Growth and Retrenchment in the Euro-Bond Market*

The Euro-bond market, while suffering some decline in activity in recent months, has continued to play an important role in international finance by providing facilities that are attractive to both borrowers and lenders.[1] The market's success can be explained by its ability to provide access to funds on a worldwide scale and to avoid many official regulations concerning foreign borrowings in local currencies. At the same time, it offers investment opportunities which are exceedingly attractive because of the outstanding quality of the borrowers, the public quotation of the securities, and the high and, in practice, frequently tax-free yields. The introduction in this country of the mandatory Department of Commerce foreign direct investment restraint program early in January 1968 induced an accelerated growth of this market, as United States corporations began to raise long-term Euro-dollars on a large scale. Under this program, transfers of United States funds for direct business investment in most Western European countries were severely restricted; American companies were thus compelled to rely even more extensively than before on foreign sources of funds to finance their investments abroad. Largely as a result, in the fifteen months from January 1968 to March 1969, total new Euro-bond borrowings soared to nearly $4½ billion equivalent, almost as much as had been issued over the entire preceding four years.

This surge in Euro-bond flotations was absorbed with a minimum of difficulty, as borrowers adjusted the terms of their offerings to meet changing investor preferences and market circumstances. In the first half of 1968, the finance affiliates of American corporations borrowed more extensively than before by issuing dollar-denominated Euro-bonds convertible into the common stock of the parent company; then in the second half many borrowers turned increasingly to straight Euro-bonds denominated in German marks. But success brought trouble. Governments in several of the capital-exporting countries became concerned about the effects of large-scale capital outflows on their own balance-of-payments positions and on the availability of funds for their domestic borrowers. Thus, beginning in April 1969, several countries started to take steps to restrict resident purchases of Euro-bonds. Market factors also led to a sharp decline in new borrowing during the second quarter.

BACKGROUND: THE EURO-BOND MARKET'S WIDENING HORIZONS

By the time the 1968 foreign direct investment restraint program was introduced in the United States, the Euro-bond market had already proved it could accommodate borrowers from an increasing number of countries with the funds of investors from many parts of the world. When the Euro-bond market first emerged in 1963, it was used primarily by a few European institutions and by private and public borrowers in the small group of industrialized countries—members of the European Free Trade Association, Japan, and Italy—which, prior to the imposition of the United States interest equalization tax, had relied on the New York market for funds. By the end of 1965, the market had provided funds for borrowers in a wide variety of countries, including all members of the European Economic Community, and for today's most important borrowers, the finance subsidiaries of American corporations.

The ultimate investors in this market reside all over the globe, although funds are channeled almost entirely through those European countries which do not impede the flow of funds by way of exchange controls or tax laws. Switzerland has been the most important single supplier of funds,

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[1] For the purpose of this article, Euro-bonds are defined to be those issues sold simultaneously in several financial centers by multinational underwriting syndicates. For further discussion of this market, see "Recent Innovations in European Capital Markets", this *Review* (January 1965), pages 9-15; "Recent Developments in International Capital Markets", this *Review* (October 1966), pages 225-29; and "Euro-bonds: An Emerging Capital Market", this *Review* (August 1968), pages 169-74.

but more than half of the Euro-bonds taken up on the Swiss market have been purchased on behalf of the Swiss banks' foreign depositors. London, as well, has been a major center through which foreign-owned funds are transmitted to Euro-bond borrowers. More recently, Euro-bonds have been purchased in the Netherlands and Belgium for the account of foreign depositors and, when interest rates in the Euro-bond market were higher than those in domestic markets, also for the account of their own residents. Italian residents, too, have been consistent purchasers of Euro-bonds.

The Euro-bond market has been able to attract funds from a wide variety of sources through a complex network of multinational underwriting syndicates. London, with its long tradition in the issuance of overseas bonds, was the first center for Euro-bond borrowing. But the rapid growth of the Euro-bond market has attracted issuers in several other countries as well, and has drawn an increasing number of bankers and securities dealers into the international selling or "subunderwriting" groups that place the issues with investors. Luxembourg early became a major center largely because of favorable securities legislation and stock exchange regulations. New York underwriters became active sponsors, especially as United States corporations expanded their European borrowing. German banks have participated in multinational issuing syndicates on a large scale ever since the abolition of a new issue tax in 1965.[2] In the Netherlands, and after 1966 in Italy, banks were given general license to act as underwriters and to participate in selling groups for issues to be listed on foreign stock exchanges; consequently, they became increasingly active as members of issuing syndicates. Although from the beginning the Swiss banks took up by far the largest share of the Euro-bonds issued, they were unable to join issuing syndicates on a competitive basis, except as subunderwriters, until the abolition of a coupon tax on interest payments at the end of 1966. In order to maintain an adequate supply of capital for the domestic economy and to ensure that higher Euro-bond rates would not exert upward pressure on Swiss interest rates, two conditions were imposed. The first requires Swiss National Bank approval for any issue exceeding a prescribed amount. The second requires the banks to place at least half of the bonds assigned to them by the consortium with foreign customers and prohibits them from publicly advertising such issues in Switzerland.

