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The Integration of European Capital Markets*

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In May 1962, in a speech to the American Bankers Association meeting in Rome, Secretary of the Treasury Douglas Dillon pointed out that long-term capital exports were contributing to a significant extent to the deficit in the U.S. balance of payments, and he urged Europeans to improve and expand their capital markets in order to reduce their own reliance and that of other countries on the United States.1/ This urging has since been repeated by others, sometimes for the same reasons, but often for reasons of European self-interest.2/ It has been argued that European capital markets are undeveloped and inefficient; that their facilities are inadequate to allow the absorption of substantial blocks of securities; and that their costs of mobilizing capital on a long-term basis are too high relative to those of the United States. Underlying all of these comments is the view that Europe has a large flow of savings and a large stock of accumulated liquidity that could move into long-term investment if only its capital market facilities to bring together borrowers and lenders were improved. These arguments are easily taken to imply that, after improvement and integration of its capital markets, Europe will play a more important role in providing long-term foreign capital to itself and to the rest of the world, and that this will reduce both the U.S. balance of payments deficit and the European balance of payments surplus. At the least, improved European capital markets would, according to this view, make Europe more self-sufficient in meeting its own long-term capital needs.

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* This paper was delivered on December 28, 1964, at the American Finance Association 1964 Annual Meeting and is to be published in The Journal of Finance: Papers and Proceedings, Vol. XX, No. 2 (May 1965).

1/ These views were later elaborated in the Secretary's testimony reported in U.S. Congress, House, Committee on Ways and Means, Interest Equalization Tax Act: Hearings . . . . on H.R. 8000 (88th Congress, 1st Session), August 1963, pp. 58-156.

2/ For example, on December 12, 1962, Per Jacobsson, the former Managing Director of the International Monetary Fund, said in an unpublished speech to the Life Insurance Association of America that, "I want to make it clear that I fully agree with Secretary Dillon and others who have insisted that the Europeans ought to improve the effectiveness of their own capital markets, so that they and other international borrowers of good standing can borrow at reasonable interest rates in those markets, and thus become less dependent on New York . . . . It is, for the Europeans, in their own true interest to establish effective capital markets. When there is no effective capital market in a country, the tendency is to rely too much on commercial bank credit for what is in fact long term investment."

This paper examines three aspects of European capital markets: first, what are the characteristics of integrated capital markets, and what is the relationship of integration to "efficiency"; second, to what extent have developments in the last three years helped or hindered the development of these characteristics; and third, what are the prospects for further development.

I

There are important capital markets in Europe, but there is no European capital market. The markets for long-term capital, including those dealing with capital in the form of securities (stocks and bonds), are organized on national lines; and they are not integrated to any significant extent. This does not necessarily mean, however, that they are inefficient.

The national capital markets are not integrated since foreigners do not have access to them on the same terms and conditions as residents. This definition of an integrated capital market was given by the Monetary Committee of the European Economic Community in 1962 and is an adequate one for present purposes.1/ In an integrated market, the charges for capital, and the terms and conditions on which it was traded, would be determined by the market place; and a foreigner who was prepared to meet domestic requirements would not be debarred or discriminated against just because he was a foreigner.2/ But in every European country today, with the exception of Germany, foreigners have a lower status than residents. The collection and mobilization of savings in Europe, and the investment of these savings, take place mostly within national boundaries. Virtually all of the security activities associated with central and local governments and public corporations, with residential and commercial construction, and with installment purchases of durable consumers and producers goods, take place in national markets. Commercial and industrial enterprises increase their financial resources through commercial bank financing, security financing (issuing stocks and bonds), and internal financing, which is the most important of the three. Most business enterprises have access to commercial bank credit and to capital markets on a national scale, if at all; and all their internal financing takes place within national boundaries. An international company is in a different position. The parent company may have access to a number of national capital markets in Europe, and its branches or subsidiaries may have access to the capital markets of the countries in which they operate. In such cases, capital may be mobilized without respect to national boundaries, not because the capital markets are integrated, but because the industrial company is integrated.

