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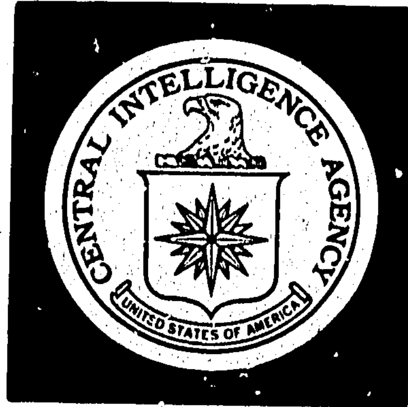

DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Recent Developments In The Eurobond Market

International Finance Series No. 24

~~Confidential~~

ER IM 70-138
September 1970

Copy No. 67

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
September 1970

INTELLIGENCE MEMORANDUM

Recent Developments In The Eurobond Market

Introduction

The Eurobond market attained a position of paramount importance among international bond markets following new US restrictions on capital outflows during the mid-1960s. The market grew at an extraordinary pace from 1964 to 1969 and provided about four times the combined total of long-term funds generated by the older and more conventional national markets for foreign bonds. In 1970, however, the Eurobond market has been facing its severest test to date.

This memorandum reviews briefly the history and significance of the Eurobond market, examines the market's capacity for surviving periods of difficult economic conditions through innovative adaptations, and assesses the prospects for resumed growth.

Background - A Growth Market Through 1968

1. The Eurobond market has been an important source of capital funds since 1963, when the US

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Interest Equalization Tax (IET)* effectively rendered the previously dominant New York bond market inaccessible to foreign borrowers. Ironically, nearly half of the funds borrowed by foreigners in New York were foreign owned. Accordingly, alternative capital market machinery was established in Europe to tap this large pool of US dollars. Thus the Eurobond market developed strictly out of private commercial need and opportunity: borrowers obtained money unavailable elsewhere at comparable terms, and investors were given new opportunities to diversify their portfolios. Both have benefited by freedom from various forms of governmental control which apply to foreign borrowings in local currencies.** For example, by employing subsidiaries in countries with lenient tax laws and issuing regulations, such as Luxembourg, interest can be paid without withholding taxes.

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* *With the objective of reducing foreign borrowing in New York, the IET was designed to penalize Americans who purchased foreign securities with a tax that would equalize interest rates prevailing in New York and the somewhat higher rates abroad. In order to attract US investors, foreigners would thus be forced to pay commensurately higher rates in New York to compensate lenders for the tax.*

** *Subtle distinctions between Eurobonds and foreign bonds permit significant differences in taxation and regulation. Eurobonds are securities, denominated in currencies that need not be of either the borrower or lender, and that are issued, quoted, and traded in several countries simultaneously. By contrast, foreign loans in Europe are issued by a non-resident borrower in the domestic capital market of a single country and are denominated in the currency of that country. Most national capital markets impose withholding taxes -- usually upward of 20% -- on interest paid on foreign bonds to non-residents. The fact that Eurobonds are also issued in bearer form provides the investor with additional means to avoid taxes.*

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2. Whereas Eurobond funds are typically used for investment purposes, Eurodollar borrowings -- their shorter term counterpart -- are employed for shorter term purposes, such as financing foreign trade.* Such Eurodollars are demand and time deposits, usually with maturities of one year or less, which are held in banks outside the United States. In mid-1970, Eurodollar deposits totaled about $40 billion, compared with approximately $12 billion of outstanding Eurobond issues. The two markets, and their respective structures of interest rates, are interrelated. For example, when interest rates in the two markets are sufficiently out of line, the Eurodollar market represents an important alternative to the Eurobond market for both investors and borrowers.

3. In 1968 the United States imposed mandatory foreign direct investment controls** to improve its deteriorating balance-of-payments position. This induced an accelerated development of the Eurobond market. US-based international companies, forced to resort extensively to offshore sources of capital to sustain their overseas growth, abruptly doubled their share of Eurobond borrowings from about 30% to 60%. This massive recourse to the Eurobond market led to an increase in new issues from $2.0 billion in 1967 to more than $3.5 billion in 1968 (see the table).

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*** These basically entailed a transformation of the earlier voluntary program, effective since 1965, into a mandatory program. Three limitations were imposed on direct investors (defined as individuals or companies in the United States who own or acquire as much as a 10% interest in the voting securities, capital, or earnings of a foreign business venture) in their foreign direct investment transactions, particularly in the developed countries of continental Western Europe. These investors were henceforth subject to (1) annual limits on amounts of new direct investment, (2) required repatriation of a specified share of total earnings from their direct investments, and (3) a reduction of their foreign balances of short-term financial assets to an average of the level for 1965-66.*

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4. The composition of new Eurobond issues also shifted dramatically in 1968. A new appetite among European investors for growth -- encouraged by the aggressive salesmanship of groups like Investors Overseas Services (IOS) -- began to assert itself at this time. Convertible Eurobonds,* almost exclusively American, provided an attractive combination of high yield and capital growth. As a result, US companies were able to obtain substantially more funds in the market at lower interest rates than would have been available by means of issuing straight debt bonds.

