Recent Developments in International Capital Markets*

Developments in international capital markets during the last year have been dominated by the appearance on the European market of a new group of borrowers, the international affiliates of United States companies.[1] These borrowers have been led to issue securities in Europe on a large scale by the United States balance-of-payments program. As a result, the combined volume of international security issues[2] in the United States and Europe, which had been increasing at the rate of about $300 million a year since 1962 and amounted to $2.6 billion in 1965, totaled more than $2 billion in the first half of 1966 alone.

The new American borrowers have increased the relative importance of international security issues in Europe. This growth has been confined to issues denominated in dollars, German marks, and units-of-account which generally stand outside of national controls over security issues. Increasing underwriting opportunities have attracted investment bankers from the United States, Italy, and Switzerland, who have entered into competition with bankers from the United Kingdom and several Common Market countries already active in the European new-issue field. In their efforts to tap broader sources of funds, the borrowers have shown considerable initiative in adapting the type and terms of securities issued to market demands. The rapidly expanding volume of dollar and German mark issues in Europe has also led to a steeper rise in interest rates for these issues than the already substantial increases in most other long-term bond rates in Europe and in the United States. Both higher interest rates and the broader range of securities offered have stimulated the interest of many European investors.

While much of the impetus for the expansion of the European market in foreign securities has derived from United States measures to reduce capital outflows, it seems likely that many of the institutional and distributional changes that have accompanied this expansion will survive the eventual elimination of capital outflow restrictions in the United States. If this is the case, the market for foreign issues should be broader and more competitive, which will be to the advantage of both international borrowers and lenders.

CURRENCIES OF ISSUE

All of the growth in international security issues over the past three years has been due to an expansion of offerings in Europe.[3] As shown in Table I, the volume of foreign securities issued in New York has declined slightly since 1963. Consequently, the proportion of issues distributed in Europe—although not necessarily to Europeans—has risen from 28 per cent of all international security issues in 1963, to 49 per cent in 1965, and to 62 per cent in the twelve months ended in June 1966. All of the growth in foreign issues in Europe, both in absolute and relative terms, has been accounted for by the expansion of issues denominated in dollars, German marks, and units-of-account.[4] As noted above, these issues, unlike other international offerings, are not subject to the strict issue controls which apply to local currency issues in most European markets.

Although all European countries exercise fairly close control over issues denominated in their national currencies, foreign currency issues are largely exempt from similar controls. In the case of Germany, controls apply to Ger-

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1 The affiliates of United States companies floating securities in Europe are usually incorporated in Luxembourg or Delaware.

2 The term "international security issues" is used in this article to describe all issues floated outside the country of residence of the borrower.

3 The data cited in this article are derived from a variety of published sources and refer to both public issues and private placements. While these data are incomplete in some respects, they are probably not misleading.

4 For a discussion of the development of these issues, see "Recent Innovations in European Capital Markets", this *Review* (January 1965), pages 9-15.

man mark issues by German residents but they do not apply to German mark issues by foreign borrowers.

Purchases of international securities by European financial institutions are, however, restricted to some degree. In some countries government institutions play a large role in collecting savings and generally confine their investments to national undertakings. Regulations governing the operations of private financial institutions sometimes limit holdings of foreign securities. On the other hand, security purchases by individuals are formally subject only to foreign exchange regulations, which are negligible in many cases. Britain guards against capital outflows on security account by requiring that foreign security purchases be financed with the proceeds of foreign security sales. However, in the Common Market countries, Switzerland, and Austria, foreign security purchases may generally be made freely. Thus, in spite of institutional limitations, securities denominated in dollars, German marks, and units-of-account, issued without important restrictions by any national authority, achieve a wide distribution among the European and other clients of European bankers. In this way, large and well-known borrowers can draw European and other funds from the capital markets of Europe even though they might not be permitted to borrow in the national currency of the country from which the funds are drawn.

Foreign security offerings in the currencies of those European countries applying strict national issue controls have, since 1963, remained below the $300 million to $600 million levels registered in the preceding five years. Flotations in Swiss francs, Dutch guilders, sterling, and Italian lire have nevertheless been significant at one time or another during the later period (see Table I). Changes in the relative importance of foreign issues in the controlled national European markets have for the most part reflected the receptiveness of the authorities to such issues, which has generally depended on domestic capital market conditions and the balance-of-payments position of the country in question. Thus, the Dutch market was practically closed to foreign borrowers in 1963-64, while foreign issues in the Italian market have expanded recently as Italy's balance of payments has moved into a strong surplus.