1/ Since this paper is concerned with the international aspects of European capital markets, it does not discuss the extent to which all residents in a particular country have access to their respective markets on the same terms and conditions.

2/ This does not mean, of course, that foreigners would pay the same interest rates as residents, just as it does not mean that all residents pay the same rate.

The Common Market has a national income approaching that of the United States and Canada, but there is no equivalent in it to Canadian provinces and cities borrowing in New York, to savings and loan associations in California tapping eastern funds to finance western construction, and to insurance companies commingling funds from everywhere and investing everywhere. The integrated part of the European capital market is confined to a small part of central and local government finance and to a small part of a small part (the bond and equity part) of business enterprises. These operations may be important in a marginal sense, but their size is often exaggerated.

Each of the national capital markets in Europe operates almost exclusively in terms of its own national currency. In each country, with the exception of Germany, operations are subject to formal or informal national regulations, including exchange and capital controls, systems of priorities, and rules governing the position of foreign borrowers relative to domestic ones. Each of these markets has its own going structure of interest rates in domestic currency. There are wide national differences in the costs of raising funds through bond issues and even wider differences in raising funds through equity securities. Commercial banks on the Continent are accustomed to meet a larger part of longer-term financing needs of their business customers than the commercial banks in the United States and Great Britain. Their activities compensate for--and perhaps have also helped to create--some of the existing deficiencies in continental capital markets. These national characteristics may in small part have developed accidentally, but they are part of a national way of doing things and for the most part they serve particular national purposes. Clearly, at least some of these purposes are different from those that motivate the creation of an integrated capital market in Europe.

The question whether European capital markets are efficient or inefficient from an international point of view must be answered in terms of the purposes these markets are designed to serve. It is possible, and indeed it is quite likely, that these markets are inefficient from the point of view of the United States, which desires to shift to Europe a larger part of the task of providing long-term capital for direct and portfolio investment. This need not prevent these markets from being efficient from the point of view of the countries of Europe, which emphasize national objectives.1/

This point may be clarified by four examples. (1) If European markets were integrated on the style of North America, interest rates would tend to equalize. Interest rates in Switzerland and the Netherlands would rise, while those in Italy and Germany would fall, but the adjustment in individual countries would be far from uniform. The increases in Switzerland and the Netherlands would be much greater in both absolute and relative terms than the decreases in high interest countries. It is understandable that monetary authorities and domestic borrowers in both of these countries have objected,

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1/ This dochotomy does not, of course, dispose of the question of "efficiency." There is still the question whether the particular national objectives are attained efficiently, and whether these objectives are consistent with (i.e., efficient in terms of) broader national objectives.

though for somewhat different reasons, to opening their capital markets to foreigners on an unrestricted basis. Business enterprises would lose one of their competitive advantages, and the population at large would find itself paying higher interest rates on mortgages and other loans.1/ (2) The balance of payments of almost all European countries reflects the limitation of capital exports, and the removal of these limitations will produce unwanted effects, at least in the short run.2/ (3) Limitations on capital markets in certain areas, such as France and Scandinavia, serve broad purposes of planning and domestic growth. Removal of limitations on foreigners would interfere with these purposes and might encourage removal of limitations on residents--despite the opinion that both kinds of limitations are useful for national purposes. (4) Finally, there is a stronger feeling in Europe (with the possible exception of Germany) than in the United States that allocations of long-term capital by a free market are unlikely to maximize the national interest. There is the feeling that the market mechanism may act to export more long-term capital than is desirable, particularly in countries with broad and active domestic markets, such as the United Kingdom, Switzerland, and the Netherlands. In relation to capital markets, there is a greater trust in administrative controls and a smaller trust in market allocations than there is in relation to other business sectors.

It is a paradox that the most efficient capital markets in Europe are in those countries which, from the point of view of the balance of payments, have a shortage of savings for export (e.g., the United Kingdom) or that are economically relatively small and that generate only a limited amount of capital. The least adequate capital markets are in such countries as Germany and France which have large volumes of savings and strong balance of payments positions. The increased volume of security issues following integration would be concentrated upon the most efficient existing markets backed up with the smallest amount of savings for export. The burden of integrating the capital markets of Europe would thus fall on those countries least able to support it.

