long run — assuming that all American banks issue certificates and all certificates are equally attractive — but banks have to provide for the possibility of additional withdrawals in the short run.

So long as the issuing of certificates is confined largely to American banks, the operation of the system is likely to reduce the amount of Euro-dollar deposits under the control of non-American holders. For the duration of the deposits obtained by American banks the dollars come under the full control of American banks, in the same way as do Euro-dollars borrowed by American banks in the market. The importance of this point should not be exaggerated, however. After all, as we saw above, dollar deposits in no

matter what form, whether owned by residents or non-residents, must necessarily be held in the form of dollars with an American bank. The difference is that so long as the dollars are under the control of a non-American holder there is always the possibility of their withdrawal at any time from the individual bank in question, but if an American bank re-borrows them in the form of Euro-dollars or in the form of deposits against which it issues certificates, it will gain full control of the dollars for the duration of the deposit. It can therefore make use of them without having to envisage their sudden withdrawal. Since, as I pointed out above, the amount involved represents a bare trickle into the vast dollar pool of American banks, the extent of the effect of the issue of London dollar certificates by American banks on their own liquidity provisions is purely marginal. But to that extent it is in a favourable sense as far as the issuing bank is concerned.

The effect of issues of certificates by other American banks tends to be of course in the opposite sense. Even if a bank remains unaffected by the original transaction, there remains the possibility that subsequent transactions in the secondary market might lead to withdrawals of deposits. Or dormant deposits might become active deposits. In other terms, the velocity of circulation of its deposits might increase. But, it must be re-emphasised, any likely change would be purely marginal.

Another question to be examined is the extent to which the dollar is liable to be affected. It depends on whether the issue of certificates means the conversion of a foreign currency into dollars, or merely the conversion of one type of dollar into another. If the certificates are acquired by holders of Euro-dollar deposits the transaction merely changes Euro-dollars into London dollars. If foreign holders of dollars acquire them it increases the amount of foreign-owned dollars re-lent outside the U.S. Since, however, the borrowers are mostly American bank branches in London who re-lend most of the dollars to their own head offices, such transactions are not likely to increase the supply of dollars in the foreign exchange market. In fact, possibly later, when certificates will come to attract flight-money, their issue might even lead to an increase of demand for dollars. At present it seems probable that the overwhelming majority of those who acquire certificates pay for them with dollars they already possess.

Since at the time of writing the Euro-dollar market is many times larger than the market in London dollar certificates of deposit, it is Euro-dollar rates that largely determine interest rates on certificates and the price at which certificates change hands in the secondary market. But this state of affairs may change if and when the volume of such certificates should increase to an extent that it comes to bear comparison with that of Euro-dollar deposits. In given circumstances it is conceivable that the tail might then come to wag the dog from time to time.

How is the new device likely to affect British banking? If a number of British banks should embark on the issue of dollar certificates it would add another profitable line to their existing international banking activities. What is much more important as a remote possibility is that British banks might be inspired by the example of London dollar certificates to issue sterling certificates of deposit to holders of non-resident sterling only, or even to holders of resident sterling. It would be a logical development, similar to the development of the inter-bank sterling market which was largely inspired by the example of the Euro-dollar market.

There is much to be said in favour of issuing sterling certificates to holders of external account sterling. It would mop up some of the supplies of Euro-sterling which are now available for speculators against sterling. At times of acute attacks on sterling, speculation is financed largely by borrowing Euro-sterling, mainly over weekends, and selling the spot exchange. On such occasions short Euro-sterling rates are liable to rise to fantastic figures. Should the by no means unlimited supply of Euro-sterling be reduced as a result of the issue of sterling certificates it would tend to cause an even steeper rise in the cost of short-period speculation, and this would discourage speculation in that form. Admittedly the result would be a widening of the discount on short forward sterling. This might not be welcome in British official circles where discouragement of speculation by raising its cost is unfashionable nowadays. But since official support to forward sterling is confined to longer maturities it is possible that the authorities do not feel strongly against encouraging an increase in the cost of short-term speculation.

What is potentially infinitely more important in the long run is the remote possibility that the example of London dollar certificates might inspire British clearing banks to issue sterling certificates to holders of resident sterling accounts. The arguments in-

volved in this question are outside the scope of the present article, however.