Despite the growth of Europe as a distribution center for international issues, the dollar remains unchallenged as the principal currency of issue. In 1965, approximately three fourths of all international security issues were denominated in United States dollars and this proportion appears to have changed little so far in 1966. The continued dominance of dollar issues in international markets is due to a number of factors. First, dollar issues in New York, while a smaller proportion of the total than in 1963 and before, remain a major segment of the market. Second, the affiliates of American companies have borrowed largely through dollar issues, although they have borrowed in other currencies as well. But dollar issues are also favored where neither American borrowers nor American lenders are involved owing to the relative freedom of such issues from European issue controls and—the most important consideration of all—the dollar's advantages as an international medium of exchange.

Table I

INTERNATIONAL SECURITY ISSUES BY CURRENCY OF ISSUE

In millions of dollars equivalent

Currency	1963	1964	1965	1965		1966
				First half	Second half	First half
Dollars (distributed in New York)	1,441	1,150	1,312	766	546	815
Dollars (distributed in Europe)	119	609	622	210	412	804
German marks	40	236	320	168	152	245
Sterling/ German mark	—	11	64	50	14	20
Units-of-account	48	10	—	—	—	50
Swiss francs	135	96	87	46	41	55
Dutch guilders	—	8	78	22	56	—
Sterling*	164	130	18	9	9	—
Italian lire	24	—	24	—	24	107
Other	39	28	61	23	38	45
Total	2,010	2,278	2,586	1,294	1,292	2,141

* Net of redemptions.

BORROWERS

The rising importance of Europe as a market for international securities is principally due to the migration to that market of borrowers affected by the United States interest equalization tax (IET), and the appearance of the international affiliates of American companies in the European markets. The IET in effect raised by 1 percentage point the interest cost of security flotations in the United States for residents of developed and certain other countries. Most of the major borrowers affected by the IET—i.e., those from the European Economic Community (EEC), the United Kingdom, the Scandinavian countries, Australia, New Zealand, South Africa, and Japan—shifted their borrowing from New York to Europe after the tax was proposed in 1963 (see Table II). Scandinavian borrowing in Europe was particularly heavy in 1964 and 1965.

Table II

INTERNATIONAL SECURITY ISSUES BY BORROWER AND BY MARKET

In millions of dollars equivalent

Borrower Market	1963	1964	1965	1965 First half	1965 Second half	1966 First half
By borrowers affected by IET						
EEC countries, (including EEC organizations)						
New York	60	14	—	—	—	—
Europe	230	270	351	119	232	353
Total	290	284	351	119	232	353
United Kingdom						
New York	155	7	80	—	80	—
Europe	16	—	68	27	41	—
Total	171	7	148	27	121	—
Scandinavia (excluding Finland)						
New York	114	—	—	—	—	—
Europe	68	255	206	130	76	78
Total	182	255	206	130	76	78
Rest of Europe						
New York	10	5	20	20	—	—
Europe	30	60	45	21	24	27
Total	40	65	65	41	24	27
Japan						
New York	200	—	62	42	20	—
Europe	59	216	25	25	—	—
Total	259	216	87	67	20	—
Australia and New Zealand						
New York	30	—	—	—	—	28
Europe	90	35	83	25	58	40
Total	120	35	83	25	58	68
United States international affiliates						
New York	—	—	—	—	—	—
Europe	—	—	334	28	306	649
Total	—	—	334	28	306	649
All borrowers affected by IET						
New York	569	26	162	62	100	28
Europe	493	836	1,112	375	737	1,147
Total	1,062	862	1,274	437	837	1,175
By borrowers not affected by IET						
Canada						
New York	734	725	734	339	395	699
Europe	—	—	—	—	—	46
Total	734	725	734	339	395	745
Latin America and Western Hemisphere						
New York	54	250	60	52	8	51
Europe	—	—	—	—	—	26
Total	54	250	60	52	8	77
International organizations						
New York	—	5	200	181	19	—
Europe	—	137	107	107	—	89
Total	—	142	307	288	19	89
Other						
New York	84	142	156	132	24	37
Europe	76	157	55	46	9	18
Total	160	299	211	178	33	55
All borrowers not affected by IET						
New York	872	1,722	1,150	704	446	787
Europe	76	294	162	153	9	179
Total	948	1,416	1,312	857	455	966
All international security issues						
New York	1,441	1,148	1,312	766	546	815
Europe	569	1,130	1,274	528	746	1,326
Total	2,010	2,278	2,586	1,294	1,292	2,141

In 1965 Japanese borrowers returned to the New York market after special provision was made whereby $100 million of Japanese government and government-guaranteed bonds would be exempted each year from the provisions of the IET. Since 1963, British borrowers have distributed their new issues almost evenly between the two markets. Borrowing abroad by residents of the EEC countries—Belgium, France, Italy, Germany, Luxembourg, and the Netherlands—has been largely concentrated in Europe both before and after the introduction of the IET.