RECENT DEVELOPMENTS

The outstanding feature in the Euro-bond market, from early 1968 through the first quarter of 1969, was the abrupt rise in borrowing by United States corporations. The bulk of the funds raised was for employment abroad; but, to a much less extent, some American firms secured funds for use in the United States. In some cases where funds were raised for use in this country, credit may not have been so readily available elsewhere, and in other cases a company intending to make a domestic corporate acquisition some time in the future obtained the necessary funds in the Euro-bond market in order to avoid disclosure of its plans at an early stage.[3] The borrowing of American firms was effected not only through domestic finance subsidiaries, as in the past, but also through finance subsidiaries incorporated in the Netherlands Antilles. In part, this latter approach was developed to obtain funds that could be employed for acquisitions in the United States or to facilitate the transmission of funds to the United States in accordance with Commerce Department regulations. ("Delaware" corporations are handicapped in repatriating funds held abroad because they lose certain tax benefits if as much as 20 percent of their total income is earned in the United States.)[4] In addition, these subsidiaries benefit from favorable local taxation and incorporation regulations and various other tax advantages.

The biggest rush of American new issues was in the first half of 1968, especially in January immediately after the announcement of the 1968 foreign direct investment restraint program and in May and June after the uncertainties of the March gold crisis were largely dispelled. For the year as a whole, new issues of American corporations and their affiliates nearly quadrupled; they rose to over $2

[2] After the German government imposed in March 1964 a withholding tax on interest payments to nonresidents holding domestic bonds, foreign bonds denominated in marks began to be offered in Germany, which were bought by nonresidents at interest rates lower than on the domestic market.

[3] The Securities Act of 1933 requires a borrower who wishes to raise funds publicly in the United States to file a registration statement; this may require disclosure of either the name of the company the borrower proposes to acquire or sufficient information to permit the company's identification.

[4] The term "Delaware" corporation is generally used to denote any international finance subsidiary incorporated in this country. As long as more than 80 percent of the income of such a qualified international finance subsidiary is derived from sources outside the United States, interest paid to nonresidents on its outstanding obligations is not income according to United States Internal Revenue Code, §861, and therefore is not subject to United States withholding tax.

EURO-BOND ISSUES, 1963 THROUGH FIRST HALF 1969

In millions of dollars

Country of borrower	1963	1964	1965	1966	1967	1968	First half 1969*
United States	—	—	331	439	527	2,059	546
Continental Europe	88	408	456	426	886	658	477
United Kingdom	—	—	25	40	51	134	189
Japan	20	162	25	—	—	180	120
Canada	—	—	—	—	—	38	138
Rest of world	25	5	83	101	305	259	176
International institutions	5	121	128	101	120	40	—
Total	137	696	1,046	1,107	1,889	3,368	1,646

Note: Because of rounding, figures do not necessarily add to totals.
* Preliminary.
Source: Annual data from 1963 through 1968 from the Bank for International Settlements *Annual Report*, June 1968 and June 1969.

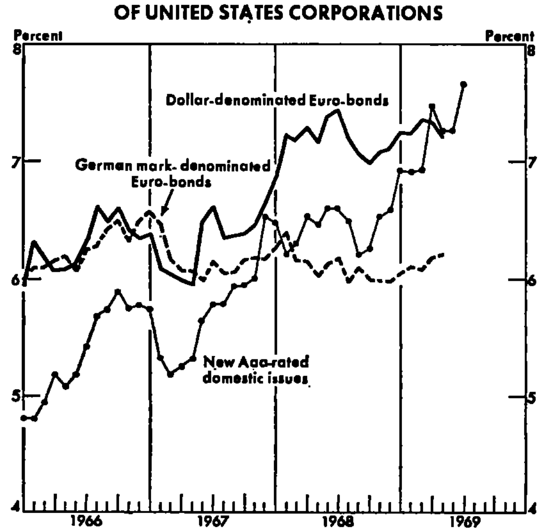
billion, or more than 60 percent of all new issues floated in the Euro-bond market, from only $527 million, or just over 25 percent of total new issues, in 1967 (see table). American borrowing was particularly heavy in January of this year but has tapered off considerably since the first quarter.

