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Foreign Security Issue in European Markets, 1963-64

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There was a significant rise in foreign borrowing on European capital markets in 1963, and in the fourth quarter non-resident security issues on these markets reached a record annual rate of \$700 million. The first few months of 1964 have shown no slackening in this activity, and, indeed, the annual rate has increased to about \$840 million.

Increased pressures from the E.E.C. and the O.E.C.D. for further liberalization of European capital markets may have been partly responsible for some of the increase in non-resident issues. Only a few of the foreign issues in Europe last year, however, appear to have resulted directly from these efforts.

Of more importance in explaining increased European lending to foreigners have been the dislocations in the international capital markets caused by the U.S. proposal for an Interest Equalization Tax. Both borrowers and lenders have apparently been affected by this move.

Supplies of new foreign securities on the New York market declined after mid-1963 as foreign borrowers awaited passage of the tax; until then, borrowers would probably have to undertake a commitment to absorb the tax or to offer terms sufficiently attractive to compensate investors for any tax liability which might be imposed. Either of these courses of action would impose heavy costs on the borrowers.

The decline in foreign security offerings in New York may also be in part the result of a desire on the part of potential foreign borrowers to avoid any influence which such issues might have on the final form of the I.E.T. In some cases the tax proposal probably resulted in foreign borrowers' seeking other means of finance in the United States, e.g., term loans from U.S. banks. The rise in foreign borrowing in Europe suggests, however, that their attention also turned to these markets for funds.

On the investor side, U.S. demand for foreign securities at interest rates close to those of the first half of 1963 dried up in the face of the costs implied in the prospective tax. With the absence of a substantial volume of foreign issues on the New York market, the foreigner with dollars to invest also had to turn elsewhere to find profitable employment for his funds at yields equivalent to those formerly readily available on foreign issues in New York. This stimulated the growth of an entrepot business in last year's most important European markets for foreign issues, London and Luxembourg; that is, a business devoted to the lending of primarily non-resident funds to non-resident borrowers.

As part of this growth came the increased use of what may be termed international currencies for foreign loans. In particular, through the efforts

of the large merchant banks, London has become the center of dollar issue negotiations in Europe. And on the Continent, the Luxembourg market, with no large indigenous supply of capital, has seen the promotion by large Belgian and Dutch banks of the Unit of Account as a currency of issue and as an aid to the liberalization and consolidation of European capital markets.

Volume of foreign Security Issues in Europe

New foreign security issues in European markets totalled \$404 million last year, and \$203 million in the first quarter of 1964.<sup>1/</sup> In contrast, only \$291 million of foreign bonds were floated in these markets in 1962.

It is somewhat misleading, however, to consider foreign issue activity in Europe for the year 1963 as a whole. As Chart 1 shows, \$178 million, or 44 per cent, of last year's new foreign issues took place in the fourth quarter. Thus, although the total of foreign issues for 1963 did not reach the 1962 level, in the six months ended March 31, 1964, European markets for external bonds attained record levels of activity.

Nearly every important market contributed to the increase in new foreign flotations in Europe last year, as shown in Table 1.

In view of its role in foreign lending in 1961 it is significant that the Netherlands market was closed to foreign borrowers in 1963. This action was attributable to the desire of the Dutch authorities to prevent possible upward pressure on domestic interest rates and to avoid a large capital outflow such as occurred in 1961.

