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EURODOLLARS

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The subject has intriged me for sometime. Not that I have any reason to feel that the subject is well understood by me, but rather a feeling that by some submersion, I might gain a better understanding. I have found it to be a complex subject, and I therefore beg your indulgence in a joint adventure into a realm of unknown for most of us.

Whether we relish it or not, we must deal with money. It is our medium of exchange-- our go between in trade. Money is accepted and desired only because it may be changed for other things. The value of money is what can be gotten in exchange for it. The price of money is based on interest rate-- what lenders charge for it, and the other is the price one country's money has in another country-- or, the exchange rate.

From the earliest times, men have used odd kinds of money. These have ranged from snails, tobacco, salt, Girffe tails, whole teeth, to cattle, and shells. As civilization progressed, it became more difficult to barter. Various metals came into use, with weight and purity of the metal, as standards of value.

The developments of money in the U.S. is a story in itself. The gold standard was adopted by leading industrial countries before World War I, and values of currencies became stable in relation to the dollar. During WW II, the issuance of large quantities of paper money to satisfy war demands, led to monetary instability, and the inability of most countries to meet the requirements of the gold standard. Great Britain left the gold standard in 1931, and the U.S. followed in 1933. In the U.S., laws were enacted to reduced to 59.06% the gold value of the dollar. An ounce of gold became worth $35 instead of $20.67 This produced a profit of $2,800,000,000, of which $2,000,000,000 was set aside for a stablization fund, to stablize the dollar in terms of value of money in other countries.

As money is the basis of exchange within a single country, it also serves the same purpose in trade beyond our borders. However, stability of currencies

is essential for inter-country trade. With this in mind, the Bretton Woods International Monetary Conference was held 24 years ago in Bretton Woods, N.H. Imbued with a sense of wartime unity and mindful that competitive currency devaluation had deepened and prolonged the Depression of the '30s, the delegates from 45 nations took only three weeks to devise the fundamentals of a corrective program.

They agreed that gold would remain the primary international asset by which nations settle their debts with one another. The U.S. dollar, then backed by 57% of the free world's nationally held supply of gold, would be the the key currency. The dollar's acceptability in world finance rests on the U.S. treasury's pledge to redeem dollars held by foreign governments for gold at an unchanging $35 per oz.

Also out of Bretton Woods came the Washington-based International Monetary Fund, the arbiter of exchange rates. Written into the articles of the IMF, which is in full and binding upon its 111 member nations, is a proviso, that no country may devaluate its currency without IMF permission. Barring devaluation, every IMF nation must buy, sell or borrow foreign currencies-- in practical terms, dollars-- in sufficient quantity to keep its own money within 1% of its delcared worth.

This provokes two separate, but related troubles. The volume of world trade is rising far more quickly than the global supply of gold. To overcome that gap, the IMF last year devised a sort of "paper gold"-- a new international money called "special drawing rights." Use of these SDRs, as they are called, awaits ratification by nations that contribute at least 80% of the IMF's $21 billion bankroll.

The seond problem--the one that caused last fall's tremors-- is the main, and perhaps mortal weakness of the monetary system. While nations that belong to the IMF are obliged to try to keep their curreny-exchange rates steady, there is no stipulation that they keep their international payments in balance at the prevailing exchange rate. The result is that all too frequently, imbalances occur in international payments, which put new strains on the monetary system.

A number of patchwork expedients help keep the system together: one is Massive IMF loans to countries with severe payments deficits (as in the case of Britain), another is currency "swaps" (which enable speculation-threatened countries to buy, and thus defend their own currency with foreign currencies), and another is the two-tiered gold-pricing system. The two-tiered system, which was established last SPRING to thwart speculation against gold itself, pegs the official cost of gold at $35 an ounce in transactions between governments, but lets it seek its own level in commercial markets.