1/ Where mortgages are issued on a short-term basis or virtually on a demand basis, as in Switzerland, higher interest rates would take effect almost instantaneously.

2/ European countries would be dissatisfied with the balance of payments results, and in swings in the results, of further opening their capital markets to foreign borrowers, and particularly to those outside of Europe. Moreover, European countries are more willing to employ capital controls to cope with balance of payments difficulties than the United States and Canada. Article VI, Section 3, of the Fund's Articles of Agreement provides that "members may exercise such controls as are necessary to regulate international capital movements . . . ." In keeping with their general philosophy on capital controls, most European countries have argued that the United States should have used capital controls to cope with its capital movements since 1958. Thus, the annual review of the United States for 1964 recently issued by the Organization for Economic Cooperation and Development recommended more curbs on capital exports, including extension of the Interest Equalization Tax to loans made by commercial banks. See The New York Times, December 31, 1964.

In short, the major factors that stand in the way of integration of European capital markets are national purposes, and the characteristics of the market that make them inefficient from an international point of view make them efficient from the point of view of the country concerned. This does not imply that integration of capital markets on a continental basis is not desirable, but it does suggest that integration is unlikely to follow a smooth course. It is interesting to note in this connection that the Belgian, Netherlands, Luxembourg economic union (Benelux), which has been in effect since February 3, 1958, and has not yet achieved integration of capital markets. Integration of capital markets in Europe will in all probability be only a part of the broader movement to economic and political integration.

II

The German capital market is the only one in Europe that is open to foreigners without formal limit, though access to it continues to be shielded by relatively high interest rates, high issue costs, and restrictions on foreign investment by institutional investors. Access to all other European capital markets is regulated to a greater or lesser extent.

The new issue market of the United Kingdom is confined to securities issued by the sterling area and the European Free Trade Association, and within that limitation issues may be subject to official opinions with respect to timing, amount, and purpose. Purchases by residents of the United Kingdom of dollar and other non-sterling securities must be made with investment dollars; these dollars normally arise from the sale abroad of domestic-owned foreign securities and usually command a premium over the official dollar-sterling market rate. The substantial new issue business in London since May 1963, denominated in dollars and in other foreign currencies, is an entrepot business, and the London issuing houses act as intermediaries between foreign borrowers and foreign investors. This new issue business is not supported by a flow of British savings. Inventories of securities involved in underwriting and in making a market may temporarily be financed with sterling, or with funds borrowed in the Euro-dollar market, but if these securities are held for more than six months, the normal rules applicable to the purchase of non-sterling area securities apply, and they would have to be financed with investment dollars.

Access to the securities markets of the Netherlands continues to be rationed in accordance with government estimates of the projected flow of savings and of the needs of the domestic economy for these savings. The residual may be made available to foreigners, depending upon considerations relating to interest rates, domestic liquidity, and the balance of payments.

Access to the Swiss market continues to be regulated by a smooth working system of formal and informal controls managed by the Swiss National Bank, and foreign borrowers must take their places in a queue of varying length.

The French market remains subject to virtually the same strong controls as in 1961.

Sweden, which generates a substantial flow of savings, restricts foreign access to its markets, but grants a preferred position to other Scandinavian countries.

National controls limit both the ability of foreigners to issue securities in a particular country and the ability of major institutional investors, such as insurance companies, savings institutions, and banks, to acquire them. Practically all developed countries have lists of domestic securities which public and private institutions may buy. These lists are designed to foster financial soundness--and to a great extent they do. Since the obligations (and the equities) of these institutions are expressed in domestic currency, there is an obvious advantage in setting up legal requirements or encouragements to investment in the same currency, thus eliminating exchange risks. On the other hand, these limitations often have a restrictive or protectionist purpose.