There remains the question about the effect of the new device on international liquidity. In dealing with this problem briefly we have to differentiate between its effect on official reserves and its effect on credit facilities available for international trade and finance.

As far as official reserves are concerned, the effect depends on whether the new depositors had already possessed the dollars or had to acquire them in the market, and also on whether the change in the form in which foreign-owned dollars are kept affects the likelihood of their use for speculative purposes. We have already observed that, should the certificate become popular, it would tend to increase buying pressure on the dollar. But since it is liable to attract "hot money" it would be a blessing of problematic value.

As for the conversion of foreign-held dollars into deposits against which certificates are issued, it is impossible to form any definite opinion whether holders of certificates are less likely to sell their dollars for speculative purposes or through flight from the dollar than holders of Euro-dollars or of ordinary dollars. Nevertheless it seems just possible that, since speculation by them entails first the sale of the certificates and then the sale of their dollars proceeds, there is marginally less likelihood for such use of them, though not less likelihood than for the realisation of, say, U.S. Treasury bills or bank acceptances for the sake of getting out of dollars.

Having regard to the above considerations, it seems possible to conclude tentatively that the new device tends to be moderately beneficial from the point of view of the reserves of the United States. Its effect on the volume of liquid resources available for international trade and finance is likely to be much more important. Since the velocity of circulation of deposits against which certificates are issued is higher than that of ordinary dollar deposits or even that of Euro-dollar deposits of corresponding maturity, the same amount of dollars is likely to do more work. A time deposit or a Euro-dollar deposit has to remain idle till maturity, even though the American bank with which it is held is in a position to use the dollars for international financing should it wish to do so. A certificate, on the other hand, can be turned into liquid cash at two days' notice, so that it is more likely to be used actively by the depositor. It means that the same deposit is apt to be used twice — by the American banking system with whom the dollars are held

and by the depositor who, having re-lent them to the American bank, has recovered its possession through the sale of the certificate in the secondary market. The original use of the dollars by the American bank does not preclude the use of the same dollars by its depositor who does not have to withdraw them from his American bank in order to be able to recover possession of his money. Even though the buyer of the certificate has to withdraw a deposit from some American bank, the American banking system as a whole will continue to be able to use the dollars in spite of their being used also by the depositor himself. It is only if the buyer of the certificate had intended to make active use of his dollars before deciding to buy certificates that the dual effect would be cancelled out.

This is one of the paradoxes of the modern banking system. All that happens is that the same amount of dollar deposits is doing more work than it would have done if the depositor had tied it down for a definite period in the form of a time deposit. We saw earlier that such an increase in the velocity of circulation of deposits may necessitate larger provision for meeting withdrawals. But the actual extent of such provisions would be infinitesimal unless the volume of London dollar certificates should increase to an amount comparable to the volume of deposit certificates issued in the U.S. — which is most unlikely.

London branches of American banks, by issuing certificates, increase their resources available for financing foreign trade. If they lend the dollar proceeds of the certificates to their head offices, the latter are enabled to expand credits, including credits for foreign trade. Once the shortage of credit in the U.S. comes to an end, a much higher proportion of the dollars borrowed by the London branches will be re-lent to finance foreign trade.

Beyond doubt, the higher degree of flexibility provided by the new device will tend to place additional resources at the disposal of international trade and finance as a result of the increase in the velocity of circulation of the deposits concerned. Once more, while Treasuries, Central Banks and economists are engaged in endless discussions about the means of increasing international liquidity, practical bankers have found a solution which should go some way towards meeting the growing requirements of international trade and finance. It can achieve that end without increasing the extent to which the international financial system is vulnerable. For there is less likelihood, not more likelihood, for sudden withdrawals of

the deposits concerned than there would be if foreign owners of dollars had not acquired certificates.

There is yet another aspect of the new device. Its use should tend to encourage the development of long-term deposits. Should it become possible to extend the maturities of certificates of deposit to, say, five years — the same as for Euro-dollars — they might provide very useful means for banks to engage in medium-term lending, because they would be able to secure offsetting deposits whose maturities could be made to coincide with those of their medium-term loans. Surely this would be a step in the right direction. For this consideration alone the new device is to be welcomed and its development encouraged.

London

PAUL EINZIG