What can be done? There is some talk of a new Bretton Woods, where the monetary system might be completely over hauled. Among the possible revisions is a realignment of the values of world's currencies. Another is an increase in the price of gold.

Other remedies are possible. Last fall's crisis heightened interest in a system of so-called "flexible exchange rates" that would avoid the wrenching upheavals of formal devaluation and revaluation. Rather than keep its currency within 1% of declared value, as current rules require, a country might be allowed to permit swings of 5% or so. To be sure, such adjustments would have to be followed by improved monetary and fiscal discipline in the U.S., and other leading industrial countries with excess inflation.

Bretton Woods, which set values for different currencies, also set intervention (protection) points. For example, one U.S. dollar equaled four German marks. Germany and the U.S. are not permitted to allow more than 1% fluctuation either side of the fixed parity. This should be doubled. With a leeway of only 1% either side of the fixed parity, governments involved must make drastic changes in their exchange rate or essentially no change at all when the currency gets out of line. Doubling the leeway to 2½% or 5% would permit maneuvering room and give governments the power to punish speculators who misuse forward foreign exchange markets in short ventures.

There is yet another facet facing the U.S. monetary problem, which for that matter is almost a common national currency problem. Our huge foreign aid program over the years is primarily responsible for slowly pushing us into unhealthy unfavorable balances in our foreign trade picture. ~~However, as is quite often the case, there is someone about, who sees a bright spot in all the gloom.~~ ?

One slowly emerging irony about the U.S. balance-of-trade deficit-- a deficit that has led to so many restrictions on the flow of dollars-- is that it has also led to the creation of what are in many ways the freest financial markets in the world. Short-term credit in these markets is ordinarily extended in Eurodollars; however, Euormarks, Eurosterling, and several other similarly prefixed currencies have also become available. Longer-term financing is available in the form of Eurobonds. A number of American companies whose freedom to ship money abroad has been curtailed by the Administration's balance-of-payment programs, are now raising capital abroad in these new international "Euromarkets." It is because the markets are international that they are also so free; no one government has been able to regulate the flow of funds in these markets or to impose interest ceilings on loans or deposits made in them.

Another point of irony about these new markets is that they are now in danger of being undermined by the very balance-of-payments deficits that originally created them. The recent sharp expansion of the deficits, and the international financial upheavals that have accompanied this process, have made it clear to holders of dollars--including, of course, holders of Eurodollars--that they are vulnerable to any change in the value of the dollar, including a change based on reordering the relationship between it and gold. Even if the dollar were devalued no more than other currencies in any such monetary revolution, it seems clear that holders of Eurodollars would be scrambling to unload them in any period of prolonged uncertainty about the rules of WORLD finance and trade.

Let us examine a little more closely the meaning of Eurodollars. The

Euro-dollarsis not a separate species of dollar, nor is the Euro-Swiss franc or Euro-Sterling distinct from the home variety of each of these currencies. They simply have earned the label "Euro" by virtue of the manner in which their holders have banked them. By the mere act of transferring a dollar balance with a bank located in the U.S. to the London branch of the same bank, a holder of dollars creates Euro-dollars. While he now has a Euro-dollar account with the London branch, the latter has a regular dollar account with its head office. When the London office subsequently lends the dollars to a borrower or redeposits them with another bank that is a nonresident of the U.S, there generally still remains a regular dollar account somewhere in the U.S. banking system, in addition to the Euro-dollar account or accounts which are created by this series of transactions. One test which may be employed to distinguish a Euro-dollar from the domestic U.S. variety, is to determine whether the banking function-- the direct deposit liabability to the depositor, plus the risk attached to the dollar's reemployment in a loan or investment-- is carried out by a bank abroad or by a resident U.S. bank.