It would be unwise to disregard the forces of nationalism in Europe or to assume that the only countries there that are likely to have balance of payments difficulties are the United Kingdom--and (as of last year) Italy. Prices and costs continue to rise faster in continental Western Europe than in the United Kingdom and the United States. Actions taken by the United Kingdom to improve its balance of payments position will inevitably have some adverse effects upon the position of the countries in continental Western Europe. Restrictions applied in Europe to imports from Japan will inevitably need to be reduced. Net remittances of interest and dividends to foreigners are bound to increase. No European country--not even Germany--feels that its reserve position is so strong and its currency so unassailable that it will be willing to suffer a substantial balance of payments deficit. There is some reason to believe that when and if European countries have to face balance of payments difficulties, their actions to liberalize and integrate capital markets will be among the first to be affected.

III

It would be incorrect to infer from the preceding discussion that capital markets in Europe will not gradually become more integrated. There have been at least six favorable developments in the last few years.

First, there is greater awareness of the need for an integrated capital market in Europe or at least in the European Economic Community. This awareness has been stimulated by, and has also been reflected in, the growing number of official inquiries into the state of the capital markets: the report by the U.S. Treasury, the activities of the OECD and its studies in Working Party 3, the activities of the Monetary Committee of the EEC and its directives on money and capital markets, and the investigations in Belgium, France, and Italy.1/

Second, a number of countries have slightly improved foreign access to their markets. The United Kingdom has opened the London market to all EFTA countries. This privilege had previously been available only to countries in the sterling area. France has permitted the sale of a new foreign issue for the first time since World War II. Switzerland and the Netherlands, however, have taken some restrictive actions as part of their programs of coping with their domestic problems.2/

Third, strong forces are encouraging the improvement of capital markets within many of the countries in Europe and these will create greater national integration; at the same time there are strong forces pushing regional integration. The national economies within the Common Market are becoming more integrated in terms of production, sales, labor force, and new investment. These developments will inevitably encourage greater cooperation in monetary and credit policy, management of international reserves, and operation of capital markets. The treaty establishing the European Economic Community envisages these developments; and the staff of the Common Market in Brussels regards them as indispensable and inevitable next steps. Comprehensive studies are under way in Working Party 3 and in a special committee recently appointed by the ECE to consider the obstacles to improvement and integration of capital markets and to recommend the steps to remove them. The EFTA countries possess the two most highly developed capital markets in Europe and have the potential for much greater integration. Integration on a scale which would encompass some of the EFTA countries and some of the Common Market countries is possible and likely. It should be noted that even under present conditions the volume of new issue activity has increased considerably in the last three years. The total of new domestic and foreign issues in the EEC countries, the United Kingdom, and Switzerland was about 85 per cent of the total in the United States in 1963, compared with about 50 per cent in 1958.

Fourth, the Euro-currency market, which is based largely on the Euro-dollar, is an integrative force. The Euro-dollar market has grown in seven years to a network of 400 banks, operating in 25 to 35 countries, and turning over $7 billion of short-term resources. Interest rates in the market are the only short-term rates in Europe that are

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1/ Economic Policies and Practices: A Description and Analysis of Certain European Capital Markets, prepared for the U.S. Congress, Joint Economic Committee (88th Congress, 2nd Session), 1964; the de Voghel Committee: Commission gouvernementale pour l'etude des problemes de financement de l'expansion economique (Brussels, 1962); the Lorain Committee: Rapport presente au Ministre des Finances et des Affaires Economiques (Paris, 1963); and Bank of Italy, Report, 1962 (abridged English version), pp. 99-118.

