Recent Innovations in European Capital Markets*

In his foreword to a study of European capital markets prepared by the United States Treasury in late 1963, Secretary of the Treasury Dillon noted that many of the factors that have tended to limit the growth of these markets "are now receiving the attention of financial leaders in Europe", and that "progress toward improving the efficiency of these markets has begun". In particular, the Secretary noted that:

> Several possible means of promoting international security issues, thereby broadening the potential market and bringing together larger aggregations of underwriting support and distribution facilities, are being actively explored. . . . New initiatives are being taken to eliminate barriers to foreign security offerings and to facilitate the use of the most developed markets within Europe as a kind of financial entrepôt for the use of borrowers and lenders of other nations.[1]

The current renewal of European interest in long-term lending, the increasing interdependence of European financial centers, and the movements of capital between those centers can be traced back to the return to convertibility of the major European currencies at the end of 1958. They were given added impetus by the progress in relaxing restrictions on capital transactions made by most European countries during the last few years. But the marked increase in the volume and types of foreign issues in European capital markets during the past year and a half—the subject of this article—was sparked by two more specific developments: in July 1963, President Kennedy proposed to Congress the imposition of an "interest equalization tax" on purchases of foreign securities by United States residents;[2] and at about this same time the British authorities were preparing the way for greater international use of the London capital market. These two developments had the effect of diverting new securities issues of industrial countries from the New York market, which had been heavily utilized by such borrowers. Concurrently, the international financial scene began to display some novel and noteworthy features, to be discussed here: the re-emergence of London as an important center for the underwriting of foreign issues; the growth of dollar issues placed outside the United States; the increase in foreign issues in Continental markets, especially Germany; the flotation of loans denominated in the so-called "unit of account"; the proposed flotation of different tranches of an issue in several centers; and increased international cooperation among financial institutions.

FOREIGN ISSUES IN THE LONDON MARKET

Participation by residents of the United Kingdom in foreign securities issues denominated in currencies other

* John Hein had primary responsibility for the preparation of this article.

[1] "A Description and Analysis of Certain European Capital Markets", Paper No. 3 of *Economic Policies and Practices*, Materials Prepared for the Joint Economic Committee, Congress of the United States, 1964, p. xi.

[2] The tax—which was enacted in September 1964, retroactive to July 1963—applies to foreign stocks and bonds, both new and outstanding, purchased from nonresidents. It specifically exempts, however, securities of international organizations of which the United States is a member, governments of less developed countries, and corporations whose principal activities are in such countries. New Canadian issues are also exempt by special Executive Order. The tax is 15 per cent on stock and other equity interests. On debt obligations (of three years or more) it ranges from 2.75 to 15 per cent, according to the remaining maturity, and is so calculated as to increase by about 1 percentage point the interest cost to foreigners of obtaining capital in this market. The legislation does not extend to bank loans made to foreigners in the ordinary course of banking operations, but grants stand-by authority to the President to apply the tax to such loans of over one year, if he should find that they "are being used to circumvent the purpose of the legislation".

than sterling remains severely limited by present British exchange controls. But this has not prevented the City of London from expanding the scale of its brokerage and underwriting activities, frequently in close cooperation with European banking houses. Its highly efficient machinery has enabled it to bring together borrowers and lenders in the underwriting of foreign issues.

As far back as October 1962 the London financial community, with the encouragement of the Bank of England, began to consider ways and means of acting as middleman between foreign borrowers and lenders. The objective was greater use of the City's capital market facilities without triggering substantial additional capital outflows from the United Kingdom to nonsterling countries. Loans of foreign-owned funds to foreign borrowers arranged in the London market have no adverse effect on the British balance of payments; in fact, they provide invisible earnings from the City's banking services, and quite possibly additional exports. Thus in early October 1962 the Governor of the Bank of England declared:

> The time has now come when the City once again might well provide an international capital market where the foreigner cannot only borrow long-term capital but where, equally important, he will once again wish to place his long-term investment capital. This entrepôt business in capital, if I may so describe it, would not only serve this country well but would fill a vital and vacant role in Europe in mobilizing foreign capital for world economic development. It would be to the advantage of British industry in financing our customers.[3]

Specific moves in this direction were announced in the April 1963 budget, which included provisions for lowering the stamp tax on stock transfers and for the issuing of bearer, as well as registered, securities. The tax on bearer securities, previously set at 6 per cent of the nominal value, was reduced to 3 per cent of market value on securities issued by residents and to 2 per cent on those issued by nonresidents. For registered securities, the rate was reduced from 2 per cent to 1 per cent (calculated at market value). Bearer issues had generally been prohibited since World War II, for exchange-control reasons.