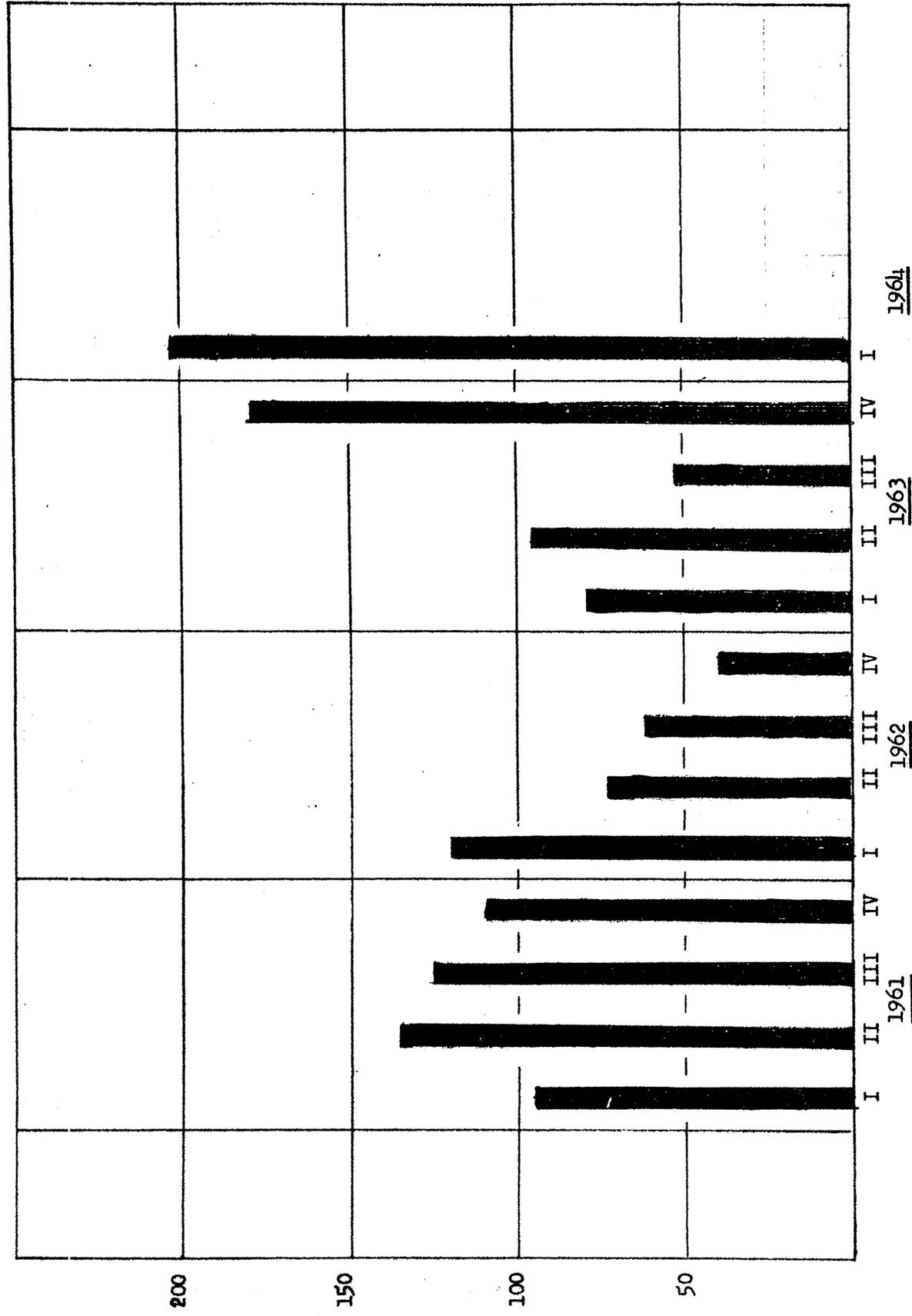
Although there was some foreign borrowing in the Italian market in 1961 and 1962 -- admittedly only by international organizations --, this activity declined again last year. An insufficient supply of investible funds on the Italian market, the general uncertainty of the Italian political and economic situation, and the high cost of borrowing in Italy, all contributed to the unwillingness of foreign borrowers and of Italian market authorities to undertake any marked development of non-resident issue activity last year.

Foreign issues in Switzerland last year were \$135 million, down slightly from 1962 (\$161 million) and substantially from 1961 (\$231 million). New foreign issue activity on the Swiss market is always strictly controlled. It appears, however, that foreign access to the market was even more restricted last year mainly because of heavy capital demands from domestic borrowers.

<sup>1/</sup> This does not include \$107.8 million equivalent of bonds by Commonwealth and Sterling Area borrowers in London, and \$42.0 million equivalent issued in the first quarter of 1964. These are omitted because of the view of the British authorities that these are not entirely "foreign" borrowers.

New Foreign Security Issues in Europe <sup>a/</sup>

1961 -- 1964  
(millions of dollars)



a/ Not including issues in the U.K. by Commonwealth or Sterling Area borrowers. See note 1, p. 2.

Source: Compiled by the author from a variety of sources.

