THE WORLD BANK
Treasury

FINANCIAL ADVISORY & BANKING

Sovereign Debt Management Forum 2014

Background Note for Breakout Session 6

Market dynamics in international capital markets for sovereign debt

I. Introduction

Strong global liquidity conditions and low interest rates in advanced economies in recent years have resulted in high demand for emerging market bonds issued in the international capital markets, and have attracted new issuers, in some cases countries with very low credit ratings. The session will discuss issues related to borrowing in the international capital markets from the perspective of different types of issuers: A frequent issuer with a large borrowing program (Brazil); a frequent issuer with a relatively small borrowing program (Sri Lanka); and a new issuer in the international capital markets (Azerbaijan)

II. Why do countries borrow in the international capital markets?

Large emerging market countries such as Brazil, Indonesia, Turkey and the Philippines have been regular issuers on the international capital markets for years. A more recent development has been low income and low rated countries that have traditionally relied on external funding from bi- and multilateral sources on concessional terms issuing in the international markets. Among these first time issuers are: Azerbaijan, Bolivia, Honduras, Mongolia, Namibia, Paraguay, Tanzania, and Zambia.

There are numerous and often country specific reasons to issue in the international capital markets. Among these are:

- The domestic market is not able to absorb the total funding need and/or it may be difficult and costly to issue long maturities at fixed interest rates
- The expected funding costs may be substantially lower than issuing domestically
- There is need for external funding to cover balance of payments deficits and/or a need to increase FX reserves
- International borrowing allow an expansion and diversification of funding sources and the investor base
- A wish to establish a reference point for corporate issuers - build a yield curve
- International bond issuance implies a high degree of visibility, and can be a tool to disseminate a positive image of the country to a broader community of investors
- The higher visibility include rating agencies, and can foster a higher degree of market discipline

- Compared to borrowing from bi- and multilateral sources, borrowings in the international markets are typically not tied to specific projects, and disbursements are immediate

Potential challenges related to international bond issuance include:

- Typically, a track record of good economic performance and a stable macroeconomic outlook are preconditions for an issuance to be successful
- Bond size is high – sometimes very high compared to the existing debt profile (Mongolia's first issuance in 2012 was equivalent to 15 percent of GDP, and more than 30 percent of the outstanding debt). The large size can imply substantial cost of carry
- The bonds are typically denominated in hard currencies
- Since the standard is to issue bullet structures, refinancing risk can be substantial
- The de-linking funding and spending can imply substantial cost-of-carry that adds to the borrowing cost
- Uncertain whether current positive market conditions will prevail

III. Regular issuers

Regular issuers in the international capital markets in general have a programmatic approach regarding frequency of issuance, issuance size, and structure, with the total annual volume depending on the size of the economy and funding needs.

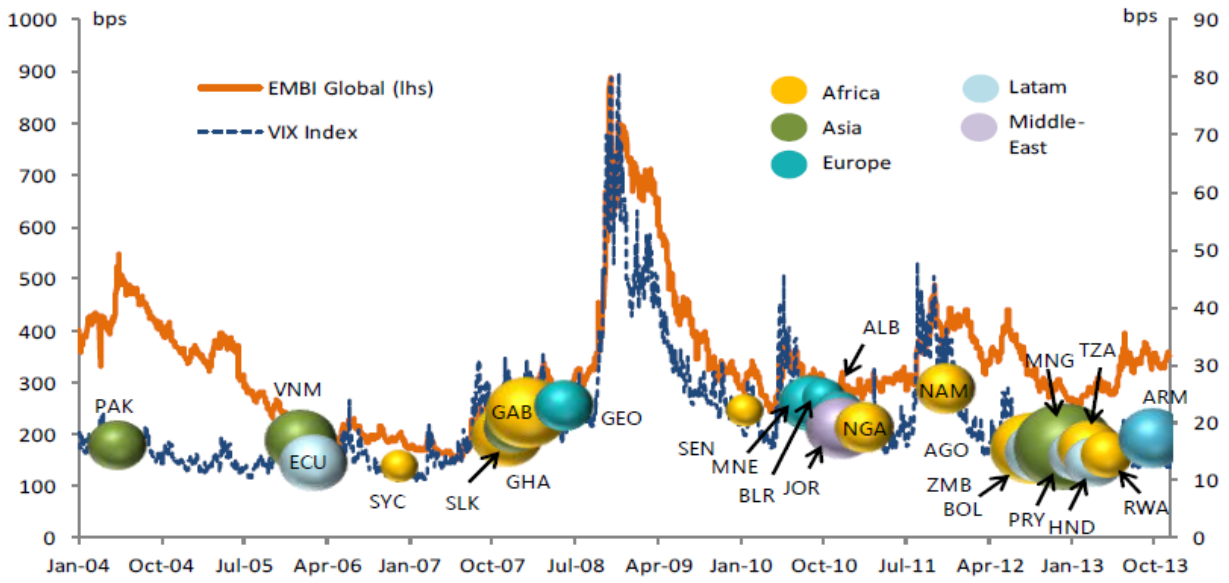
Some regular issuers have been diversifying their international issuances away from the most common financial terms (10 year maturity, fixed interest rate, bullet structure). Examples include Brazil that have issued internationally in local currency, and Indonesia that have issued sharia compliant structures, and others have issued new benchmark and at the same time buying back off-the-run bonds. These innovations have taken place in very favorable market conditions.

IV. New issuers

Prior to the global financial crisis, on the background of high liquidity and investors searching for diversification and yield, there was high demand for international bonds, even from issuers with relatively low rating. While the crisis effectively resulted in a sudden stop, issuances have pick up substantially from 2010 onwards, see figure 1. Fourteen different first time issuers have tapped the international capital markets since 2010.

Some of the first time issuers are low income or blend countries, i.e. in parallel with the international bond issuance they are borrowing at concessional terms. In many cases the bond proceeds have been targeted at infrastructure investments. From a portfolio point of view the international bond implies a substantial change in the debt composition towards higher interest cost and lower average time to maturity.

Figure 1. First-Time Issuances by Region, 2004-13



Source: "First-Time International Bond Issuance –New Opportunities and Emerging Risks", A. Guscina, G. Pedras and G. Presciuttini, IMF WB14/127.

V. Issues for Discussion

- What are the main drivers for international borrowing, and how does this type of borrowing fit with the debt management strategy?
- What are the main drivers when the debt managers move from domestic or concessional financing to market borrowing in foreign currency? What drives the choice of currency and maturity – market practice, or country-specific choices to ensure consistency with strategy?
- How has the arrival of new borrowers impacted the market, and will these borrowing opportunities remain open?
- Is external borrowing typically linked to specific projects? When this is not the case, how is cost of carry taken into account when alternative borrowing options are evaluated?
- How is refinancing risk managed? Sinking fund? Amortizing structures?
- How important is rating for the cost of borrowing? Initiatives regarding investor relations?
- Pros and cons of being a regular issuer - a country that is not a frequent issuer may decide to pursue an opportunistic approach and look for tailor-made financial terms rather than than attempting to build benchmarks