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3. The international debt securities market

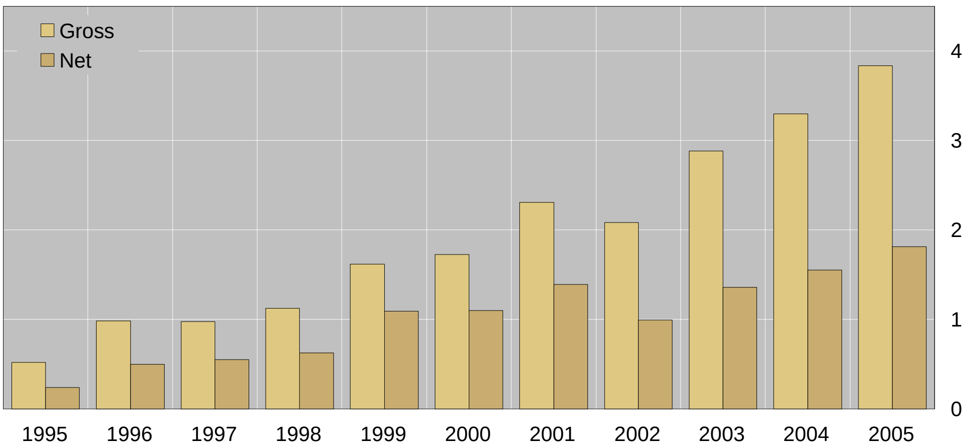
Global gross issuance of international bonds and notes increased by 25% in the fourth quarter of 2005, and was 4% higher than the average during the previous nine months. This is a departure from past experience, as the last few months of the year have traditionally been among the quietest on the international debt issuance calendar. For the year as a whole, borrowers issued a record amount of bonds and notes in the international market, with gross issuance up by 16% over 2004 and 120% higher than the average over the period 1995–2004 (Graph 3.1).

Global net issuance of bonds and notes more than doubled in the fourth quarter, rising from $237 billion to $572 billion. In particular, net issuance grew significantly amongst US, euro area and emerging market borrowers. Net issuance also grew rapidly for the year as a whole: by 17% globally and by 26% in emerging market countries. Despite relatively high global GDP growth in 2005, the ratio of net issuance to global GDP was at its second highest level ever. Japan was one notable soft spot in the international debt securities market last year, with net issuance of bonds and notes totalling only $8.5 billion in 2005.

Borrowing by emerging market countries remained strong, capping a record-breaking year in which gross issuance rose by more than 50%.

Annual gross and net issuance of international bonds and notes

In trillions of US dollars; gross refers to announced issuance



Sources: IMF; Dealogic; Euroclear; ISMA; Thomson Financial Securities Data; BIS. Graph 3.1

Emerging market borrowers evidently took advantage of very favourable financing conditions throughout most of the year, including the narrowing of spreads to new historical lows (see the Overview). Following a lacklustre third quarter, issuance by euro area entities in the international market increased by almost 50% on a quarterly basis. US borrowers were also unusually active, with gross issuance of bonds and notes rising by 20%. High-yield issuance in developed economies declined during the quarter, despite spreads holding steady throughout the period.

Record-breaking year for emerging market borrowers

Net borrowing by emerging markets almost doubles …

Borrowers in emerging market countries completed a record amount of issuance, on a gross basis, in the international bond and note markets in 2005. Gross issuance was $231 billion for the year, while net issuance totalled $96 billion (Tables 3.1 and 3.2). In the fourth quarter, gross and net issuance of bonds and notes were up by 5% and 87%, respectively. The robustness of this segment of the market is all the more surprising given that many issuers had already met their borrowing requirements for the year; in fact, some countries were expected to have already achieved their borrowing targets for 2006 by the end of last year.