Table 1

Foreign Security Issues in Europe, 1961-64  
(in millions of dollars equivalent)

Market	1961 Total	1962 Total	1963 Total	1963				1964 I
				I	II	III	IV	
Austria	--	5.0	--	--	--	--	--	--
Belgium	--	--	8.0	--	--	--	8.0	--
France	--	--	12.0	--	--	--	12.0	--
Germany	24.9	25.0	40.0	25.0	--	--	15.0	60.0
Italy	24.0	48.0	24.0	--	24.0	--	--	--
Luxembourg	5.0	11.0	63.5	--	4.5	11.0	48.0	7.0
Netherlands	159.4	39.0	--	--	--	--	--	--
Sweden	6.7	2.0	19.0	19.0	--	--	--	--
Switzerland	231.4	161.2	134.6	34.3	46.7	12.5	41.1	22.8
United Kingdom	112.0	65.2	107.8	37.8	--	14.0	56.0	42.0
Commonwealth & Sterling Area	--	--	103.0	--	20.0	29.0	54.0	113.5
Other	--	--	511.9	116.1	95.2	66.5	234.1	245.3
Total	563.4	356.4	511.9	116.1	95.2	66.5	234.1	245.3

Source: Compiled by the author from a variety of sources.

The other two markets of importance last year -- London and Luxembourg -- both showed an astonishing increase in activity, primarily due to the development of entrepot facilities for lending in dollars or Units of Account. From a total of \$65 million of foreign issues in 1962, all in sterling to Commonwealth or Sterling Area borrowers, the amount of foreign borrowing through London last year rose to \$211 million, of which \$103 million represented issues to non-Commonwealth and non-Sterling Area borrowers. All but \$28 million of the \$103 million was in the form of dollar loans.<sup>2/</sup>

The increase to about \$64 million in foreign financing through the Luxembourg market, not including those issues floated in both London and Luxembourg, was equally striking, particularly in view of country's limited amount of domestic capital. Moreover, almost all of these issues were denominated in one or another form of the Unit of Account. The Luxembourg market also served as a major Continental trading and issuing center for foreign securities initiated in London so that non-residents might avoid the U.K. stamp and withholding tax. In all, \$20 million of these simultaneous issues or listings were made in 1963 and about \$77 million in the first three months of 1964, primarily in dollar denominated issues.

Foreign issue activity so far this year indicates that London's position as the center of the Euro-dollar market and the facilities for trading and listing available in the City have placed it in the forefront of European markets. Of the \$203 million equivalent of foreign placings in Europe during the first quarter of 1964, \$113 million (55 per cent) took place through London, nearly all in dollars.<sup>3/</sup> In contrast, foreign flotations in Switzerland have totalled only SF 100 million (\$23 million); and in Germany, DM. 240 million (\$60 million).

Table 2, giving data on foreign borrowing in New York in 1963 and 1964, provides a basis for comparison of foreign activity in this country and in Europe. During the last quarter of 1963 and the first quarter of this year, when the market for foreign borrowing in New York was comparatively inactive, \$51 million and \$101 million, respectively of foreign securities were placed. As the Table shows, however, in first quarter of 1964, foreign borrowing on the New York market was entirely by borrowers expected to be exempted from the proposed I.E.T., including Canada, international organizations, and less developed countries. It is thus clear that the tax proposal caused a substantial shift in foreign borrowing from New York to Europe, and, indeed, several borrowers, e.g., the Austrian Government, explicitly stated that their decision to borrow in Europe was the result of the U.S. tax proposal.

<sup>2/</sup> The \$28 million represents \$14 million equivalent in sterling to Japan and \$14 million equivalent in Swiss francs to Copenhagen.

<sup>3/</sup> Excluding issues by Commonwealth and Sterling Area borrowers. See note 1., above.

Table 2

Foreign Security Issues in New York, 1962-64  
(in millions of dollars)

	1962 Total	1963 Total	1963				1964 I
			I	II	III	IV	
All Borrowers	1241	1313	518	538	206	51	101
Borrowers potentially liable to the I.E.T.	459	442	98	217	93	34	0
Borrowers not poten- tially liable to the I.E.T.							
Canadian Borrowers	434	778	367	321	73	17	89
Other Borrowers, including inter- national organ- izations	348	93	53	0	40	0	12

Source: Federal Reserve Bank of New York.

Foreign Borrowers in Europe

Table 3 points out several distinguishing features of the foreign borrowers in Europe in 1963 and the first quarter of 1964. First, borrowing by Scandinavian countries, particularly Norway and Denmark, has been exceptionally heavy in the two entrepot markets, London and Luxembourg. These two countries alone accounted for 15 per cent of the foreign flotations in Europe in 1963 and slightly more than 30 per cent in the first quarter of 1964.