5. A sharp drop in dollar-denominated straight debt issues in 1968 was more than offset by an unprecedented demand for issues in denominated Deutschemarks (DM). This shift reflected a higher degree of confidence in the mark than in the dollar, and the lower interest rates the DM bonds carried compared with dollar issues. Investors were willing to accept this lower rate of interest because of their expectations that the par value for the undervalued DM would soon be raised.

6. Meanwhile, the institutional structure of the market continued to broaden. A greater variety of maturities were offered, particularly in the five- to ten-year medium-term range. US companies operating in the United Kingdom adopted the practice of issuing sterling bonds convertible into the stock -- valued in dollars -- of the parent company. An ever-widening clientele of borrowers and lenders developed through a complex network of multinational underwriting syndicates. Although the major market for Eurobonds was originally in London, others emerged in Switzerland, Germany, and Belgium.

Significance of the Eurobond Market

7. The Eurobond market has benefited the US economy in several ways. Overall, it has aided the

* *While terms vary, these convertible bonds permit the holder to exchange his bonds for common stock at a conversion price, about 10% to 15% above the stock price prevailing at the time of issue, any time between a period of 6 to 18 months after issue and the bond's final redemption date.*

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US balance of payments by checking the outflow of capital. This has been accomplished without inhibiting the international operations of US corporations because a large part of the international capital raising activities that had been concentrated in New York until the middle of 1963 spread to other world financial centers. The Eurobond market tends to strengthen the dollar's role as an international currency. Moreover, it enhances the potential of US companies for overseas expansion by increasing their chances of obtaining long-term capital. In time, this investment aids the US balance of payments by generating a return flow of profits.

8. The market has had significant effects on others as well. The new facilities make it easier for borrowers to raise long-term capital as there has been a mobilization of funds that might have remained in official hands or in short-term investments. Borrowers have access to a usually cheaper market and in the currency or currencies most suitable to their purpose. Western Europe has moved a step closer to the integration of its capital markets through the consolidation of Eurobond issuing facilities. However, the greater freedom of capital movement, demonstrated by an increased volume of funds transiting national boundaries, represents a potentially unsettling effect on international equilibrium. In turn, participating countries find it more difficult to manage their domestic monetary policies. But attempts by national governments to curtail the outflow of domestic capital led to the creation of the Eurobond market in the first place. All in all, the world appears the gainer: facilities are provided through which the excess capital of countries in balance-of-payments surplus such as Germany and Switzerland can be tapped more efficiently, thus contributing to an increase of international liquidity.

<u>1969: The End of an Era of Sustained Growth ...</u>

9. The sustained expansion of the Eurobond market ended in the spring of 1969. It has been followed by a prolonged retrenchment, largely because of adverse economic conditions in the United States and various actions by governments in Europe and the United States. Rising US interest rates were quickly reflected in higher Eurobond interest

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rates. Therefore, borrowers balked; at the same time the appeal of convertible bonds -- the principal form of Eurobonds at that time -- was greatly reduced by the fall of the faltering US stock market.

10. The governments of several major European countries became increasingly concerned in early 1969 with the loss to the Eurobond market of scarce funds required by domestic borrowers. Both Germany and Italy effectively reduced this diversion by limiting the participation of their domestic banks in underwriting international bond issues. Similar actions to reduce the amount of capital outflow from their markets were taken in Switzerland and Belgium. The restrictions imposed in some countries on the sale of foreign mutual funds, which are large investors in Eurobonds, also reduced the demand for these securities.

11. At the same time, the US government eased mandatory foreign direct investment controls, thereby permitting US companies to rely more on both capital transfers from the United States and retained earnings for overseas investment. And because US companies -- as a hedge -- in 1968 had borrowed funds in the Eurobond market well in excess of investment needs for that year, considerable sums were carried over. Accordingly, US companies in 1969 placed only $1 billion in Eurobonds, compared with $2 billion in 1968. New US corporate Eurobond issues were equivalent to only about 10% of total expenditures for overseas plant and equipment in 1969, which contrasts with approximately 25% in 1968.

...and in 1970: A Threatened Breakdown

12. After a brief recovery in the fourth quarter of 1969, Eurobond activity quickly resumed its descent early in 1970. Among the principal contributing factors to the dismal performance this year have been a further fall in the US stock market, a resurgence of US interest rates in the spring, and German government restrictions on foreign access to the DM capital market because of liquidity problems following revaluation of the mark.

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13. The market for new Eurobond issues showed unprecedented weakness during May-August 1970. The liquidity problems afflicting the IOS, and the bankruptcies of the Penn Central Transportation Company and the Four Seasons Nursing Centers in the United States further diminished confidence in the US economy on the part of prospective European investors. Accordingly, the prices of outstanding Eurobond issues dropped sharply -- many by 25% to 50% -- causing prospective buyers of new issues to become increasingly wary. Offerings of new convertible bonds have been discontinued entirely since April.

