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Invasion of the European Capital Market by US Firms

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
July 1968

INTELLIGENCE MEMORANDUM

Invasion of the European Capital Market by US Firms

Summary

A large expansion in the Eurobond market this year has permitted US companies to carry out most of their European investment plans despite US restrictions on capital movements to Europe. New issues in the Eurobond market totaled $1.5 billion in the first half of 1968, an increase of 62 percent over the same period in 1967. US firms accounted for all of the increase, and their share of the market rose from 30 percent in all of 1967 to 81 percent in the first half of 1968. Some smaller European borrowers have been squeezed out of this market by the heavy competition from large US companies who can pay higher interest rates and offer more attractive terms.

Some US companies had been concerned that the US prohibition on transferring dollars for direct investment in Europe might prevent them from meeting their investment plans in Europe this year. However, the Eurobond market has proved extremely resilient and has absorbed all new issues with frequent oversubscriptions. The market's volume probably will exceed $2 billion for 1968 as a whole.

Although the development of the Eurobond market has had no direct effect on the US balance-of-payments program, it has offered US firms an attractive

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alternative to transfers of funds from the United States and has permitted them to adapt to the program with a minimum of complaint. The surge of Eurobond borrowing has also demonstrated the confidence of Europeans in the long-term strength of the dollar and their continuing willingness to hold relatively illiquid dollar-denominated securities. Moreover, Europe's growing market for dollar funds represents a rising private demand for dollar balances -- which results in dollars being kept out of central bank reserves, where they would constitute direct claims against the US gold stock.

From the European point of view, the strength and flexibility of the Eurobond market has tended to ease problems of domestic monetary and fiscal policy. Few US firms have had to compete for funds in the thin national capital markets. Central banks have thus been able to avoid rising domestic interest rates or the inflationary monetary policies that would have been necessary to keep interest rates from rising.

Background

1. With the announcement by President Johnson on 1 January 1968 of the new US balance-of-payments restrictions, US firms were virtually prohibited from transferring dollar funds out of the United States to finance investment in continental Western Europe. They have, however, been able to maintain investment plans by turning to European markets as a source of capital financing.

2. The European capital markets -- markets for long-term funds -- have two major institutional elements: (1) a domestic capital market in each of the principal Western European countries, in which debt or equity securities are issued in local currency and traded domestically; (2) a large and growing international market -- the so-called "Eurobond" market -- in which securities denominated in one or more currencies are issued, quoted, and traded in several national centers simultaneously. The Eurobond market is the most dynamic segment of the Western European capital market and it is the segment which US firms have invaded most heavily.

3. The Eurobond market became important in the early 1960's, particularly after 1963, when the US Interest Equalization Tax (IET),* which effectively closed the hitherto prominent New York market to new foreign issues, stimulated a shift of foreign borrowing to centers outside the United States. The Eurobond market subsequently grew rapidly. Demand for funds came both from US companies and from foreign companies and governments. The supply of funds -- mainly US dollars -- came from both Europeans and others, many of whom had previously invested in the New York capital market.

* *The intent of the IET was to tax US citizens' investments in foreign securities at rates that would equalize interest rates prevailing in New York and the (nominally higher) rates abroad. In order to attract US investors, foreigners would thus be forced to offer higher rates in New York to compensate lenders for the tax. This, in turn, removed the incentive for foreigners to borrow in the hitherto lower-cost US capital market.*

No single financial center outside New York has the combination of technical facilities and access to funds in very large amounts to handle a significant portion of the international capital market. The increased resort to Eurobond financing, which marshalls the facilities of many centers, was thus a logical outgrowth of the eclipse of New York in this field. The annual volume of new issues in the Eurobond market during the 1963-67 period is shown in the following tabulation:

Year	Amount (Million US $)
1963	346
1964	800 (est.)
1965	1,079
1966	1,429
1967	1,878

4. Eurobonds are debt securities with long-term maturities. Thus, they differ from Eurodollars (or other Eurocurrencies), which are bank balances traded or loaned by banks at short or medium term. Because of lower taxes and convenient issuing regulations, Luxembourg is the principal country of issue for Eurobonds. They are usually denominated in US dollars, not only because US dollars are widely held and used extensively to finance international transactions, but also because a large portion of the market is taken up by American issuers. Although these bonds can be traded anywhere in the world, London and Zurich are the principal markets.

5. The specific form of a Eurobond issue depends on the ingenuity of the borrower and the underwriting syndicate in making the issue attractive to prospective investors. For example, to offer a hedge against currency devaluation, an issue may be made redeemable in one or more currencies. The currency in which a bond is denominated may be specified at the time of issue or a range of options may be left to the holder's choice at the time of interest payment or repayments of principal. Bonds may be issued to the bearer rather than to a named

individual, in order to satisfy the investors' desire to avoid taxes. Eurobonds may be secured or unsecured, and some are convertible into common stock of the issuing corporation.