These changes, which became effective in August 1963, and the general encouragement of foreign issues by the British authorities have resulted in a considerable expansion in the use of the London capital market by Continental European countries and Japan. Most of this activity has taken the form of dollar operations in which British financial institutions have acted as underwriters, gathering dollar funds owned by non-United States residents and putting them to work in longer term loans. (Previously, such funds might of course have been attracted into foreign issues floated in New York.) In a few cases, other nonsterling currencies have been used as well, and some issues have been denominated in sterling. (Countries belonging to EFTA—the European Free Trade Association, of which the United Kingdom is a member—have been given the right to raise loans in London in either sterling or foreign currencies.)

These foreign issues began in May 1963 with a private placing by the Belgian Government of $20 million in three-year bonds, the first loan not denominated in sterling placed in London since World War II; a second similar Belgian placement followed in December 1963. Meanwhile, another important issue occurred in July 1963, when a London merchant bank agreed to float—jointly with three banks in Belgium, Germany, and the Netherlands—a $15 million issue of a private Italian company engaged in operating and maintaining Italy's new national highway system. This issue attracted considerable attention as the first postwar nongovernmental (although government-guaranteed) issue in a foreign currency to be floated in London. The first postwar offering of sterling bearer bonds by a nonsterling-area country followed in August 1963 in the form of a £5 million refunding issue by the Government of Japan.

On the occasion of the Lord Mayor's dinner in October 1963—one year after the Governor of the Bank of England had called for the re-establishment of the City of London as a financial entrepôt—the Chancellor of the Exchequer praised the London market for its contribution to invisible earnings in Britain's balance of payments and declared that "for the future, foreign currency loans, i.e., those which are no drain on the reserves, are being allowed almost without restriction". The Chancellor thus indicated that the authorities were satisfied with the initial response of the City, but also that they were not yet ready to permit a further relaxation of controls over the outflow of British funds to the nonsterling world. This also meant that the proceeds of sterling loans raised by nonsterling-area borrowers were to be spent on purchases of goods and services in the United Kingdom, but such loans have in fact been negligible.

Since late 1963, British underwriters have arranged in the London market a fairly continuous series of nonsterling issues, all but one of which have been denomi-

[3] Speech delivered at dinner given by the Lord Mayor to the Bankers and Merchants of the City of London, October 3, 1962.

Table I
UNITED STATES DOLLAR ISSUES IN EUROPE
July 1963-December 1964

Borrower or country of borrower	Amount (millions of dollars)	Number of issues	Comment
Japan	132.0	10	$22.5 million by city of Tokyo; remainder by private industry
Denmark	107.0	8	All by public sector or nationalized industries
Norway	92.0	7	All by public sector or nationalized industries
Italy	50.0	3	$25 million by state holding company; $15 million by national highway system; $10 million five-year issue by official long-term lending institution
European Coal and Steel Community	30.0	1	
Austria	28.0	2	$18 million by government; $10 million by nationalized steel company
Finland	26.0	3	All by private industry
European Investment Bank	25.0	1	
Belgium	20.0	1	Privately placed three-year government issue
Portugal	20.0	1	National government
Council of Europe	10.0	2	European Resettlement Fund
Israel	5.0	1	Private development corporation
Total	545.0	40	

nated in dollars.[4] In this connection it is worth recalling that London has an underwriting mechanism developed over a period of about 150 years and can provide quotation on Europe's largest stock exchange. Furthermore, various recent British steps, such as the resumption of bearer securities, should go a long way toward inducing international investors to make use of London's financial facilities. Finally, the London market has shown its ability to attract funds from a number of financial centers for investment in securities issued by borrowers with excellent international credit standing.