2/ Germany recently announced a proposal to withhold income tax on interest paid to foreigners on German securities. This proposal would bring Germany into line with most other industrial countries and, what is much more important, reduce the inflow of foreign capital. The position of foreigners with respect to interest payments on foreign securities issued in Germany (whether denominated in deutsche mark or in other currencies) remains unchanged. There is no withholding.

freely determined by competitive forces; and these forces are so international in scope that no one country, not even the United States, can control them.1/ Interest rates in the Euro-dollar market are generally low enough (and they are additionally shaved in tight competitive situations) to be competitive for some transactions in every country and to be competitive for all transactions in many countries. Billions of dollars have been deposited in banks in Canada, the United Kingdom, and continental Western Europe; and the difference between rates of interest paid on these deposits and on comparable assets in the United States has steadily decreased in the last few years.2/ Business enterprises, despite their speeches, showed by their transactions that they considered the dollar to be the trading and reserve currency and, as later developments have suggested, the international unit of account. The market in Euro-dollars has grown despite misgivings in some quarters since 1958 about the strength of the dollar and many who have held dollars could not find any better currency in which to hold their assets.3/

The Euro-dollar market has helped to unify short-term capital markets in Europe and suggests how operations based on foreign currencies may effect long-term capital markets; but even if it does not, it has brought a new spirit of competition and expansion to European commercial banking, and encouraged the same attitude in investment banking. Moreover, the Euro-dollar market has provided a mechanism for collecting and investing some medium-term funds and (as already noted) for financing a part of new security issues.

1/ It may be recalled in this connection that Under Secretary of the Treasury Roosa explained that the United States had to raise its rediscount rate to 4 per cent in the wake of the recent British increase to 7 per cent in order to prevent the outflow of U.S. funds to the Euro-dollar market.

2/ "Euro-Dollars and the New York Money Market," DM/64/60, October 15, 1964, p. 9 (to be published in IMF Staff Papers, Vol. XII, No. 1 (1965)). Part of the difference in interest rates on (say) U.S. Treasury bills and on Euro-dollar deposits in London is attributable to the difference in the quality of the two securities. Another part is attributable to the difference in legal status of a dollar claim in the United States and a dollar claim elsewhere. See Joseph Dach, "Legal Nature of the Euro-dollar," American Journal of Comparative Law (Vol. 13, No. 1), Winter 1964.

3/ Some European central banks placed official dollar funds in the Euro-dollar market directly or via swap transactions with their commercial banks; and the Bank for International Settlements, using dollars deposited by its members, has at times been one of the largest suppliers of dollars to the Euro-dollar market. It may be of interest in this connection to note that the Bank's description of its activities in Part III of its Annual Report has never mentioned its Euro-dollar activities nor has it distinguished between dollar assets held in the United States and other dollar assets. This was the case even in the Annual Report for 1964, which devoted Chap. V of Part II to "The Euro-Currency Market." In this chapter, the BIS described its own activities in the one sentence that "besides central banks, funds have been deposited in the Euro-market by international organizations, particularly the Bank for International Settlements" (p. 132).

Fifth, the proposal in July 1963 for an Interest Equalization Tax of up to 15 per cent on American purchases of foreign securities, which was an effort to reduce the balance of payments deficit of the United States, and the enactment of this proposal in September 1964,1/ have stimulated greater new issue activity in Europe. This in turn has encouraged greater integration of capital markets.2/ The European mechanism for underwriting, issuing, and placing new securities was presented with an extraordinary, though possibly temporary, opportunity. There has been a sharp increase in the number and value of new foreign security issues in Europe. These issues individually were relatively small in American terms, the smallest being $5 million and the largest, $25 million, but they were sufficiently large that the underwriters considered it desirable--and politic--to have an underwriting group of 3 to 8 houses and a selling syndicate of 30 to 100 organizations in 5 to 12 countries.3/ Average participations in the selling group were about $400,000, with individual ones ranging from about $50,000 to $750,000. Some participants, such as major Swiss banks, accepted their quotas for sale to their trust and agency accounts, while deploring the fact that they could not, under Swiss regulations, be members of the underwriting group, thus earning an additional commission. Other participants sold to their own particular customers. There are no evidences of great competitive efforts to acquire and sell to new customers, though there appear to be instances in which selling group members in some continental countries sold to investors in other continental countries. Underwriters and syndicate members in the United Kingdom did most of their selling outside of that country, since few of the new security issues (and none of the straight bond issues) were attractive in terms of security dollars.