6. Eurobonds have been issued by American, European, and Japanese firms as well as central and local governments of various countries. The principal buyers -- banks and other financial institutions -- have been attracted by the quality of the issuers, fixed returns, and comparatively high yields. Eurobonds are blue chip securities, and they attract investors rather than speculators. New issues are underwritten by syndicates of the largest and most prestigious commercial banks and investment banking houses in the Free World.

Recent Developments

7. Severe US restrictions on capital outflows to Western Europe have stimulated unusually large security sales by American firms in the Eurobond market. In the first half of 1968, Eurobond sales by all borrowers totaled $1.5 billion -- a 62 percent increase over new issues during the same period in 1967. The share of US firms in total new issues has risen from 30 percent of the $1.9 billion total in 1967 to 81 percent for the first half of this year. US firms have accounted for all of the large increase in Eurobond sales so far this year and have, in addition, taken some of the funds that otherwise would have gone to European borrowers.

8. Most Eurobond issues in 1968 have been dollar-denominated, convertible into common stock after specified future dates. These convertibles, almost exclusively American, have proven very attractive, and all have been heavily oversubscribed. In contrast, the more traditional straight-debt securities preferred by European issuers have not been as well received by investors. Although dollar-denominated bonds have predominated, some issues have been in Deutsche Marks or a Deutsche

Mark/Sterling option, French Francs, or European Units of Account.*

9. Eurobond interest rates this year have been generally stable. They gained fractionally during the first half of March, reflecting some movement out of securities and into gold, but quickly fell back when the gold crisis abated after 17 March. During June, they began rising once again, this time reflecting the increasing tightness in all dollar markets as a result of restrictive monetary policies in the United States and somewhat reduced dollar outflows from the United States. Rates are now slightly higher than 7 percent on straight debt issues, about one percentage point above comparable levels in 1967; on convertible issues the rate is about 5 percent, unchanged from a year ago. These rates are only fractionally higher -- less than 0.5 percent -- than comparable domestic long-term corporate bond yields in the United States.

10. The large-scale entry of US firms into the Eurobond market has squeezed out some of the smaller European borrowers. The larger American companies are able to pay higher interest rates than most European firms or even central and local governments, and they have greater flexibility in offering attractive terms -- such as the much-coveted option for convertibility into common stock. Many American companies probably could, if necessary, pay rates up to 10 percent -- a rate that would exclude most other Eurobond issuers.

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* *The "Unit of Account" is equal to the gold value of one US dollar, and bonds using it offer investors the option of buying the bonds and receiving payment in the Unit of Account equivalent of any of 17 major currencies. This financing technique was first offered by a syndicate headed by Belgian bankers early in the 1960's. It is designed to give the investor a multiple protection against currency devaluations by permitting him to demand principal and interest payments in what he considers to be the strongest currency at the time the payments fall due.*

11. The non-American borrowers who have been squeezed out of the Eurobond market this year have been forced to find alternative sources of capital funds. The non-American borrowers who remain in the market are comparable in size, power, and prestige to their American competitors. For example, ENI (the state-owned Italian energy firm) and KLM (Royal Dutch Airlines) are now in the process of placing new issues totaling $75 million.

12. In the face of heavy US competition, some non-US borrowers have turned to national capital markets as a source of funds. Borrowing in the West German market has become increasingly common, especially since the liquidity of that market has been vastly increased by heavy inflows of funds seeking a safe, strong-currency haven during the sterling, dollar/gold, and French franc crises of this year. The governments of Quebec, Kobe, and Mexico all have tapped this market in recent months. Interest rates and borrowing costs in Germany now are equal to or lower than those in the Eurobond market, and the German market has been able to handle them in stride. The Swiss market also has experienced an increase in activity, but it remains a relatively high-cost, low-volume market for foreign borrowers.

13. The buyers' side of the market has changed very little. Banks and financial institutions remain the principal purchasers. Since mid-1967, disruptions of normal international financial flows have caused very large international movements of liquid funds, and some of these funds found a haven in Eurobond investments, although the exact amounts are unknown. There is little evidence that holders of liquid dollar balances in the United States have transferred large amounts to Europe for reinvestment in Eurobonds. Present interest rate differentials offer little or no incentive for making such transfers.

Outlook

14. With new issues of Eurobonds continuing to be announced and planned, observers foresee only one possible check on the growth of the market: a

"glut" of American issues similar to the oversupply of bonds generated by Japanese firms in the much smaller market existing a few years ago. US corporations have borrowed more than twice as much in the Eurobond market during the first half of 1968 (over $1 billion) as during all of 1967. Normally, a "summer lull" in new issues takes place during July and August, but this year offers no such prospect. Indeed, Texaco has announced the summer-season placement of the market's largest single issue to date -- $75 million.

15. Even with the decreased number of non-American issues, the market's absorptive capacity continues to surprise even seasoned observers. Activity remains feverish, and oversubscriptions are common. At the beginning of this year, bankers and financial writers were pessimistic about the market's capacity to take up the $1 billion of new American issues then projected for 1968 as a whole. By midyear, the market had easily absorbed a total volume of $1.5 billion. Predictions that new issues will top $2 billion for the year now appear not only reasonable but also well within the market's capacity.