The amount of Euro-dollars in existence is difficult to estimate because of the multiple interbank deposits that are a regular phenomenon of the market. The Bank of International Settlements, after making adjustments to minimzie double-counting, estimated a total of $13 billion of such bank deposits denominated in dollars as of the end of Dec., 1966

With resepct to bank deposits, for example, the distinguishing characteristic of a Euro-currency is that it is deposited in a bank in a country to which the currency is not "native." If any owner of US.dollars or German marks deposits them in the Paris office of a French bank, they are Euro-dollars or Euro-marks. The bank of deposit need not be European. Canadian banks, for instance, accept deposits in currencies other than Canadian dollars, and these deposits are also known as "Euro." By far the greatest share of Euro-currencies

(estimates run as high as 80%) is donominated in U.S. dollars, and therefore it is common practice to refer to the entire Euo-currency market as Euro-dollar market.

The process that CREATED this vast sum of Euro-ollars began when the U.S. balance-of-payments deficit left more and more American dollars in the hands of foreigners. Among the early contributors of the Euro-dollars were Soviet banks and their branches, including the London brach of Moscow Narodny Bank. They began moving their dollars from the U. to Europe some years back; the object is supposed to have been to conceal these holdings and prevent them from being frozen during any cold-war flare-up. Russians certainly did not start the Euro-dollar market! French and Italian banks were making sizeable dollar loans nearly twenty years ago, and there were even some deposits in dollars and sterling in Vienna and Berlin during the 1920's.

However, for many years the foreigners were content to leave the dollars in the U..S.-- so, they were not becoming Euro-dollars. The Euro-dollar market was still of minor consequence in 1957-58, and was probably only about $2 billion as recently as 1960. Then foreigner's holdings began flowing abroad, attracted by the higher rates there. The heart of the Euro-dollar market now is in London were 16 U.S. branch banks play the leading role. The dollar's role in international financing has been enhanced, while that of sterling has been reduced. At the same time, London has become more important as a center of international financial activity, while New York's importance has diminished. One hundred thirty branches of international banks have been opened in London. The unofficial headquarters are in the "city", a one square mile section of old London. London HAS become the gravitation point of dollars accumulated in the Far and Middle East. London has created a market in the sense of a meeting place where dealers gather, or where an indicator board flashes rates. All the billions that change hands result from telephone, or telex calls between banks.

In the absence of any single national authority, the Bank for INternat'l. Settlements is performing some central-bnnk functions for Euro-dollars. The BIX performs two jobs in the market. One is fact gathering, as it tries to estimate the size and main characteristics of the market. The other involves intervening on behalf of the central banks that are among its shareholders. Like any

other money market, the Euro-dollar market undergoes seasonal and other strains, and sometimes needs temporary office help to keep it on an even keel.

Aside from more attractive lending rates abroad, the new U.S. restrictions on direct investment abroard, effective Jan 1, 1968 raised several kinds of questions for companies with interests abroad. First, the President's program would require American companies with foreign operations to borrow more money abroad, and secondly, if the program were successful, the balance-of-payments deficit would be reduced--which might mean higher borrowing rates abroad. However, there has been no crisis, and despite those persistent nationalist feelings that American business is already too powerful in Europe, bankers on most of the Continent still generally want to make money available.

Euro-dollars just do not sit still. The popular funneling of Euro-dollars had been into Euro-bonds. However, recent developments have shown a shift to the convertible Euro-bond. As the market seems to be on its way to becoming a private preserve for big American corporations, it is more and more centering around a new security--the convertible bond. Curiously, the popularity of the old kind of regular Eurobonds explains the present shift to convertibles. The market for Eurobonds grew out of a high-velocity, short term market in Eurodollars. But as it matured and gained strength, the market turned out to have something to offer to long-term borrowers as well. Yet the interest rates, of course, had to be high enough to attract the prospective lender.

