Euro-Bonds: An Emerging International Capital Market*

Throughout most of the postwar period, and indeed as late as 1963, virtually all bond issues floated by foreign borrowers outside their own national boundaries were offered through the facilities of a single national market —typically the New York, London, or Swiss markets— and were denominated in the currency of the country in which they were floated. In recent years, however, this conventional form of "foreign" bond issue has been eclipsed by the emergence of the Euro-bond market as the focal point for international issues. The Euro-bond market, although centered in Europe, has no national boundaries. Unlike most conventional bond issues, Euro-bonds are sold simultaneously in several financial centers through multinational underwriting syndicates and purchased by an international investment clientele which extends far beyond the confines of the countries of issue. The market has been tapped by a multitude of government and private borrowers from a wide range of foreign countries, and since 1965 United States corporations or their overseas affiliates have become the most important single group of borrowers. However, the one aspect of the Euro-bond market that most differentiates it from all conventional foreign bond issues is that Euro-bonds are denominated in a currency other than those of the markets of issue. Occasionally Euro-bonds are denominated in pounds sterling or German marks. From time to time, issues may provide currency options, which enable the creditor to demand repayment in one of several currencies and thereby to reduce the exchange risk inherent in single-currency foreign bonds. However, more often than not, interest and principal on the bonds are payable in United States dollars. In short, the Euro-bond market, as it has developed over the past few years, has become essentially a market for dollar-denominated obligations of foreign as well as United States borrowers, purchased by non-United States investors.

The need to create a more unified European capital market, although generally recognized for many years, became particularly pressing after mid-1963 when interest costs in the New York market increased substantially for European borrowers as a result of the United States interest equalization tax. Individual domestic securities markets in Europe have limited capacity to absorb large bond issues at frequent intervals, and access to these markets by foreign borrowers has long been subject to official restrictions. Indeed, almost all the major continental European countries exercise direct control over conventional foreign bond issues in their markets—in some cases to insulate the level of domestic interest rates from foreign demands and in others for balance-of-payments reasons. In contrast, the control exercised over European investors' purchases of foreign currency securities on foreign markets has been less stringent than the limitations on the issue of foreign securities in their own markets. Thus, in order to create adequate facilities for borrowers to raise funds in Europe, ways had to be found that would permit borrowers to tap several European financial centers simultaneously while avoiding restrictions on borrowing in local currencies. To achieve this, investment bankers in the United Kingdom, the United States, Belgium, and elsewhere began to arrange securities issues denominated in dollars or in European currencies for sale outside the country of currency denomination. This technique has not only avoided national restrictions of foreign borrowing in local currencies, but also enabled borrowers to mobilize funds on a continental scale.

The Euro-bond market in the few years of its existence has already developed into a highly efficient channel for the redistribution of savings, both within Europe and between Europe and the rest of the world. The market has managed to attract a stream of investors from European and other countries to take up issues at yields somewhat below those prevailing on a number of individual European capital markets. With the growth of the Euro-bond market, a number of European countries have reemerged

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as exporters of sizable amounts of long-term funds. The market has not only led to an international redistribution of long-term capital, but also tended to mobilize dollars that might have remained in official hands or in other forms of short-term investments. By linking the leading European capital markets together, the Euro-bond market has been an integrating influence on those markets in a period when steps toward more formal integration of capital markets have been very few.

THE DEVELOPMENT OF THE MARKET

Before the emergence of the Euro-bond market, most international borrowing took the form of flotations of dollar-denominated securities by foreigners in the New York market. Canadian and World Bank bond issues accounted for virtually all the funds raised by nonresidents in New York prior to 1958, but thereafter there was a steady growth in bonds issued by Western European countries as well. Although United States investors were the major source of funds for the purchase of these issues, substantial amounts were also purchased by European and other nonresident investors, particularly after the return to convertibility of the major European currencies at the end of 1958. In numerous cases, New York underwriters of foreign bonds offered in the United States arranged a selling group of leading banks and dealers in the major European financial centers to facilitate sales of bonds to non-United States investors. Foreign investors often found foreign dollar bond issues attractive not only because they were denominated in dollars, but also because yields on foreign governments' dollar issues offered in the New York market were often higher than those on bonds of the same governments issued in their domestic markets and denominated in local currencies. To the extent that foreign funds were attracted, the New York market served as an intermediary between foreign borrowers and foreign lenders. Thus, long before the Euro-bond market had emerged as the dominant segment of the international capital market, dollar-denominated bonds had become an important instrument through which non-United States lenders could employ their resources internationally.

