

against the guilder, it would sell spot dollars, say, to a Swiss bank, and buy them back (at a lesser cost in guilders) forward. It would then lend guilders to the customer and in turn, for the customer's account and risk, convert the guilders into sterling. The bank's customer benefits by receiving a loan at substantially lower interest cost than would have been the case if he had borrowed lire, and then used the lire to purchase sterling. He has assumed a foreign exchange risk, however, but so great is the confidence in the stability of European exchange rates that this is often of little concern to international traders. In fact, the willingness of firms in Italy and to a growing extent in France, to take uncovered exchange risks in dollars is of great significance in current foreign exchange market developments.

Banks in several other countries have been important on the demand side of the continental dollar market. In recent months, Japanese banks have taken in very sizable amounts. In Germany, the acceptance of continental dollars or other foreign currencies and their use for foreign trade financing was furthered until recently by regulations under which the resulting bank liabilities, if offset by a foreign currency asset, were free of reserve requirements. However, since July 1, 1960, this special exemption from reserve requirements no longer applies.

Canadian banks have been large borrowers in the continental dollar market, primarily for the purpose of relending to securities dealers and brokers in the New York money market. Among foreign banks, the Canadian banks have been in a particularly favorable position to extend such loans since through their agencies in New York they can supervise such operations.

Overseas branches of U.S. banks have become depositories of very sizable amounts of continental dollars, running into several hundreds of millions of dollars. They have used the market as a means to recapture some of the time deposits that had escaped, or were about to escape their head offices, because of the interest rate ceiling on such deposits under regulation Q and the attractiveness of money market investments either in the United States or elsewhere. These branches have little trouble in attracting dollar deposits, suppliers of dollars being ready to place their deposits with them even at rates substantially below the prevailing market level.

Considerable amounts of continental dollars have at times been swapped by British banks into sterling and then employed at considerably higher rates for loans to hire-purchase finance companies or to local authorities. The spread between rates paid on dollar deposits and the far higher rates received on domestic loans does not, however, represent a net return to the British banks, since covering the exchange risk by the purchase of forward dollars has usually involved paying a substantial premium for such dollars and this represents an additional cost. Japanese banks also have been reported to have converted substantial amounts of dollar deposits into their own currency.

Many other banks also make use of the continental dollar market to engage in covered interest arbitrage in various forms. The existence of an active market for dollar and other currency deposits greatly facilitates interest arbitrage operations. Arbitragers may take in dollars, swap them into another currency, and then employ them for short-term investments, say, in Treasury bills, if and when the interest rate differential after adjustment for the swap costs makes such a transaction worthwhile. Quite a number of European banks, notably among the so-called intermediaries, employ dollar and other foreign currency deposits for such operations, occasionally combining two or more swaps to maximize their profits. The total amount of dollars employed in interest arbitrage is not known, but is believed to be smaller than the aforementioned uses of dollar deposits.

IMPLICATIONS OF THE MARKET

With the development of the continental dollar market, European banks now have easy access to a large pool of funds that can be used to cover their dollar financing needs. Since European banks have been willing, moreover, to accept a relatively small spread between the rates they pay on foreign currency deposits and their lending rates, they have been able to offer their customers rates well below either the commercial bank prime loan rate or the cost of acceptance financing in the United States. One consequence has been some relative decline in the position of New York as an international lending center—a development which is confirmed by statistical evidence showing that in recent years acceptance and other credits extended by U.S. banks to British, German, and Italian banks have declined significantly.