Bond Case Briefs

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Hey, State Treasurers: Europe's Having a Sale on Money!

Several governments in Europe are now borrowing at negative interest rates. Switzerland recently auctioned 10-year bonds at a yield of minus 0.055 percent. Within the Eurozone, yields have turned negative on German, French and Dutch bonds maturing within five years.

Even less fiscally sound countries are able to float paper at extremely low rates. For example, 30-year bonds issued by Spain recently yielded 2.04 percent — this from a country with 23 percent unemployment and a 98 percent debt-to-GDP ratio.

European government interest rates are low due to sluggish economic growth, fears of deflation and an aggressive bond-buying program implemented by the European Central Bank. The benefits of low Eurozone interest rates are not only being realized by European governments. Foreign companies and countries are also enjoying the cheap money, borrowing over $20 billion in Europe during the first quarter, while U.S corporations issued $50 billion in Euro-denominated debt last year.

Can U.S. states — and perhaps even large cities and counties — benefit from Europe's sale on money? Judging from the experience of Ontario and other Canadian provinces, the answer appears to be yes. Ontario has been issuing Euro-denominated debt for many years. Earlier this year, Ontario issued a 10-year Euro bond with a coupon of 0.875 percent; recently, the bond was trading at yields below 0.5 percent. This compares quite favorably to New York State general obligation bonds maturing in 2025 that recently yielded 1.8 percent.

In fact, Ontario has a weaker credit rating than New York, so the Empire State might fare even better in the Euro market. The province is rated one notch lower than New York by both S&P and Moody's, and a look at relative fiscal conditions suggests that this rating differential is, if anything, too modest. In 2013, Ontario had a primary government debt-to-GDP ratio of 38.8 percent, while New York State's ratio was only 4.4 percent.

U.S. states may not have previously considered issuing overseas because of the tax exemption on interest. But some municipal securities, such as pension obligation bonds, are taxable. Further, the benefits of tax exemption in the U.S. have been offset by negative sentiment in the domestic municipal-bond market. European investors used to funding governments with high levels of debt and aging populations may be less frightened by the negative news about state finances reported in the U.S.

A couple of cautionary notes are in order. By borrowing in a foreign currency, a state takes on currency risk. This can be ameliorated by purchasing a currency swap. When negotiating a swap agreement with a financial institution, however, treasurers should learn from the bad experiences that Chicago and other municipal borrowers have had with interest-rate swaps. These deals often have fine print that could mandate balloon payments in the event of a rating downgrade.

Second, American states borrowed in Europe during the 19th century, and the story had an unhappy ending. Many European investors were stuck with Reconstruction-era bonds that were later repudiated by the Southern states that had issued them. The London-based Corporation of Foreign

Bondholders pressed states to honor these bonds into the 1930s, at which point Britain and other European countries needed relief from their World War I debts to the U.S. federal government. The U.S. state defaults then became a non-issue.

Since another Civil War does not appear in the offing, perhaps European investors will be ready to once again lend to American states — and to so at the low interest rates they afford to foreign companies, sovereigns and our neighbors to the north.

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