The market for dollar-denominated bonds issued outside the United States first began to take shape after the announcement of the United States interest equalization tax in July 1963. With the announcement and later the retroactive imposition of the tax, borrowers from most Western European countries and Japan were effectively discouraged from participation in the United States capital market. Although the American lender was (and remains) legally liable for the interest equalization tax, in effect the foreign borrower has to absorb most or all of the tax, since to be salable to United States investors the after-tax yield must be competitive with yields on comparable domestic securities. Consequently, new foreign bonds issued by developed countries in the New York market quickly subsided. For those borrowers subject to the tax, the only feasible alternative source of international funds was Western Europe itself.

Initially, the center of international financing shifted to London. Shortly before the announcement of the United States interest equalization tax, the London capital market had begun to reemerge as an important center for international securities issues.[1] As far back as October 1962, the British authorities had begun to explore the possibility of reviving London as a capital market where foreign-owned funds could be channeled to borrowers through the issue of foreign currency bonds, that is, bonds denominated in currencies other than sterling. The use of a currency other than sterling was necessary to minimize outflows of domestic funds for the purchase of nonresident issues. In other respects, however, the London market, with its long tradition in the issuance of overseas loans, was in a good position to take advantage of the effective closure of the New York market. Most of the leading financial institutions in London had extensive overseas connections. Costs of placing a foreign issue in London were lower than in Continental centers and, on average, not much higher than in New York. Finally, London provided all the advantages of a broad and active securities market.

Specific steps were taken to make the London market even more attractive for nonresidents in August 1963, when the issue of bearer securities which had been prohibited for exchange control reasons was again permitted and the tax on securities transfers was reduced substantially. At about the same time, the facilities of the London market were opened to members of the European Free Trade Association (EFTA) to raise loans in sterling, and in October were extended to all other countries for the issue of foreign currency bonds. Foreign borrowers quickly responded to these measures. As early as May 1963, the Belgian government issued the first of a series of dollar-denominated bonds in London, all of which were sold to investors outside the United States.

The Belgian issue was soon followed, shortly after the

[1] For a discussion of the revival of the London capital market, see "Recent Innovations in European Capital Markets", this *Review* (January 1965), pages 9-15.

interest equalization tax was announced, by a series of flotations by other European borrowers and Japan. From July 1963 through the end of 1964, more than $800 million was raised through Euro-bonds, most of which were issued through London and denominated in dollars. The bulk of the bonds was issued by the Scandinavian governments and by private borrowers from Japan, all of whom had been large borrowers in the New York market before mid-1963. Borrowers from the same countries also turned to domestic securities markets on the Continent, but the scope for conventional bond issues was further reduced in April 1964 when the Swiss authorities placed severe restrictions on new foreign issues. Indeed, by 1964, the first full year after the announcement of the interest equalization tax, the volume of Euro-bond sales, at about $700 million, was more than twice as large as the combined amount of conventional foreign bond issues floated in both London and in Continental financial centers.

The shift of European borrowing from the New York market to London and other European financial centers was followed in the latter half of 1965 by the entry of United States corporations or their foreign affiliates as large borrowers in the Euro-bond market.[8] Under the voluntary balance-of-payments program, announced in February 1965, participating corporations were asked to improve by 15 per cent to 20 per cent the aggregate of selected components of their individual balance of payments with developed countries. A wide range of possibilities was allowed to achieve this improvement, including higher exports, increased repatriation of earnings, and increased borrowing abroad. As a result, participating corporations began to borrow heavily overseas, even at interest rates substantially above those in the United States. The demand for finance was initially met through direct borrowing from banks, but after mid-1965 the volume of Euro-bond flotations by United States firms began to increase sharply, and for the year as a whole amounted to $331 million, or about one third of total Euro-bond issues. With the appearance of United States corporations as large borrowers in the Euro-bond market, the London institutions that had been active in the market lost their early lead as sponsors of Euro-bond issues to New York underwriters.

The adoption of progressively more stringent balance-of-payments guidelines for United States companies in 1966 and again in 1967 resulted in a further increase in their recourse to the Euro-bond market. However, during 1966, as credit conditions tightened throughout the industrial world, offering yields on Euro-bonds rose to the highest levels in the short history of the market. A large number of borrowers postponed previously announced issues, pared down the size of their borrowings, or in some instances shortened the maturity of the loans in order to avoid expensive long-term commitments. With the return to monetary ease on the Continent in 1967, more normal issue activity was resumed and the volume of Euro-bonds amounted to almost $1.9 billion. Issues by United States borrowers again accounted for roughly one third of the total. Since the start of 1968, and largely as a consequence of the new United States balance-of-payments program, United States companies have clearly become the dominant borrowers in the market.