In the past year or so, British financial institutions have also participated in the sizable amount of dollar issues outside the United States that were arranged and underwritten by consortia headed by banks on the European Continent or by United States underwriters. Several of these issues have subsequently obtained quotation on the London Stock Exchange, and some have also been listed on the New York Stock Exchange, which permits the listing of certain foreign issues even when no distribution takes place to United States investors. New dollar issues outside the United States and underwritten by institutions in London and other centers rose from $35 million in the second half of 1963 to $330 million in January-June 1964 and amounted to an additional $180 million in the second half of 1964. About two thirds of this grand total of $545 million was arranged and placed in the London market. These bonds have generally been of 15 or 20 years' maturity, carrying a 5½ to 6½ per cent coupon. The major borrowers have been governments, municipalities, and industrial firms of the Scandinavian countries, Finland, and Japan, with Japanese issues alone accounting for some $132 million or 24 per cent of the total (see Table I).

FOREIGN ISSUES IN CONTINENTAL MARKETS

In addition to dollar issues arranged and placed on the European Continent, there has been a rise recently in foreign issues floated in certain Continental European markets and denominated in national currencies. The most noteworthy development in this respect has been the sharp increase in foreign issues in Germany. Such issues (all of which were denominated in German marks) rose to nearly $225 million equivalent last year, from only $40 million in 1963 and $25 million in 1962. As in the case of dollar-denominated issues placed in Europe, the bulk of the foreign loans floated in Germany was accounted for by Scandinavian, Finnish, and Japanese borrowers, with Japan alone taking $75 million or one third of the total (see Table II). The remainder consisted of issues by international institutions, including the Inter-American Development Bank. Again, as in the case of European dollar issues, these German mark loans generally are bonds of 15 or 20 years' maturity carrying a 5½ to 6½ per cent coupon.

This record activity in the German market seems to have been stimulated not only by the United States interest equalization tax, but also by proposed German legislation. In order to curb the inflow of long-term capital and thereby alleviate the German payments surplus, the German authorities in March 1964 proposed a 25 per cent withholding tax on nonresidents' interest income from German bonds. It was announced subsequently, however, that the tax—which has not yet been enacted—would not

[4] The exception was a 60 million Swiss franc loan floated by the city of Copenhagen in October 1963. This issue met with objections by the Swiss authorities. Its denomination in Swiss francs was regarded as interfering with Swiss controls over domestic liquidity and new issues in the Swiss market, and as contributing—to an undesirable degree—to the use of the Swiss franc as an international currency. A $25 million loan by IRI, the Italian state holding company, in June 1964 could be subscribed to (and issued) in either dollars or German marks.

Table II

FOREIGN ISSUES IN GERMANY IN 1964

Borrower or country of borrower	Amount (millions of dollar equivalent)	Number of issues	Comment
Japan	75.0	2	$50 million by government; $25 million by city of Osaka
Finland	47.5	4	$23 million by government; rest by long-term lending institutions
European Coal and Steel Community	25.0	1	
European Investment Bank	20.0	1	
Denmark	18.8	1	City of Copenhagen
Inter-American Development Bank	15.0	1	
Eurofima	12.5	1	Company established by sixteen European national railway administrations to finance rolling stock
Norway	10.0	1	City of Oslo
Total	223.8	12	

apply to income from German mark issues of foreign borrowers. This provision greatly stimulated demand for such issues, presumably to a large extent by foreigners (who during the second quarter sold sizable amounts from their German domestic bond holdings). It also enabled foreign borrowers to place their issues in the German market on somewhat more favorable terms than German borrowers could receive. In addition, the German authorities have proposed abolition of the 2½ per cent tax which foreign and private domestic borrowers currently have to pay on new issues; this should further facilitate the placement of foreign securities on the German market.

In France, where no issues by borrowers outside the franc area had been permitted since World War II, the authorities in November 1963 announced their intention to authorize the reopening of the capital market to foreign borrowers. Such issues (whose proceeds are to be spent largely in France) initially have been limited to international institutions. Accordingly, in December 1963 the European Investment Bank was able to place a 60 million franc ($12 million) issue with French insurance companies and other institutional investors. This was followed in July 1964 by a 150 million franc ($30 million) flotation of the European Coal and Steel Community. In Belgium—where until 1960 most foreign issues were those of the Congolese colonial authorities and of companies active in the Congo—the European Investment Bank in December 1963 made a further private placement of 400 million francs ($8 million).