14. The already difficult situation for Eurobonds was further complicated by renewed reservations about the strength of the US dollar. Concerns were provoked by Canada's decision in May to let its dollar float. Investors feared, despite official denials, that other major currencies might subsequently follow suit.

15. The introduction of yet another innovation rescued the Eurobond market from a threatened collapse. Two large debentures featuring floating interest rates* were issued in May and June 1970, for $125 million by ENEL (the Italian National Electricity Agency) and for $75 million by the US Pepsi Cola Company, respectively. Because investors are largely protected against loss of capital, both of these sizable issues were quickly oversubscribed at a time when the market could generate only nominal interest in other types of issues.

16. Nevertheless, the Eurobond doldrums persisted throughout the summer. Borrowers were generally unwilling to pay dearly for funds over a long fixed period, and lenders feared capital losses at coupon rates below 10%. A major shift in activity occurred from the long-term capital market to short-term Eurodollar financing, including bank lending and the issuance of commercial paper by US overseas corporations.

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* *Floating rates are reset every six months slightly above the current market rate for Eurodollar deposits, thereby assuring that the value to the holder will remain approximately unchanged.*

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Prospects

17. Early signs have appeared of a likely recovery of the Eurobond market. Several US-based companies announced plans to raise substantial sums in the market during September. A strong investor response to these announcements led the largest of the borrowers, Esso Overseas Finance, to cut the rate of interest for its 15-year straight-debt debentures from the original offering of 9.5% to 9%.

18. There are several reasons for expecting an imminent resurgence of new Eurobond issues. An increase in US economic activity this fall is generally expected. The rate of US inflation may decline and become slower than in other industrial countries. Partly for this reason, short-term interest rates should continue to fall.* An already revived investor interest in convertibles should gain momentum if recovery on Wall Street continues. Many companies that contracted short-term or medium-term obligations are anxious to convert their holdings into long-term obligations. The market for Eurobonds denominated in marks and Dutch guilders has become more active, and should continue so. And the recent scarcity of new issues has enabled the market to absorb the large inventories carried by dealers since early in the year.

19. In the long run, the Eurobond market will flourish so long as controls continue to obstruct the free movement of capital across national boundaries. Restrictions on foreign issues in European capital markets are not likely to be soon removed. The maintenance of sovereignty in economic policies is jealously guarded by national governments. Yet Eurobonds would not vanish even should all fiscal restrictions be eliminated.**

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* *Eurodollar interest rates were dampened by reduced interest rates in the United States following the Federal Reserves easing of credit in late summer -- by reduction in reserve requirements.*

** *In April 1969 the US government took the first step toward elimination of the IET by reducing the tax on the purchase of foreign securities from 1-1/4% to 3/4%.*

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They would still offer the borrower and lender a number of advantages. Unlike the New York bond market, they are not subject to SEC regulations. Because of the choice of currencies in which the bonds are denominated, they provide a means of minimizing exchange risks. Finally, there is less likelihood of adverse government intervention in the Eurobond market than in national markets.

19. The organization of trading in outstanding Eurobonds is widely considered the Achilles heel of the market. The viability of an active secondary market depends on a speedy and safe system of clearing transactions, involving participants geographically dispersed. Although many technical problems remain, the institution of central clearing systems, such as Euroclear and the Center of Delivery (CEDEL),* and the growth of international brokerage organizations add greatly to the attractiveness of the market for investors. Both Euroclear and CEDEL, organized expressly to clear and deliver Eurobonds, will be computerized by early 1971.

** Secondary market clearing is equally relevant to a new form of international security that also is expected to appear very shortly, the Euro-equity. The establishment of this market will enable common stocks of international companies to be traded anywhere in the world without restriction. Some initial groundwork had been laid this past spring, but plans were temporarily abandoned as a result of the poor showing of the US and other stock markets. However, some European bankers believe that, as stock markets demonstrate a renewed vigor, the Euro-equities market will emerge as an important international market to rival that for Eurobonds.*

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New Issues of International Bonds

Million US$

	1965	1966	1967	1968	1969	1970			
						Jan-Mar	Apr-Jun	Jul	Aug
Eurobonds	1,041	1,142	2,002	3,573	3,155	601	698	180	91
By borrower:									
US companies	358	439	562	2,096	1,005	202	203	42	--
Other	683	703	1,440	1,477	2,150	399	495	138	91
By currency:									
US dollars	726	921	1,780	2,554	1,722	504	485	75	20
DM	203	147	171	914	1,338	--	104	55	55
Other	112	74	51	105	95	97	109	50	16
By type of issue:									
Straight	931	900	1,742	1,663	2,024	484	663	180	91
Convertible	110	242	260	1,910	1,131	117	35	--	--
Foreign bonds	376	378	403	1,135	813	59	33	70	--

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