The number of underwriters and selling group members considered desirable for relatively small security issues testifies to the fragmentation of the market and the importance of contacts. Nevertheless, the fact that so many firms could be assembled and that the selling group members

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1/ The tax on purchases of capital stock is equal to 15 per cent of the value of the stock; the tax on purchases of debt obligations is a percentage of the actual value related to the maturity of the obligation. Thus, if the period remaining to maturity is 3 years, the tax rate is 2.75 per cent; 10 years, 8.3 per cent; and 15 years, 10.3 per cent. The full rate of 15 per cent applies to obligations with a maturity of $28\frac{1}{2}$ years and more.

2/ Needless to say, the Interest Equalization Tax may be regarded as a force operating against integration of capital markets on a global scale.

3/ One of the more interesting recent issues was the one for $25,000,000 by the Istituto per la Ricostruzione Industriale (IRI) in June 1964. This was an issue of 5 3/4 per cent bonds due 1975-79, with detachable warrants to purchase Finsider common shares. These bonds could also be denominated in deutsche mark on the same terms. There were four managing underwriters and fifty organizations in the selling group for this issue.

did for the most part place their allotments in firm hands provides clear evidence of some market integration. More recently, American underwriters and securities dealers have joined in the new issue business in Europe.1/

These developments suggest that the Interest Equalization Tax has been a barrier to the security issues subject to tax.2/ The competitive advantage of the securities market3/ in the United States, considering only the relatively low cost on which money can be obtained, is apparently less than was once thought.4/ Costs and interest rates on new security issues in Europe have been reduced as activity and competition have increased. Although interest rates in general are higher in Europe than in the United States, the differential between interest rates on foreign issues and those on domestic issues is less in Europe than in the United States--Canadian issues being a notable exception. Moreover, a substantial part of the foreign dollar public issues floated in New York before the Interest Equalization Tax was sold abroad--some estimates run as high as 50 per cent--and

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1/ For example, the sale in December 1964 of $25,000,000 of 5½ per cent dollar bonds due in 1984 was managed by 3 U.S. investment bankers and underwritten by 67 houses in 12 countries, as follows: United States, 17; France, 10; Germany, 8; Belgium, Netherlands, and United Kingdom, each 5; Denmark and Italy, each 4; Norway and Sweden, each 3; Luxembourg, 2; and Austria, 1.

2/ Term loans by commercial banks, including those with maturities of three years and more, are not subject to the Interest Equalization Tax, and have increased sharply. This had led to suggestions that they should be controlled or taxed in the same manner as security issues. Outstanding long-term banking claims of U.S. banks against foreigners, as reported in the U.S. Treasury Bulletin, December 1964, were as follows (in millions of U.S. dollars):

	Dec. 1961	Dec. 1962	Dec. 1963	Oct. 1964
Europe	493	578	1,101	1,484
Canada	274	304	275	292
Japan	24	74	248	350
All other	1,243	1,204	1,391	1,556
Total	2,034	2,160	3,015	3,682

But see the views of George H. Chittenden in "The Changing Role of U.S. Banks in International Financing," a paper delivered at the American Finance Association 1964 Annual Meeting, Commercial and Financial Chronicle, Jan. 7, 1965.

3/ Both public issues and private placements. During the latter half of 1962 and the first half of 1963, there was a growing tendency for new issues to take the form of private placements.

4/ Nathaniel Samuels, "Perspectives on the New York Market--Capital Market Aspects," Commercial and Financial Chronicle, October 29, 1964; Federal Reserve Bank of Cleveland, Economic Review, January and June 1964; Federal Reserve Bank of Chicago, Business Conditions, September 1963. Cf. the conclusions in "International Investment: The Role of Security Markets," in the Bank of England's Quarterly Bulletin, June 1963.

in some cases sales to foreigners were rationed in order to provide participations for American investors. The transfer of new issue activity from New York to Europe was assisted by the active demand there for securities denominated in dollars.

Sixth, the integration of capital markets will be accelerated to the extent that there develops one, or only a few currency units in which foreign security issues are denominated.