To the borrower, the convertible is appealing i As interest rates on straight European bond issues crept up, the convertible was costing around 5%, instead of 7 to 8%. To the lender, there were several eye-catching attractions. After a fixed period, the investor has the option of converting his bond into the commonstock of the issuing corporation. So, it has a built-in equity feature. ~~If the stock rises, and should not rise, the bondholder~~ OR FALLS IF the stock shows appreciation possibilities, the bondholder would convert; if no

he would stay on the sidelines as a normal bondholder.
~~may retain possession and collect his interest.~~

One of the larger ironies of the present international investment scene is the fact that this all-purpose investment instrument, chiefly the creation of American corporations, is not available to American citizens. Under a law aimed at protecting the U.S. balance of payemnts, convertible Eurobonds, like regular Eurobonds, cannot be offered for sale to American citizens by the issuing institutions. Nor can such bonds be purchased in the secondary market by Americans unless they pay the prohibitively high interest equalization tax of up to 18 3/4%. A manager of a large Swiss bank has made the statement that the "Eurobond could almost be called a present to the non-American investor from the US. Gov't. and the U.S. Corporations."

We might add here that an American who goes to a European bank to place a purchase order for a convertible Eurobond will politely be told by the bank that he is making himself liable to prosecution under U.S. Law if he does not poney up the interest equalization tax. The bank will still sell the American the bond, feeling that their responsibility ends with the warning. So far, the U.S. authorities have made no move to prosecute violators of the law.

Some economists have wondered whether, desptite its considerable usefulness these days, the Euro-dollar market is some transitory phenomenon that will gradually disappear when the U.S. again begins to show a balance-of-payments surplus. Two close friends of the market-- Fred Klopstock of the N.Y. Federal Reserve Bank, and Oscar Altman of the International Monetary Fund doubt that it will disappear. They feel that other countries running surpluses might still want to convert part of them into Eurodollar assets; meanwhile, bankers and businessmen in countries running deficits might borrow from the U.S. and convert the loans into Eurodollars.

Buyers of the Eurobonds come from all over the world. They are believed to include the Vatican, the pension fund of the United Nations, foreign insurance

mutual funds, withthe highest percentage going into the hands of wealthy individuals. Individuals have a yen for anonymity, with a considerable portion of the bonds which pass thru Swiss bansk going into non-Swiss investors, with anonymous numbered accounts. Many of buyers are seeking refuge from inflation or policitcal risks in their own countries, and many of them intend, legally or illegally, to avoid paying taxes on the interest income from the bonds.

There have been two main reasons for the ability of U.S. companies to raise money so quickly thru the Eurobonds. One is the prestige of some American companies, and the other is the appeal of the convertible debentures. Those who are bearish on the dollar have a special predispostion toward convertibles. They assume that stock prices, and therefore the prices of their convertibles, will rise if there is adollar devluation.

In view of the fact that Eurodollars are a tremendous source of additional credit to U.S. banks, the Federal Reserve, in line with their recent tight money policies, have put new rules into effect. These restrictions are to make borrowing of Eurodollars a less attractive avenue for American banks. Heretofore, Eurodollars were not counted in the deposits, and therefore, reserves were not required. Affective OCt. 16, banks will now need to keep a 10% reserve on their borrowing of Eurodollars. The Fed. Reserve states this will remove a special advantage to member banks that have used Eurodollars not subject to reserv requirements to adjust to domestic credit restraint.

U.S. banks borrowings of Eurodollars more than doubled since Jan. 1, and reached a record $14.6 billion during the week ending July 30. Banks TURNED to this source of funds because they could legally pay whatever interest rate it took to attact them, and because they haven't had to put any such deposits into reserves. The Fed. Reserve action however, is not intended to interfere with the normal operations of U.S. banks, or U.S. coppprations in financing business abroad.

The immensely valuable new markets for both Eurobonds and Eurodollars, are a real tribute to the ingenuity of businessmen who are OBLIGED to borrow in a world increasingly beset by restrictions on borrowings. However, the markets are still dependent upon continging confidence in the U.S. dollar. The U.S. Dollar is not static, so the stability picture would ALSO appear to be a bit unstable.