Some European countries, such as the Netherlands and Switzerland, have of course long been substantial exporters of long-term capital. But the Netherlands closed its market to foreign borrowers in 1963, and except for two issues totaling 55 million guilders ($15 million) by the European Investment Bank and the European Coal and Steel Community the market remained closed in 1964 as well. This decision largely reflected the desire of the Dutch authorities to prevent the capital outflow and the upward pressures on domestic interest rates that might have resulted from foreign flotations. And in Switzerland, which maintains strict controls over all new issues, a heavy demand for capital by domestic borrowers led the authorities to adopt a somewhat stricter attitude toward foreign issues. As a result the 379 million francs ($88 million) of such issues authorized last year was noticeably below the 588 million francs ($136 million) permitted in 1963.

NEW TYPES OF FOREIGN ISSUES IN EUROPE

The search for ways to attract long-term funds into foreign issues led at one time to the flotation of bonds denominated in European "units of account". However, there have been only six such issues, totaling $68 million, and none has been floated since April 1964 (see Table III). The issues, with maturities ranging between 15 and 20 years and coupons between 5½ and 6 per cent, were generally offered in Luxembourg, with a Belgian or Luxembourg bank heading the underwriting syndicate. United States underwriters participated in two issues.

Units of account, which were first used in the bookkeeping of the former European Payments Union,[5] are a composite of seventeen European currencies. They serve as a common denominator for issues floated in several markets and provide a limited guarantee against exchange rate changes for debtors and creditors with liabilities and claims in foreign currencies.

The unit of account is an entirely artificial yardstick that is used solely to measure the value of contractual loan

[5] The European Payments Union was established in 1950 under the aegis of the Organization for European Economic Cooperation, and continued to function until the advent of convertibility at the end of 1958. It was designed to achieve transferability of the currencies of its seventeen members through monthly settlements of each member's current payments with the other members as a group. The net debtor or creditor positions resulting from the clearing were expressed in "units of account" (1 unit = 0.888671 grams of fine gold = US$1) and were settled partly in gold or dollars and partly by credits granted to or received from the Union.

Table III

UNIT-OF-ACCOUNT ISSUES

Borrower	Amount (millions of dollar equivalent)	Date	Comments
SACOR (Portugal)	5.0 5.0	February 1961 May 1962	Partly state-owned oil refinery
Norges Kommunalbank (Norway)	12.0	January 1963	State-owned long-term credit institution
Imatran Voima (Finland)	5.0	July 1963	State-owned electric-power company
Cassa per il Mezzogiorno (Italy)	18.0	October 1963	Official development fund for southern Italy
Banco de Fomento Nacional (Portugal)	13.0	November 1963	Official development bank
Greater Copenhagen (Denmark)	10.0	April 1964	Seven Copenhagen municipalities
Total	68.0		

obligations. It is not a means of exchange, but is designed to minimize exchange risks by keeping the value of claims and liabilities as constant as possible. As under the European Payments Union, each of the seventeen Western European currencies that are included—the so-called reference currencies—bears a fixed relationship to the unit of account through its own gold/dollar parity as communicated to the International Monetary Fund.[6] Since its appearance in early 1961, the unit-of-account formula has taken a number of different forms. It has always provided that the value of the unit would change only if the values of all seventeen reference currencies changed; however, under the terms of the more recent loan agreements at least two thirds of these changes must be in the same direction. Under these conditions, the value of the unit—and hence of the securities denominated in these units—would be adjusted, after a lapse of two years, in the same direction and proportion as the currency among the two thirds (or more) that had changed the least. The protection afforded by this complex formula is of course not absolute. It does not cover the borrower if his currency is devalued, or the lender if his is revalued, vis-à-vis all the others.

Belgian bankers who are the original sponsors of this new means of financing—in particular Fernand Collin of the Kredietbank—readily admit that "the system is not simple and certainly not for people who are unfamiliar with monetary problems". The scheme "had to be complicated, because every possibility had to be foreseen—even those that will probably never occur",[7] but it was hoped such a multicurrency unit would provide a means of weaning the Continental investor away from his preference for local issues (or for the hoarding of gold).