A new group adding its demands to the European market, and also largely covered by the IET, has been the international affiliates of American companies. Their issues, amounting to $955 million in the twelve months ended in June 1966, are almost entirely responsible for the increase in total international security issues since mid-1965. Guidelines issued in February 1965 by the United States Department of Commerce to 500 corporations operating in industrialized foreign countries, requested these firms to help improve the United States balance of payments. Further guidelines, issued in December 1965, doubled the number of participating companies, expanded the overseas areas covered to include the Middle Eastern oil countries, and emphasized direct investment outflows from the United States. Participating companies were requested to plan their 1966 foreign investment program in such a way that the 1965-66 average annual direct investment flows of funds from the United States to the countries specified, plus undistributed profits of affiliates in those same countries, would amount to no more than 90 per cent of the sum total of the two items during the three-year period of 1962-64.

In view of the fact that direct investment in 1965 was already higher than in the base period and was expected to rise further in 1966, the firms concerned were thus encouraged to borrow abroad the funds needed to finance foreign investments. It should perhaps be noted that financing abroad is by no means new for foreign affiliates of United States firms; in fact such financing amounted to $2.7 billion in 1964, much in the form of bank loans and trade credits. But reliance on public security issues was insignificant until mid-1965, when these were undertaken on a large scale in order to reduce direct investment flows from the United States. All in all, security flotations in the European market by borrowers affected by the IET and the United States guidelines on direct investment outflows totaled $493 million in 1963, $836 million in 1964, $1,112 million in 1965, and $1,147 million in the first half of 1966.

Other borrowers, not affected by the IET or the direct investment guidelines, have also turned to the European markets. International organizations, particularly the International Bank for Reconstruction and Development and the Inter-American Development Bank, borrowed more than $100 million in 1964 and again in 1965. In addition, borrowers from Finland, Mexico, Jamaica, Canada, and other countries have on the average borrowed about another $90 million a year in Europe from 1964 to mid-1966.

As for the American market, Canadian borrowers continued to take about $735 million each year during 1963-65. In addition, the borrowers deflected from New York by the IET have to a large extent been replaced by a varying group of borrowers from nations not covered by the IET, including Latin American countries, the Philippines, and Finland.

RECENT MARKET DEVELOPMENTS IN EUROPE

With one new group of borrowers following fast on the heels of another, the market in Europe has at times become congested, and planned issues have had to be reduced in size or postponed. Most recently, foreign affiliates of some of the less widely known American firms have had to forego proposed European issues. In other instances, however, reduction or elimination of borrowing by residents of some countries has been related partly or entirely to other factors. In 1964 Japanese industrial borrowers in Europe reduced their borrowing plans when the convertible securities which they had issued became depressed in response to security market conditions in Tokyo. This year Japanese borrowers have moderated their borrowing as credit conditions in Japan have eased. In Denmark, the inflationary impact of heavy borrowing abroad by local governments and utility companies in 1964 led the authorities to call a temporary halt to such borrowing.

For borrowers remaining in the international securities market, interest rates have climbed sharply since the entrance of American borrowers in 1965. For example, the average yield on four long-term Scandinavian dollar bonds quoted in London—which is roughly representative of trends in yields on European dollar issues—rose from 5.53 per cent in February 1965 to 6.81 per cent in August 1966, as the prices of these securities dropped by nearly 20 per cent. This 1.28 percentage point rise in yields was markedly steeper than the 0.64 percentage point rise in the average yield on United States Government bonds or the 0.82 percentage point rise in the average yield on government bonds in the Common Market countries and Switzerland during the same period.

Rising interest rates and the search for new sources of funds have led to modification in the type and maturity of international securities offered in Europe. Since the beginning of 1966, American borrowers have relied heavily on convertible bonds, with about 60 per cent of the securities floated by affiliates of American companies offering convertibility into the shares of the parent corporation. Mexican, Italian, and British companies have recently made or are making similar offerings. When the supplies of longer term funds have temporarily dried up, or when such funds have become available only at very high rates of interest, borrowers have turned to issues of five years or less to maturity. About one third of the non-United States security issues placed in Europe so far in 1966 have been of this relatively short-term type. Since May, the affiliates of United States companies have also issued $100 million of such obligations.