Second, the most important single user of European bond financing has been Japan. Furthermore, this activity took place in a variety of markets. The greater part of the Japanese flotations, however, has been placed in London where, with the exception of a refunding issue in the summer of 1963, they represented dollar loans.

These two groups of borrowers, the Japanese and the Scandinavians including Finland, accounted for \$257.5 million of new foreign issues placed in New York in the first half of last year. This represented approximately 78 per cent of the total of foreign issues apart from borrowing by Canada, less developed countries and international institutions. Their prominence in the London entrepot market last year and in the first quarter this year and their heavy reliance on dollar issues strongly suggest that, for these borrowers, London has become the principal market of recourse when New York is no longer available for bond flotation.

Table 3 also shows that, for many issues last year (all in dollars), wider investor appeal was sought through simultaneous issue in both London and Luxembourg. The data in parentheses under the figures for the Luxembourg market represent that part of the total also issued in London. About 50 per cent of the Luxembourg market's dollar activity and slightly over 25 per cent of the dollar issues in London fell into this dual market category in 1963, but in the first quarter of 1964 they accounted for about 90 per cent and 75 per cent respectively of these markets' dollar activity.

Two qualifications must be made to the picture of the movement toward more liberal capital markets in Europe presented in Table 3. First, the apparent opening of the French market last year is largely illusory since the single non-resident issues last year was by the European Investment Bank, an E.E.C. organization and thus not completely "foreign" to French authority. The opening of the Belgian market to the E.I.B. was similar.

Secondly, nearly \$80 million equivalent of the foreign borrowing in the Swiss market last year was by French and German interests. In the face of large payments surpluses for these countries and, in the case of Germany at least, heavy inflows of foreign capital, such flotations point to the high interest and issue costs in the French and German capital markets, which give first class domestic companies strong incentives to go abroad for long-term funds.

Table 3

**Foreign Security Issues in Europe, by Borrower Origin and Market of Issue, 1963, 1964<sup>a</sup>**  
(in millions of dollars equivalent)

Borrower origin	Market of Issue												Total <sup>b/</sup>					
	Belgium		France		Germany		Italy		Luxembourg		U.K.s/		Switzerland		Sweden		Total <sup>b/</sup>	
	1963	1964 <sup>a</sup>	1963	1964 <sup>a</sup>	1963	1964 <sup>a</sup>	1963	1964 <sup>a</sup>	1963	1964 <sup>a</sup>	1963	1964 <sup>a</sup>	1963	1964 <sup>a</sup>	1963	1964 <sup>a</sup>	1963	1964 <sup>a</sup>
EEC Total	8.0	12.0	15.0	25.0	24.0	—	—	20.5	—	55.0	—	95.3	11.4	—	—	—	229.8	36.4
Belgium	—	—	—	—	—	—	—	—	—	40.0	—	—	—	—	—	—	40.0	—
France	—	—	—	—	—	—	—	—	—	—	—	30.3	11.4	—	—	—	30.3	11.4
Germany	—	—	—	—	—	—	—	—	—	—	—	47.9	—	—	—	—	47.9	—
Italy	—	—	—	—	—	—	—	16.0	—	15.0	—	—	—	—	—	—	31.0	—
Luxembourg	—	—	—	—	—	—	—	—	—	—	—	13.7	—	—	—	—	13.7	—
Netherlands	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
EEC organizations <sup>c/</sup>	8.0	12.0	15.0	25.0	24.0	—	—	4.5	—	—	—	3.4	—	—	—	—	66.9	25.0
U.I.	—	—	—	—	—	—	—	—	—	—	—	16.0	—	—	—	—	16.0	—
Scandinavia (incl. Finland) Total	—	—	—	—	—	—	—	23.0	44.0	14.0	59.0	17.6	—	19.0	—	—	73.6	76.0
Denmark	—	—	—	—	—	—	—	—	12.0	14.0	24.0	—	—	9.5	—	—	23.5	24.0
Norway	—	—	—	—	—	—	—	12.0	32.0	—	35.0	17.6	—	9.5	—	—	39.1	42.0
Finland	—	—	—	—	—	—	—	11.0	—	—	—	—	—	—	—	—	11.0	10.0
Other European	—	—	—	—	—	—	—	20.0	18.0	—	18.0	5.7	—	—	—	—	25.7	18.0
Japan	—	—	—	—	—	—	—	20.0	22.5	34.0	22.5	—	11.4	—	—	—	59.0	58.9
Other	—	—	—	—	—	—	—	—	—	—	14.0	—	—	—	—	—	—	14.0
Totals <sup>b/</sup>	8.0	12.0	40.0	60.0	24.0	—	—	83.5	84.5	103.0	113.5	134.6	22.8	19.0	—	—	404.1	203.3