It is important to note that all unit-of-account issues have been floated by either nationalized companies or private companies in which the government is the main shareholder. Moreover, in four of the issues (the second through fifth in Table III) payment of interest and principal is guaranteed by the government—which adds to the attraction that such issues may have for the lender. The borrower can probably raise funds in this fashion in larger amounts and on more favorable terms than in any one national capital market, but he can also incur commitments in foreign currencies that few private borrowers may wish to take on.[8]

An additional procedure that would permit foreign borrowers to obtain a larger amount of savings than could be tapped in any one Continental market has been proposed though not yet implemented. This is the so-called European parallel loan, which would involve the simultaneous flotation on different markets of different tranches of an issue, with each tranche denominated in the national currency of the country in which it is placed. This proposal was put forward in the fall of 1963 by Hermann J. Abs of the Deutsche Bank. In Mr. Abs' view,

> each individual loan could be raised within the limits of each country's financing capacity in different amounts varying between the equivalents of, let us say, \$5, \$10, \$20, or even \$50 million. In spite of their plurality, the European capital markets could then represent themselves as one

[6] Thus, one unit of account equals 0.357 pound sterling or 4 German marks or 4.937 French francs, and so on.

[7] F. Collin, "Europe's Unit of Account", *Statist*, February 28, 1964, p. 635.

[8] Another type of bond issue that, in a very limited sense, can be compared to unit-of-account financing was offered in Europe in 1964. These are issues with an exchange option, which entitles the lender to request payment of interest and amortization in one or more currencies, including or excluding the currency in which the issue is denominated. The Finnish Government borrowed 40 million marks (\$10 million) in Germany on this basis, with investors having the option of receiving payment in marks or dollars; and the city of Turin raised £4 million (\$11 million) in London, with a repayment option in sterling or German marks. Although this issue was denominated in sterling, subscriptions had to be paid for in external sterling, i.e., sterling held by nonsterling-area residents, which for all practical purposes is like any other foreign currency for British investors.

> market well capable of raising a total amount not falling short of that which the United States market could provide.[9]

In such issues, the terms and conditions of all tranches would be as uniform as possible. Variations in the issue price would take account of differences in long-term rates in the different markets. Since this type of issue is largely designed to appeal to institutional investors—such as insurance companies and pension funds—that are limited to or prefer investment of their funds in securities denominated in their national currencies, the risk is reduced that investor demand would tend to concentrate on the highest-yielding tranche.[10]

INTERNATIONAL COOPERATION AMONG FINANCIAL INSTITUTIONS

Recent years have also witnessed a general broadening of cooperation among financial institutions, both within Europe and between Europe and other continents. Indeed, it can be said that a more truly international financial community is gradually coming into being, stimulated no doubt in good part by the new worldwide money market in dollars and European currencies. (One of the important characteristics of this market is that funds in a given currency may be deposited with banks in various countries and traded actively among nonresidents.) This internationalization of financial markets is reflected in the proliferation of foreign branches and agencies of commercial banks; in the cooperation across national frontiers among financial institutions in such sectors as mortgage and real estate financing, international investment trusts, instalment credit, and equipment leasing; and in the setting up of international banking groups.

For example, new links have been forged between British financial institutions and their counterparts outside the United Kingdom. In December 1963, the Midland Bank announced two separate moves in this direction. The first was an agreement with the largest commercial bank in each of three Continental countries—the Amsterdamsche Bank (since merged with the Rotterdamsche Bank), the Société Générale of Belgium, and the Deutsche Bank—to form a "European Advisory Committee". Under this agreement, the four banks are pooling information about investment and credit conditions in their countries and have set up arrangements for giving special attention to each other's customers.

The second move, announced a few days later, was the creation of Midland and International Bank Ltd. by the Toronto-Dominion Bank, the Standard Bank (South Africa), the Commercial Bank of Australia, and the Midland Bank itself. In this grouping—which is backed by £3.4 billion of resources and a combined network of 5,000 branches—the links are considerably more formal. The Midland Bank will hold about 45 per cent of the £10 million issued share capital and the Canadian, South African, and Australian members about 25, 20, and 10 per cent, respectively. In addition to the continuing exchange of information, the operations of the new institution will include medium-term export financing (up to ten years), the financing of projects in the four countries, participation with outsiders in larger scale financing, and—"in appropriate circumstances"—underwriting of new issues. These operations will be financed by the acceptance of deposits from the public for up to twelve months. Despite the Commonwealth slant of the new group, the four founding banks have noted that they stand ready to admit new partners from any quarter.