BORROWERS, LENDERS, AND INTERMEDIARIES

As noted above, the Euro-bond market, in its early stages, was used primarily by borrowers from a relatively small group of industrialized countries, all of which had relied heavily on the New York market before mid-1963. As a group, the Scandinavian countries, particularly Norway and Denmark, have always ranked among the leading borrowers in the Euro-bond market. Other members of the EFTA, notably Portugal and Austria, have also utilized the market to a considerable extent. Japan was a heavy borrower in 1964, but in 1965, when it received a limited exemption from the United States interest equalization tax, Japanese borrowers again began to turn increasingly to the New York market. International institutions, largely the European Coal and Steel Community and the European Investment Bank, have borrowed steadily for a number of years. Among the leading non-European borrowers other than United States companies, the Australian and New Zealand governments have been the most continuous and active participants in the market.

During 1967 the market was broadened by the entry of several continental European countries which had not previously utilized the market on a very large scale. France alone absorbed $157 million through Euro-bond issues, and Spain entered the market for the first time. In total, flotations by European borrowers amounted to almost $950 million during 1967, or almost twice as much as the volume of issues by United States companies. A num-

[8] For tax and other reasons, borrowings by United States corporations are usually done through financial subsidiaries, domiciled in either Luxembourg or Delaware. In either case, purchases of these bonds by United States residents are subject to the interest equalization tax. Thus, bonds issued by United States companies are described throughout this paper as United States borrowing abroad, although in a technical sense bonds issued through Luxembourg-based affiliates represent borrowing by overseas affiliates of United States firms.

ber of less developed countries in Latin America also appeared in the Euro-bond market, despite their exemption from the United States interest equalization tax. The Mexican government entered the market for the first time in 1967, borrowing a total of $85 million through a series of issues at rates not substantially higher than market yields on its outstanding bonds in the New York market.

United States companies, as already noted, absorbed almost one third of the funds raised through the Euro-bond market in each of the past three years, but in recent months the market has seen an avalanche of issues by United States corporations. Under the revised and more stringent balance-of-payments program announced on January 1, 1968, transfers of United States funds for direct investment in most Western European countries are subject to a complete moratorium. The new program permits companies to continue to invest abroad, but they must rely to a far greater degree than before on foreign sources of funds and, within the allowable limits, on reinvested earnings. In effect, overseas projects must be financed largely with funds obtained locally—through the Euro-bond market, through bank borrowing, or through the regulated and limited national securities markets. In response to the program, affiliates and subsidiaries of United State corporations borrowed about $1.3 billion through the Euro-bond market during the first half of 1968 alone—an amount roughly double the volume of United States borrowings for 1967 as a whole. As a result, the total volume of Euro-bond flotations by all borrowers during the first half of 1968 rose to an estimated $1.7 billion—or more than the volume of conventional foreign bond issues in Europe and the United States combined.

This enormous surge in the amount, frequency, and average size of the flotations has been absorbed by the market with relatively little difficulty. To be sure, new issue activity came to a virtual standstill in March as a result of the uncertainty in the gold and foreign exchange markets, and offering yields on straight debt bonds issued by United States corporations this year have risen to as high as 7.5 per cent. In an effort to broaden investor interest, United States (and other) corporate borrowers have shifted increasingly from straight debt issues to bonds convertible into common stock.[8] Thus far this year, convertible issues by United States corporations have amounted to about two thirds of their total. In every instance, the convertible issues have been oversubscribed, at yields close to 5 per cent. The marketability of such issues depends, of course, on the terms of the conversion, how foreign investors rate the company's stock, and on general stock market developments in the United States. In a declining market, convertible issues might not normally sell as well as they have this year. Nevertheless, the shift from predominantly straight debt to convertible issues has considerably extended the absorptive capacity of the Euro-bond market.

The funds invested in Euro-bonds come from a variety of sources outside the United States, although their relative importance is difficult to quantify. Whether issued by United States or foreign borrowers, the bonds must find their market almost exclusively with non-United States investors. Purchases by United States residents are probably negligible because they are subject to the interest equalization tax, and the net yield on Euro-bonds after payment of that tax has generally been lower than yields on comparable domestic securities. Of course, some funds may become available indirectly from the United States if foreigners, in order to acquire Euro-bonds, sell some of their holdings of United States securities to United States residents.