The access of other borrowers to the Euro-bond market does not seem to have been seriously impaired by the emergence of this large-scale borrowing by American corporations. To be sure, some placements may have been postponed, particularly in those months when United States corporate borrowing was heaviest, and as a result new issues of all borrowers other than United States corporations were at about the same level as in 1967. However, by midyear, borrowers in some European countries—Finland, the United Kingdom, and especially the Netherlands — increased their flotations substantially. These countries continued to borrow heavily during the first half of 1969; in addition, German and Swiss firms returned to the market for the first time in two years. The appearance of borrowers from countries with relatively free access to the United States market—Japan and Canada—is evidence that throughout 1968 and the first six months of this year the Euro-bond market continued to provide funds at relatively attractive rates.

Faced with rising interest rates (see Chart I), borrowers found ways to adjust the terms of their issues so as to satisfy investors' preferences and reduce borrowing costs. During the first half of 1968, the heavy volume of new issues contributed to sharply rising yields on straight dollar issues. Under these circumstances, and with a buoyant New York stock market, American corporate borrowers shifted dramatically from straight debt issues to convertible dollar bonds. Later, Dutch and British companies also issued convertible securities. Indeed, outstanding convertible dollar issues rose more than $1.9 billion during 1968, compared with only $250 million during the previous year, whereas straight dollar issues rose by only $535 million, compared with more than $1.4 billion in 1967 (see Chart II). While terms vary, these convertible bonds typically permit the holder to exchange his bonds for shares at a conversion price about 10 to 15 percent above the stock price prevailing at the time of issue, any time between a period of six to eighteen months after issue and the bond's final redemption date. As a result, the investor can benefit from a rise in the price of the common stock of the parent company and, at the same time, receive an interest income yield which is generally greater than the dividend yield provided by that common stock. Because these features make convertible bonds relatively more attractive to investors, the direct interest expense to the borrower of a convertible issue is generally less than that for a straight bond. The yield spread between the two has been about 1½ percentage points, but in mid-May 1968, when the demand for con-

Chart I

MARKET YIELDS ON HIGH-GRADE BONDS OF UNITED STATES CORPORATIONS



Note: The two Euro-bond series are based on the ten most recent outstanding long-term bond issues by United States corporations.

Sources: Board of Governors of the Federal Reserve System, Morgan Guaranty Trust Company, and the First National City Bank.

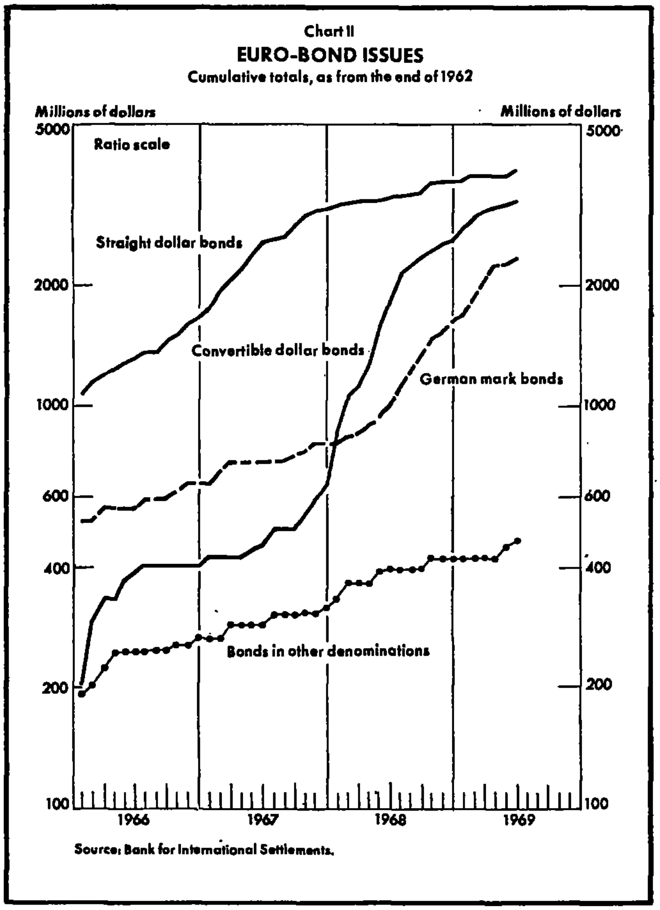


Chart II
EURO-BOND ISSUES
Cumulative totals, as from the end of 1962

Source: Bank for International Settlements.

vertible Euro-bonds was quite heavy, it widened to between 2 and 3 percentage points.