(20.0)(77.5)

Double offerings

a/ European Investment Bank, European Coal and Steel Community, INTERFRIGO.

b/ The sum of the offerings in individual markets may be larger than the total because of double offerings of some issues in London and Luxembourg.

c/ Excluding issues by Commonwealth and Sterling Area borrowers. See note 1, above.

Unit of Account Issues

European markets saw another change of singular importance last year: the growth of Unit of Account issues as a practical method of widening the market for foreign issues.

In 1961 and again in 1962 the Portuguese development agency, S.A.C.O.R., employed the Unit of Account for bond issues totalling \$10 million equivalent in all, but with these exceptions the Unit of Account received little attention as a method of finance until last year. In 1963, however, a total of \$43 million equivalent of such issues were floated -- all through Luxembourg -- and in 1964 there has already been a UA 10 million (\$10 million) issue through Luxembourg by Greater Copenhagen.

The present definition of the Unit of Account such as found in the prospectus of the Copenhagen issue has been concisely framed by Claudio Segré as follows:

"The U.A.'s value is defined in terms of a gold weight with which the 17 'reference currencies' -- which are those of the countries forming part of the former European Payments Union and do not include the dollar -- are linked through their gold parity as communicated to the International Monetary Fund. Nevertheless the U.A.'s value can change if the gold parity of all the reference currencies should change, provided that at least two-thirds of the currencies have moved in the same direction. In this case the U.A.'s value varies to the same extent and in the same direction as the currency -- belonging to the 'two-thirds group' -- which has suffered the smallest percentual variation in comparison with its original gold parity."<sup>4/</sup>

The appeal of these issues is two-fold. First, they provide a good deal of protection against exchange risks for the investor. That is, he is protected from capital loss through extreme and/or isolated currency devaluation; only a general change in currency values will affect his investment and that by the minimum amount possible.

Second, these issues generally allow investment and repayment to take place in a number of currencies. Institutional investors and others who may have fixed commitments in their own or other currencies may thereby undertake purchases of the issues with a minimum risk of exchange losses.

From the viewpoint of the European markets and investors, therefore, the Unit of Account offers one course by which international capital flows may be undertaken and through which an advance toward more unified European capital markets may be made. Moreover, from the viewpoint of the United States, these issues appear to be an attractive alternative to

<sup>4/</sup> Claudio Segré, "Foreign Bond Issues in European Markets," Banca Nazionale del Lavoro Quarterly Review, no. 68, March, 1964, p. 24.

dollar issues abroad and, consequently, a possible valve through which pressure on our position may be lessened.

### Foreign Borrowers in London

In contrast to the lack of activity which has characterized most of the post-war years on the foreign issue market in the U.K., last year saw the substantial increase in foreign borrowing described above. With this increase came several important changes in the character of the London market; in particular, the year saw the first non-sterling issue placed on the market since the war, the first sterling issue to a non-Sterling Area borrower and the emergence of a substantial underwriting business in the City.

In an address delivered in October, 1962, the Governor of the Bank of England said,

"The time has now come when the City once again might well provide an international capital market where the foreigner can not only borrow long-term capital but where equally important he will once again wish to place his long-term investment capital. This entrepot 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."<sup>5/</sup>

Despite this encouragement, however, many restrictions on foreign borrowing remained in the U.K., and early 1963 saw little or no foreign borrowing there. In May the picture began to change as negotiations for a three-year dollar loan to the Government of Belgium were completed.

The Belgian issue made two important inroads on market traditions and regulations in London. First, this loan marked the beginning of the use of the London market for dollar borrowing. The importance of this development cannot be overemphasized. Second, it represented the admission of a non-Sterling Area, non-E.E.T.A. borrower to London's underwriting facilities, although not to the market for sterling funds.

A broader opening in the City's facilities to foreign borrowers took place in July with the Autostrada loan. Like the Belgian issue it was denominated in dollars, but it represented a further breakthrough in that it was the first non-government loan in London to be made in dollars. Moreover,

<sup>5/</sup> Quoted in The Banker, CXII, no. 441 (November, 1962), p. 735.