SOURCES OF FUNDS

There is very little reliable information regarding the sources of funds flowing into the international security markets. In the United States market, the percentage of total foreign issues purchased by Americans has increased from 86 per cent in 1962 to 92 per cent in the first half of 1966. The decline in foreign participation in foreign issues floated in New York may reflect the fact that dollar bonds have been issued in Europe at higher interest rates than on comparable instruments in the United States. Similarly, foreign securities issued in Switzerland, and denominated in Swiss francs, have probably been taken up primarily by Swiss residents because their yields are competitive with domestic issues in this market but not competitive with yields on European dollar bonds. But little can be said about the sources of funds used to purchase dollar, unit-of-account, and German mark issues in Europe.

Balance-of-payments data for the United Kingdom and the Common Market countries show substantial purchases of securities from foreigners, but these are slightly outweighed by sales of securities to foreigners. However, sizable European and non-European purchases of international securities are made through Swiss banks, which are reported to have purchased for the account of their clients as much as 50 per cent of many recent dollar issues. In the absence of information on sources of capital channeled through Switzerland, it is impossible to judge the extent to which the European capital markets have served to export European capital to the rest of the world and the extent to which they have merely served as intermediaries between non-European lenders and borrowers. At any rate, the broader range of securities offered in late 1965 and 1966 is reported to have stimulated European interest, although the recent drop in prices on outstanding international securities may have dampened this interest in the last few months.

UNDERWRITERS

The adaptation of international security issues to rapidly changing issue controls and financial requirements has been greatly aided by the leadership exercised by a number of national groups of investment bankers. During 1963 and 1964 bankers in Britain, Belgium, and Luxembourg took the lead in developing the market for European dollar and unit-of-account bonds. German banks actively cultivated the market for foreign German mark issues and, in 1965, sponsored one parallel loan—the simultaneous offering in several European markets of local currency tranches of one international loan. Prior to the passage of the IET, United States investment bankers had for many years placed with foreigners substantial portions of securities issued in New York by European and British Commonwealth borrowers. With the large scale entry of United States borrowers in mid-1965, the scope of American bankers' European operations was greatly increased. Thus during the first six months of 1966, United States investment bankers participated in the underwriting of almost all dollar issues in Europe.

Italian banks are also achieving a more important position in the underwriting of international issues thanks to the investment interest of their clients. Dutch and Swiss banks, which were predominant as underwriters in 1960-62 when their governments permitted a larger volume of foreign security issues, have played lesser roles since 1963. The failure of Swiss bankers to assume the underwriting function on other than Swiss franc issues, in spite of large purchases of many other issues by their clients, was governed by the attitude of the Swiss authorities and by certain tax disadvantages on foreign issues underwritten in Switzerland. Foreign borrowers in Switzerland were required to pay a stamp tax of 1.2 per cent of the nominal value of the issue, and a coupon tax, payable annually, equal to 3 per cent of the interest paid on all securities issued in Switzerland.

In 1965, however, provision was made for the elimination of the coupon tax effective January 1967, and a consortium of Swiss banks has recently been formed to participate in international underwriting syndicates. The Swiss National Bank has agreed to a $10 million underwriting participation by the Swiss consortium in a $25 million issue, but reportedly on the condition that the issue not be advertised in Switzerland and that 50 per cent of the portion underwritten by Swiss banks be placed with foreigners.

CONCLUDING REMARKS

International security issues are basically of two types: those which are subject to the strict control of national issue authorities and those which are largely free of such controls. Nearly all the major financial centers have felt constrained to impose some degree of capital issue control, especially with regard to foreign issues in their national currencies. The largely control-free sector of the market, centered in issues denominated in dollars, German marks, and units-of-account, constitutes both a safety valve and a limited channel of communication between national capital markets. Given institutional restraints within each market, the existence of this unrestricted market has not served to eliminate interest rate differences between national markets. But it has given large borrowers an alternative to their domestic markets. This, combined with the already existing international mobility possessed by security purchasers, has served to reduce the barriers tending to isolate these markets. Ideally, however, the relaxation of issue controls in the major financial markets and the reduction of other institutional barriers to international capital movements remain the best means to achieve an improved international distribution of capital resources.