By fall, when interest rates in the United States were rising rapidly, issue conditions for dollar-denominated securities became less attractive. At the same time, a high level of liquidity in the German capital market kept German interest rates low. As the differential between dollar and German mark-denominated Euro-bonds widened, many borrowers—particularly governments and international institutions—were induced to switch to German mark issues despite any risk of revaluation of the German mark. In fact, new mark-denominated issues rose from \$200 million equivalent during the first half of 1968 to \$600 million in the second half and, during the first quarter of 1969, reached \$460 million. For investors, the possibility of a mark revaluation made these issues attractive, despite their relatively low yield. In addition, German residents, particularly German banks, bought substantial amounts as yields on mark-denominated Euro-bonds became more favorable relative to yields in the domestic market. Before last year, German investment in the Euro-bond market had been relatively small, representing mostly unsold portions of new issues left with German underwriters.

During the fifteen months through March 1969, new financial techniques were developed in the Euro-bond market, which led to a further broadening of its scope. In the United Kingdom, subsidiaries of overseas (especially American) companies began issuing sterling securities convertible into the common stock of the parent company. These sterling-dollar convertible issues differ somewhat from convertible Euro-bonds; they are regarded as domestic securities by British authorities and they can therefore be purchased by British residents, but the proceeds must be used within the United Kingdom. In addition, the secondary market for outstanding Euro-bonds developed substantially during this period. Most issues are listed on at least one of the major stock exchanges as a formality necessary to make a security "eligible" for purchase under the exchange-control regulations of a number of countries. But, in fact, the secondary market is largely an over-the-counter market in which dealers make their quotes on the basis of their own positions and the prevailing Euro-dollar rates. The secondary market now comprises a number of dealers and banks in the United Kingdom, on the Continent, and in the United States. A further development was the handling by international syndicates of secondary stock offerings. In some cases, the securities sold were those issued in connection with a company take-over, which the shareholders of the acquired company did not want to keep.

From the point of view of European countries, the Euro-bond market has tended to make management of domestic capital markets more difficult. Since Euro-bond issues are often substitutes for long-term local investments, the Euro-bond market tends to bring long-term interest rates in the European national markets more in line with each other. In the early months of this year, as the hectic pace of Euro-bond borrowing continued, some European countries decided they could not permit a repetition of last year's sizable capital outflows. In order to prevent undue congestion in the German capital market, the semiofficial Capital Market Committee decided, early in April, to bring the volume of foreign German mark issues in which German banks participate below the average for the first three months of this year. The Bank of Italy, in an attempt to protect the relatively low domestic long-term interest rates, has been requiring since the beginning of April special authorization for banks who wish to participate in Euro-bond issues. Authorization is now granted only when the borrower has business interests in Italy. For similar reasons, in Belgium, a bill is pending that would authorize the government to restrict resident purchases of foreign securities.

Not all the decline of more than $530 million in new-issue activity in the Euro-bond market during the second quarter of 1969 was a direct result of these countries' measures to restrict resident purchases of foreign securities. Many borrowers may have been discouraged by the continuing high interest rates. The high interest rates obtainable on Euro-dollar deposits, together with the stock market decline in New York, substantially reduced the attractiveness of long-term investment generally and of convertible bonds in particular. Furthermore, many American corporations probably still have sufficient proceeds from previous borrowings available to wait for more favorable terms.

The emergence and development of this international capital market has been a consequence of various countries' attempts to curb the outflow of domestic capital: it was initiated in order to avoid controls on foreign borrowing in domestic currency, and it expanded at a hectic pace with the adoption of successive balance-of-payments programs in the United States. Last year, the Euro-bond market proved its capacity to attract an ever-widening clientele of borrowers and lenders and to accommodate transactions in various types of debt and equity securities. Attempts by some of the Continental countries to curtail resident participation in the Euro-bond market are unlikely to do more than slow this growth. However, such policies may constitute the first attempts to brake the increase in the number of local financial institutions participating in syndicates issuing Euro-bonds. As a result, these policies may also hamper the strengthening of international financial intermediaries in those countries that adopt these measures and thus make more difficult the path to eventual integration of the European capital markets.