The dollar has emerged as the most important currency unit of account, partly because of its unique characteristics, and partly because there are no convenient substitutes. Half of all the $1 billion of new foreign issues in Europe in the last 15 months (apart from British Commonwealth issues) were denominated in dollars.1/

The Swiss franc is not a candidate for this "honor and privilege" because the Swiss authorities are unwilling to open their markets to unlimited international operations and they are opposed to the issue of securities outside of Switzerland denominated in Swiss francs. These views are consistent with their general position that they do not want to increase international transactions involving Swiss francs nor do they want foreigners to hold liquid balances in Swiss francs.2/ For reasons that are not altogether clear, the Swiss have the means to compel international respect for these views.

There have been a few security issues denominated in deutsche mark. Nevertheless, this currency, despite its strength since 1952, does not have the general international acceptance of the dollar and the Swiss franc. Moreover, Germany is unlikely to be a good market for foreign securities for some time because of its high level of interest rates.

The French franc is unlikely to take on a greatly expanded international role, partly for reasons of France's obligations to the French franc area and partly for reasons similar to those of Germany.

Sterling is unlikely to serve as a unit of account unless it is backed by a flow of savings in sterling seeking foreign investment outside of the sterling area.

There have been two recent proposals for ways in which to express new security issues: the European Unit of Account (EPUnit), and the use of two or three currencies with an investor option on the currency in which he elects to receive principal and/or interest.

1/ From July 1963 through September 1964. See "Divisive Forces in World Capital Markets," First National City Bank of New York, Monthly Economic Letter, November 1964, p. 130.

2/ In line with this general attitude, Switzerland does not wish foreigners to hold sizable blocks of existing securities of Swiss companies or to acquire real estate and some other kinds of assets there.

Belgian banks have made a great effort to introduce the EPUnit.1/ This unit currently has the same value (in terms of gold and therefore in terms of the dollar) as that used by the former European Payments Union. The value of the EPUnit would be changed under defined conditions relating to the amount of change, the direction of change, and the number of changes of its 17 constituent currencies. The first security issue denominated in EPUnits was floated in 1961; in all, seven issues have been floated with a par value of 68 million EPUnits (equivalent to $68 million).2/ There are many difficulties in defining the conditions under which the value of the EPUnit will change, since the 17 constituent currencies are of very different strength and economic importance, and they have had very different parity histories in the postwar period. The EPUnit must steer a difficult course to avoid a gold guarantee, which would be illegal in many countries, and yet provide protection against significant changes in value. These changes must reflect equitably the amount and direction of change in the value of all constituent currencies, which cannot be expected to move together, or even in the same direction. It is not surprising that the definition of these conditions has changed from one security issue to the next, and that there is no clear agreement as to what the best set of conditions may be.

As already noted, Switzerland has objected to the inclusion of its currency in the definition of the EPUnit. Some other countries appear to have objected more quietly. For whatever reason, the effective interest rates on issues with government guarantees denominated in EPUnits "have been higher than the rates on ordinary bond issues in Switzerland and the Netherlands, and approximately the same as the rates on domestic bond issues in Belgium, France, the United Kingdom, and the Federal Republic of Germany."3/ These interest rates appear to be lower than those that would have had to be paid by these borrowers in their own countries in domestic currency--assuming they could have borrowed there--but this comparison is weakened by special tax exemptions accorded to these issues. "When account is taken of the tax privileges, the effective yields on the bonds in units of account may possibly be higher than the yields on domestic issues in the country of the issuing country."4/ These comments suggest that the borrowers in EPUnits have given a maintenance of value guarantee which may increase their financial obligations, but that the investors have nevertheless obtained interest yields at least equal to those on ordinary foreign issues.

It is perhaps too early to write off the prospect of substantial growth in the use of EPUnits, but it may be noted that their use in 1964 was much smaller than in 1963, despite the increased volume of foreign securities denominated in other currency units.

1/ Fernand Collin, The Formation of a European Capital Market, and Other Lectures (1964); Claudio Segrè, "Foreign Bond Issues in European Markets," Banca Nazionale del Lavoro, Quarterly Review, March 1964, pp. 23-27; Jean van der Mensbrugghe, "Bond Issues in European Units of Account," International Monetary Fund, Staff Papers, November 1964, pp. 446-57.