Both of these moves are significant in many respects. Especially noteworthy is the fact that under the first arrangement the Midland Bank will be linked with "universal banks" on the Continent—that is, with institutions able to engage in a much wider range of banking activities than British clearing-bank conventions allow. This arrangement joins not only banks but also capital markets—that of London, with acknowledged expertise, and those of three Continental countries, with various institutional inflexibilities but wider latitude for commercial banks. There can be little doubt that the greater internationalization of banking implied by these steps portends greater mobility of capital, which may in turn contribute toward a lowering of barriers between individual European markets.

CONCLUDING OBSERVATIONS

The recent growth in foreign issues in European capital markets suggests that Europe may eventually become again an important exporter of long-term capital. It will be recalled that prior to 1914 Europe played a key role in this respect and made a major contribution to the early development of public facilities (such as transportation) in

[9] Hermann J. Abs, "Parallel Loans to Mobilize Continental Funds", *The Times* (London), March 11, 1964.

[10] A variant of this type of financing, actually used in two Belgian issues in 1960 and 1961, is an exchange-option issue in which the investor has the choice of subscribing in one of the currencies included in the option, in addition to the choice as to interest and amortization payments. Investors in countries whose currency is so included could then consider the bonds as denominated in their national currency.

Eastern Europe, the Western Hemisphere, and other then-underdeveloped countries. Subsequently, Europe's ability to function as a long-term capital exporter was curbed by a series of events—World War I and its aftermath, the economic disturbances of the 1930's, World War II, the needs of postwar reconstruction and, finally, the unprecedented investment boom in Europe itself. In the past year and a half, however, Europe has been able to increase markedly the volume of its foreign lending, partly as a result of the capital market techniques described in this article. These have the common characteristic of making it possible to mobilize the resources of several European financial centers at one time, with the issues expressed in dollars or in other currencies that have considerable investor appeal across national frontiers.

However, it is generally true that the net benefit of the international movement of capital will be more nearly assured if capital can move equally freely among different countries. To the extent that countries retain controls over foreign issues in their markets as well as over investor participation in issues abroad, the burden of providing capital internationally is shifted largely to other countries. And, in these countries, long-term funds may tend to flow out at times and in ways that create difficulties at home for the national authorities. In other words, the new types of financing described here, whatever their merits, cannot be considered a substitute for a more far-reaching development and strengthening of freer national capital markets. Although it is likely that recent foreign borrowings in Europe have attracted some long-term European funds over and above those that ordinarily would have participated in such issues in the New York market, the increased international capital flows within Europe have perhaps been stimulated more by the novel (and, to investors, attractive) features of these issues than by a genuine broadening of the individual European markets themselves.

Such a broadening requires the easing or removal of a host of inhibiting factors—legislative, institutional, and psychological—that still characterize various foreign markets. These factors not only tend to bar the flow of capital between countries, but also to limit the efficiency, growth, and diversification of domestic capital markets in general. Such factors, of course, vary in nature and degree of applicability from country to country. They include exchange controls, discriminatory treatment of foreign borrowers, strict regulations governing the composition of the portfolios of institutional investors (which often discriminate against foreign securities), various listing and trading restrictions on foreign issues that are stricter than those on domestic securities, and—on a more general plane—controls over new issues, the pre-empting of the market by the public sector, and official encouragement of specific types of financial investment. If the reform of national markets were to be accelerated, both their domestic activity and their internationalization might be furthered substantially.

As regards the United States, this country's balance of payments has benefited from the proposal and subsequent enactment of the interest equalization tax, which brought about a shift of new foreign issues by European and Japanese borrowers from the New York market to European financial centers. As a result, United States investors reduced their purchases of new European and Japanese issues from $326 million in the first half of 1963 to $110 million in the second half and to under $40 million in 1964; they continued of course to invest in issues of other borrowers, while United States banks substantially increased their loans to foreigners in general. It is clear that the proximate cause of any balance-of-payments relief obtained by the shift in borrowing to Europe has been the influence of the tax, rather than subsequent European adjustments. Moreover, the United States is still carrying a major share of the burden of providing long-term capital to the underdeveloped world. Steps that tend to make national capital markets in Europe more liberal and more genuinely "international" in their lending activities are therefore to be welcomed.