… as financing conditions remain favourable

The financing environment faced by emerging market borrowers has continued to be very positive, with secondary market spreads holding steady around record lows during the period. The surge in issuance and the decline in spreads have been driven by what many perceive to have been a marked decline in the structural macroeconomic risks in these countries (see the Overview). For instance, the ratings on 13 emerging market sovereigns were raised by at least one of the three major rating agencies between 1 October 2005 and 31 January 2006.[1] In addition, there has been little sign that the risk appetite of investors for emerging market bonds has waned.

From a regional perspective, gross issuance of all international debt securities (bonds and notes plus money market instruments) increased on a quarterly basis in Africa and the Middle East, emerging Europe and Asia-Pacific, but declined in Latin America; net issuance increased in all regions except Africa and the Middle East (Graph 3.2).[2] Sector-wide developments in emerging market countries experienced a reversal from the previous quarter, with governments and financial institutions increasing both their gross and net borrowing of international debt securities, while corporates scaled back theirs.

Large deals from the Middle East …

The largest deal from emerging markets in the fourth quarter came out of the Africa and Middle East region: a $3.5 billion US dollar-denominated two-year bond by PCFC Development. Other large issues from the region included

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1 Of the countries receiving ratings upgrades, two were in Africa and the Middle East (Oman and Saudi Arabia), three in Asia (China, Kazakhstan and Korea), five in emerging Europe (Bulgaria, Lithuania, Russia, the Slovak Republic and Turkey) and three in Latin America (Brazil, Mexico and Venezuela).

2 Excluding the Republic of Argentina's repackaged issues totalling $15.7 billion from the first quarter of 2005.

Gross issuance in the international bond and note markets

In billions of US dollars

	2004	2005	2004	2005			
	Year	Year	Q4	Q1	Q2	Q3	Q4
Total announced issues	3,296.9	3,836.3	822.3	1,076.9	979.5	791.7	988.1
Bonds	1,782.7	2,045.0	434.9	595.8	516.9	427.8	504.4
Notes	1,514.2	1,791.3	387.4	481.0	462.6	363.9	483.8
Floating rate	1,254.5	1,470.7	327.9	335.5	412.0	273.6	449.7
Straight fixed rate	1,985.1	2,323.9	483.2	724.9	561.0	511.7	526.3
Equity-related[1]	57.4	41.7	11.2	16.5	6.5	6.5	12.1
US dollar	1,153.1	1,322.3	284.1	315.8	300.6	329.0	376.9
Euro	1,596.6	1,832.0	389.7	568.9	533.8	301.3	428.0
Yen	111.2	114.8	25.9	30.6	27.0	30.8	26.4
Other currencies	436.0	567.2	122.6	161.6	118.2	130.6	156.8
Developed countries	3,008.3	3,447.7	751.9	953.9	888.6	701.4	903.9
United States	773.6	835.7	182.3	214.6	168.4	206.1	246.6
Euro area	1,469.4	1,792.4	364.8	532.4	519.7	297.9	442.4
Japan	62.0	56.3	9.9	13.9	13.3	19.0	10.2
Offshore centres	39.2	50.4	13.5	11.4	13.3	12.4	13.3
Emerging markets	152.4	230.9	35.1	83.3	49.4	47.8	50.3
Financial institutions	2,684.9	3,173.1	688.3	841.7	815.2	677.3	838.8
Private	2,279.5	2,744.7	592.1	696.6	682.7	605.8	759.5
Public	405.4	428.4	96.2	145.1	132.5	71.5	79.3
Corporate issuers	269.9	239.4	75.0	58.6	56.8	48.2	75.9
Private	232.7	208.5	60.9	55.1	43.9	40.2	69.2
Public	37.2	30.9	14.0	3.4	12.9	7.9	6.6
Governments	245.0	316.5	37.3	148.3	79.3	36.1	52.8
International organisations	97.1	107.3	21.8	28.3	28.2	30.1	20.7
Completed issues	3,300.5	3,817.2	864.3	1,016.4	1,022.0	768.5	1,010.3
Memo: Repayments	*1,747.6*	*2,003.8*	*439.8*	*521.5*	*512.3*	*531.1*	*438.8*

[1] Convertible bonds and bonds with equity warrants.