British investors can participate in Euro-bond issues only by purchasing investment dollars at a premium or by borrowing dollars either through the Euro-dollar market or directly from United States banks. Such borrowing is subject to official approval, however, and after allowance is made for the cost of obtaining dollars through these channels, there is usually little or no incentive for United Kingdom investors to purchase Euro-bonds. However, with the exception of the Scandinavian countries, few countries on the Continent maintain any restrictions that impede the flow of funds into the Euro-bond market. Italy has been a large and continuous lender in the market for several years, and the net flow of funds from the Netherlands and Belgium has been considerable at times. Although German banks have participated actively in underwriting and selling Euro-bonds, German investment in the Euro-bond market has been relatively small because yields on domestic securities were, until quite recently, considerably higher. Since the start of 1968, however, as long-term interest rates in Germany moved lower, German residents have become large investors in Euro-bonds. Switzerland has been the most important single source of funds for investment in the Euro-bond market, particularly since late 1966 when Swiss banks entered the market as formal underwriters and on that basis alone

[8] For the nonresident investor, one of the main attractions of a convertible issue is that it usually offers a more generous current income than the dividend of the underlying stock. Not only is the coupon rate normally higher than the dividend yield on the stock at the time of issue, but the foreign investor, while subject to the United States withholding tax on dividend payments, receives bond interest free of United States tax.

tended to absorb one third or more of the issues. Thus, in broad terms, the most important sources of funds for investment in Euro-bonds are those countries with strong balance-of-payments or reserve positions, mainly continental European countries. However, a major part of the issues in Switzerland are subscribed for the accounts of nonresident holders of Swiss francs. In view of Switzerland's role as a haven for flight capital, a large part of the funds supplied to the Euro-bond market through the Swiss banks undoubtedly reflects participation by investors from the Middle East, Latin America, and other less developed areas.

In view of the need to reach an international investment public which is geographically widespread, the size of the underwriting syndicates participating in Euro-bond issues is usually much larger than those arranged for conventional bond issues. Indeed, the market has developed to its present size largely by patient and continuous expansion of the range of investors. For Euro-bond issues, a managing syndicate, which normally includes a minimum of four or five members, agrees to subscribe to the issue at the issue price, less a commission of about 2½ per cent. The leading members of the syndicate are usually drawn from New York, London, Belgium, and Germany, but many syndicates may include a leading bank of the borrowing country, particularly for Scandinavian or Japanese borrowers.

While many of the issues are sponsored by New York or London banks, the success of the market depends on a cooperative effort of a large number of financial institutions throughout Europe in placing loans with international investors. Once organized, the sponsoring syndicate makes arrangements with a group of underwriters—among them bankers and securities dealers—drawn from a wide range of countries. The principal underwriters in the market include a total of about 100 of the leading European banks, of which as many as 50 may be involved in marketing a single issue. Underwriting groups are chosen not only for their capacity to absorb the issues if the need arises, but also for their financial contacts and expertise in forming national selling groups which can place the issue with investors. In some instances, the underwriters act as the selling group itself. But more often than not, the selling group includes members not represented in the underwriting group and thereby achieves even wider geographic coverage. In this way, virtually the entire European capital market is tapped for funds.

Because of the careful management of the pace at which issues are brought forward, the periods of heavy overhang of securities in the market have been fairly brief. Since the same issuing houses act for many borrowers and appeal largely to the same group of investors, the flow of bonds to the market can be regulated and issue prices carefully tailored to changing market conditions. To be sure, the market suffered periods of "indigestion" in late 1965 and again during 1966 as interest rates rose sharply throughout Western Europe. Since then, however, periods of strain have been relatively short in duration and no more pronounced than those on domestic securities markets.