2/ The countries involved in these issues were Denmark, Finland, Italy, Norway, and Portugal.

3/ Jean van der Mensbrugghe, "Bond Issues in European Units of Account," IMF Staff Papers, November 1964, p. 454.

4/ Ibid., p. 455.

Issuing bonds denominated in two or three currencies, with an option for the investor to obtain payment of principal and interest in the currency of his choice at parities fixed at the time of issue, is another possibility.[1/] This proposal has not evoked much support. It is frowned upon by a number of European governments--and also by the United States.

Suggestions have been made for issuing foreign currency loans in parallel in national tranches, e.g., the tranche floated in Germany would be denominated in deutsche mark and that sold simultaneously in France would be denominated in French francs.[2/] The issues in the participating countries would be floated simultaneously, and the terms and conditions of all loans would be uniform as far as possible. The various tranches would carry the same nominal interest rate, but the issue prices could vary from one country to the other to provide an interest yield conforming to the level of interest rates in the participating countries.

This parallel issue procedure may have the effect of increasing the international flow of long-term capital but it is doubtful whether it would facilitate the integration of European capital markets. Moreover, it is by no means clear that money market conditions in European countries will usually permit parallel security issues simultaneously. Finally, to the extent that the tranches in each country are reserved for domestic borrowers--and this tends to be the case--this procedure shields the present national structure of capital markets.

IV

In conclusion, it should be noted that an integrated capital market in the Common Market is still a long way off, while an integrated market which will also include the United Kingdom and other EFTA countries is an even more distant prospect.

The interests of European countries continue to run in two directions: to operate domestic capital markets for domestic purposes, and to broaden domestic markets in line with international purposes. Domestic objectives have had the greater strength for more than 30 years, and they may become even stronger if one or more important countries in the European Economic Community run into balance of payments difficulties or if disagreements over the future development of the international financial system become more intense. But international objectives, which lead to integration on a multinational scale, have great underlying strength. These objectives are consistent with the growing integration of production, distribution, investment, and commercial banking in the Common Market. They should gain force steadily though quietly; and they will be assisted by the gradual removal of special national hindrances and costs that stand in the way of national capital markets operating at lower cost.

1/ See S. G. Warburg, "Double Currency Clause Would Aid European Investment," The Times (London), March 19, 1964.
2/ See Herman J. Abs, "Parallel Loans to Mobilize Continental Funds," The Times (London), March 11, 1964.

It is impossible to forecast with any precision how integration of long-term capital markets, which involves substantial equalization of interest rates, will be furthered. Integration will be facilitated if foreign securities can be denominated in one currency, or in any one of a small number of currencies. For the time being, the dollar is the most important single unit of account for foreign issues. But as the Common Market develops, one or more member currencies may well be accorded greater international status. The development within the Common Market of common attitudes and institutions, and the adoption of a far-reaching agricultural policy with uniform support prices, are making it more and more difficult for one Common Market currency to change its parity against the others. Such developments tend to bring European capital markets together, and they may in time be strengthened by a changeover to a common currency and a complete monetary union.

Capital market activities in Europe were stimulated first by the announcement and then by the enactment of the Interest Equalization Tax. These provided a strong boost to the European securities business, which had once been highly developed but had subsequently been curtailed by the war, postwar controls, and inconvertibility. It is regrettable that the increased competitiveness of capital markets in Europe were the results of higher taxes in the United States rather than reduction of tax and operating costs and of impediments in Europe. Nevertheless, the increased activities of securities markets in Europe may lead to some cost reductions there, and they may strengthen the voices that ask for rationalization and integration of capital markets in Europe. These voices now have the additional support that comes from higher profits earned in European capital markets which must rationalize themselves against the day when they will no longer have the protection of the U.S. Interest Equalization Tax. It would appear that capital market activities in Europe, compared to what they were before 1963, have gained permanently against those in the United States, even if the Interest Equalization Tax should lapse at the end of 1965.