Sources: Dealogic; Euroclear; ISMA; Thomson Financial Securities Data; BIS. Table 3.1

the State of Israel's euro-denominated bond for €750 million ($891 million), its largest issue since April 2004 in the international debt securities market, and an $850 million US dollar-denominated bond from National Bank of Abu Dhabi PJSC. The Lebanese Republic (classified in the BIS statistics as an offshore centre) was able to complete a US dollar-denominated bond for $750 million on 18 October, despite a rise in political tension in the region around the time of the deal.

… and Russia

Russian entities completed several deals in the fourth quarter, leading the way in the substantial increase in issuance from emerging Europe. Much of the issuance from Russia was by financial firms. The largest deals were completed by the financing arm of a large energy producer, Gaz Capital SA, and the financial firm VT Bank for Foreign Trade Capital SA. Elsewhere in emerging Europe, the Republic of Turkey issued a US dollar-denominated bond for

Main features of net issuance in the international bond and note markets In billions of US dollars								
	2004	2005	2004	2005				Stocks at end-Dec 2005
	Year	Year	Q4	Q1	Q2	Q3	Q4	
Total net issues	1,552.9	1,813.4	424.4	494.8	509.6	237.4	571.6	13,995.4
Floating rate	634.4	677.1	193.5	98.5	242.8	45.4	290.4	3,974.5
Straight fixed rate	924.7	1,155.9	235.3	398.6	272.0	200.5	284.9	9,698.0
Equity-related	–6.2	–19.6	–4.4	–2.2	–5.1	–8.5	–3.8	322.8
Developed countries	1,434.2	1,661.5	396.5	461.1	476.5	192.9	531.1	12,423.7
United States	225.3	267.8	61.8	63.9	47.9	42.1	113.8	3,444.6
Euro area	779.1	939.0	222.2	283.3	317.4	56.5	281.8	6,100.1
Japan	17.4	8.5	0.4	4.9	–2.4	5.0	1.0	264.0
Offshore centres	19.5	27.1	9.0	2.8	8.6	8.6	7.1	174.1
Emerging markets	76.4	95.9	21.6	29.0	15.3	18.0	33.6	861.8
Financial institutions	1,305.1	1,576.9	365.0	394.1	447.4	223.3	512.1	10,513.3
Private	1,095.3	1,387.1	316.3	318.0	370.4	212.7	486.0	8,951.9
Public	209.9	189.8	48.7	76.1	76.9	10.6	26.1	1,561.4
Corporate issuers	73.5	64.6	42.7	14.3	14.1	–3.1	39.5	1,517.6
Private	55.7	63.2	34.7	22.4	6.9	–4.8	38.7	1,286.5
Public	17.8	1.4	8.1	–8.1	7.1	1.6	0.8	231.0
Governments	151.4	143.0	19.4	84.5	39.0	–0.7	20.3	1,428.7
International organisations	22.9	28.9	–2.7	2.0	9.3	17.9	–0.2	535.8

Sources: Dealogic; Euroclear; ISMA; Thomson Financial Securities Data; BIS. Table 3.2

$750 million in November and a €350 million ($409 million) bond in early December. Later that month, Moody's raised the Republic of Turkey's long-term foreign currency rating from B1 to Ba3.

From Asia-Pacific, the largest deals were completed by the Republic of Indonesia: two US dollar-denominated bonds, one for $900 million with a 10-year maturity and one for $600 million with a 30-year maturity. But the largest total amount of issuance from the region during the quarter, on both a gross and a net basis, was from South Korea, led by a government issue. On 26 October, two days after Fitch upgraded the Republic of Korea from A to A+, the government completed a two-tranche deal: one tranche was a 10-year euro-denominated bond for €500 million ($601 million) and the other a 20-year $400 million US dollar-denominated bond.