Indeed, with the notable exception of the Swiss capital market, the Euro-bond market is a less expensive source of long-term capital for foreign borrowers than most European domestic securities markets and not much more costly than the New York market. Part of the explanation would seem to be that almost all the issues are free of income or withholding tax of the borrowing countries, and since most bonds are issued in bearer form and held outside the country of the investor, the domestic income tax can be evaded. Thus, for all practical purposes, those investors who choose to do so may regard the gross yield on Euro-bonds as virtually tax free. A further explanation for the relatively low interest costs in the Euro-bond market is the character of the borrowers themselves. Many of the borrowing governments are regarded as prime borrowers in international capital market, as are most of the industrial and commercial borrowers. Finally, the use of the dollar as the predominant currency for Euro-bond issues has helped to extend the absorptive capacity of the market and at the same time stabilize market yields. Since there are no restrictions on the use of the dollar as a vehicle for international investment, foreigners can easily switch between dollar issues quoted in New York or elsewhere. In fact, the average yield in the New York market either on foreign bonds or on issues of United States corporations is, in a broad sense, the effective minimum yield which can be offered to investors in the Euro-bond market. For, if yields in the Euro-bond market fall below yields on comparable issues in New York, foreigners would tend to buy outstanding issues in New York.

CONCLUDING OBSERVATIONS

In less than five years, and largely as a consequence of United States balance-of-payments measures, Europe has become a major source of funds for foreign borrowers and has assumed the same role as an entrepôt that the New York market had played earlier. Indeed, many of the same considerations that had made the New York market attractive to both European borrowers and lenders have made dollar bonds attractive in Europe. Dollar-denominated issues can command wider participation, and hence a larger market, than securities denominated in other currencies. Thus, the market has widened the alternative sources of long-term capital available to borrowers. Moreover, for foreign lenders, especially those who prefer dollar-denominated assets, the array of investment opportunities has been broadened considerably.

The development and expansion of the Euro-bond market has major implications for the United States balance-of-payments position. When United States corporations finance foreign business investment through Euro-bond market borrowing rather than by exporting domestic funds, our balance-of-payments position benefits. The spending abroad of dollars acquired abroad merely results, of course, in a reshuffle among foreigners of an unchanged total of liquid claims against the United States. This contrasts with the case where a United States corporation spends abroad funds acquired in this country, the immediate effect of which would be to increase the total of foreign liquid claims against the United States and thus our deficit on the liquidity basis. Also, the Euro-bond market has helped to improve our balance-of-payments position by providing foreign official and private borrowers a viable alternative to the United States market. When foreigners borrow funds in this country for use elsewhere the United States balance of payments is worsened, but this is not the case when the borrowing is done in the Euro-bond market, even though the loans are denominated in dollars. The growth of Euro-bond issues has a potentially favorable effect as well on the United States balance of payments measured on the official reserve transactions basis. By limiting the expansion of liquid dollar claims held abroad in the manner described above, the spillover of dollars into foreign official reserves is diminished. Additionally, the presence of an attractive investment outlet for foreign-held dollar balances may tend to strengthen the willingness of private foreigners to accumulate liquid dollar balances rather than sell them to their central banks.

Of course, these beneficial effects on the United States balance of payments are partially offset, even in the short run, by an increase in interest payments to nonresidents. Moreover, to the extent that nonresidents' purchases of convertible bonds issued by United States corporations are financed through the sale of outstanding equities to United States investors, there is no improvement at all in the United States balance of payments, because in this case dollars would flow out from the United States to the same extent they would if the foreign investment had been financed here rather than abroad. (In fact, however, foreigners have been net buyers of outstanding United States securities in 1967 and thus far this year.) Finally, it should be noted that, if outstanding Euro-bond indebtedness of United States corporations should at some point begin to decline as a result of repayments exceeding new borrowings, the effect of that would be a deterioration in the balance of payments.

In addition to its effects on the balance-of-payments positions of this and other countries active in the market, the development of the Euro-bond market has introduced a new element of fluidity into the structure of European capital markets. As noted earlier, Europe's national capital markets are heavily insulated by a variety of regulatory, institutional, and psychological barriers to capital flows both within Europe and between Europe and the rest of the world. The emergence of the Euro-bond market has, however, tended to unify these individual markets. Since Euro-bond issues are for many European investors an alternative to long-term investments available in local markets, the Euro-bond market tends to bring long-term interest rates in Europe's various national markets closer together than they would be otherwise.

Despite the strong link which the Euro-bond market has forged between national markets, substantial insulation remains. Although liberalization of capital movements has gone quite far in a number of European countries, foreign bond issues are still treated on a discriminatory basis as compared with domestic issues. To be sure, the removal or relaxation of restrictions on foreign issues would undoubtedly result in some loss of control by the monetary authorities over the structure or level of domestic interest rates. But until foreign bond issues are permitted freely and on the same terms that govern the issue of domestic securities, European capital markets will remain less than fully integrated. The development of the Euro-bond market is only a partial substitute for the removal of many of the official restrictions that still characterize various European capital markets.