British residents were granted permission to purchase these bonds, although -- as with succeeding dollar issues -- only against investment dollars available only at a substantial premium.

The Autostrada issue marked one further advance in London's development. For the first time since the war permission was granted for the issue to be quoted in dollars on the London Stock Exchange. Thus the entrepot character of the market was widened to include trading as well as underwriting facilities.

In August two further developments of significance took place. First, the stamp taxes on domestic and foreign bearer securities were cut in half, to 3 and 2 per cent, respectively, thus encouraging the issue of such bonds in competition with Continental markets where bearer bonds form the major share of fixed interest securities. Second, the Government of Japan was allowed to issue \$14 million equivalent of sterling denominated bonds, breaking the prohibition against non-Commonwealth, non-Sterling Area or non-E.F.T.A. borrowing in sterling. Although this loan was for the purpose of refunding a maturing obligation of the Japanese, it did mean that new sterling funds were tapped directly by a foreign borrower with the possibility of repercussions on the U.K.'s reserves.

The character of foreign issue activity through London in late 1963 and this year has pointed out many of the barriers to foreign borrowing still existing in that market. Among the more important are those imposed by the stamp tax on bearer securities and the withholding taxes on interest payments. The major result of these taxes has been the strong parallel development with London of the Luxembourg market where, unlike London, these deductions may be avoided by non-residents.

This year London has continued to emphasize its entrepot character, lending primarily non-British funds to non-British borrowers. With the exception of an Israeli issue for £5 million (\$9 million), the dollar has been currency of finance. The total of these dollar issues in the first quarter was \$104.5 million.

At least one underwriting house in London has recently voiced support for permitting sterling issues in London by foreign borrowers. Despite this, however, it has appeared that, with the exception of Commonwealth borrowers, e.g., Australia, sterling may be the least likely currency for a foreign issue in London.

### Conclusion

It is clear that, with the I.E.T. proposal hanging over New York, European capital markets can and do compete with the U.S. for new foreign issues. On the other hand, the flotation of the Belgian and Autostrada issues in London before the I.E.T. proposal, the existence of markets for foreign issues in the Netherlands and in Switzerland in the past and earlier Unit of Account issues, indicate that what may now be a stronger competitive advantage for European markets would not necessarily disappear with the expiration of the tax.

Of course, one aim of the tax proposal was that these markets would be developed by foreign and their own domestic borrowers as permanent alternatives to New York. To judge from the experience of the last few months, the proposal has at least directed some of the attention of foreign borrowers toward these markets. More important, it has demonstrated that there are funds available to these borrowers abroad.

Increased European foreign lending, however, has raised several questions, two of which are of importance to the U.S. position. The first concerns the ability of these markets to continue to absorb foreign issues at the rate witnessed in the last few months. As pointed out in the U.S. Treasury study of European capital markets, aside from the dollar funds which may be available, the domestic financial resources of many such markets are severely limited by the pattern of personal saving, by exchange controls, and by regulations governing institutional investment.<sup>6/</sup> Moreover, much of the activity on these markets is dominated by the flotation of domestic central government bonds, thus restricting the funds available to other domestic borrowers and, in turn, further limiting the already small portion of the market potentially available to foreign issuers. These and other characteristics of European markets have led some observers to the conclusion that the recent heavy foreign activity on European markets may be only a short-term phenomenon.<sup>7/</sup> In this case the New York market may come under renewed pressure from foreign borrowers.

Finally, with the expiration of the I.E.T. there may be a movement of U.S. funds to European markets for investment. High yields, continuation of the high rate of dollar issues, and the further development of UA issues as an attractive form of investment, all augur for increased U.S. investor interest in European issued foreign securities. The extent to which such a movement might take place cannot be predicted, but should sizeable flows occur, the net result for the U.S. payments position would be the same as if the foreign issue market in New York had continued at a high level.

<sup>6/</sup> Economic Policies and Practices, Paper No. 3, "A Description and Analysis of Certain European Capital Markets" (Materials prepared for the Joint Economic Committee, Congress of the United States), Chapter 5.

<sup>7/</sup> See, for example, Times (London), Dec. 28, 1963, page 11, "Dollar Balances Roam Abroad," The Economist, February 15, 1964, p. 631, "A Holding Operation?" and March 21, 1964, p. 1140, "Time for a Pause."