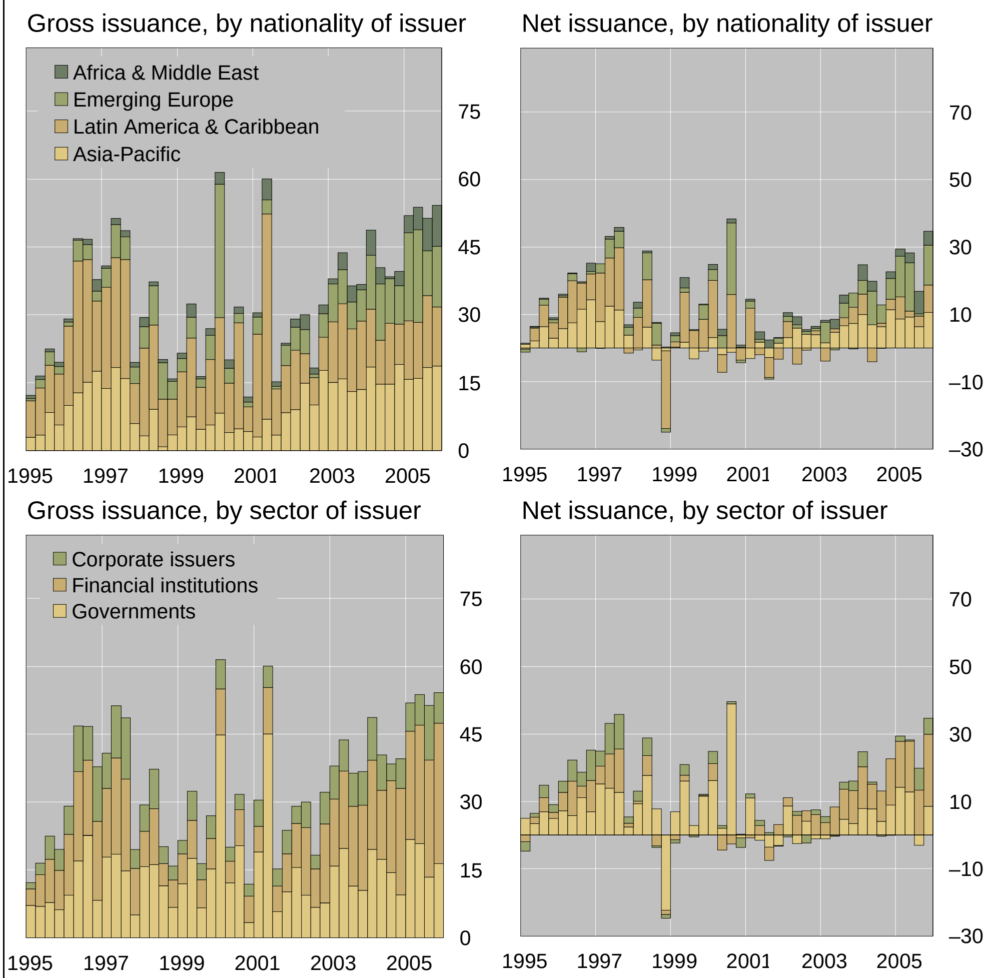
Ecuador returns to the international capital markets

Even though gross issuance in Latin America fell in the fourth quarter, net issuance more than doubled to $8.2 billion. Brazil and Venezuela, with net issuance of $2.3 billion and $2.9 billion, respectively, posted the largest gains.[3] Moreover, the region was the source of two significant events in international debt markets during the period. First, Brazil and Argentina fully repaid their IMF loans in December. Second, Ecuador returned to the international capital markets for the first time since its default in 1999. On

[3] In early February 2006, Standard & Poor's raised the government of Venezuela's rating from B+ to BB–.

International debt securities issuance by emerging market entities[1]

In billions of US dollars



[1] Excluding issuance by the Republic of Argentina in the first and second quarters of 2005.

Sources: Dealogic; Euroclear; ISMA; Thomson Financial Securities Data; BIS. Graph 3.2

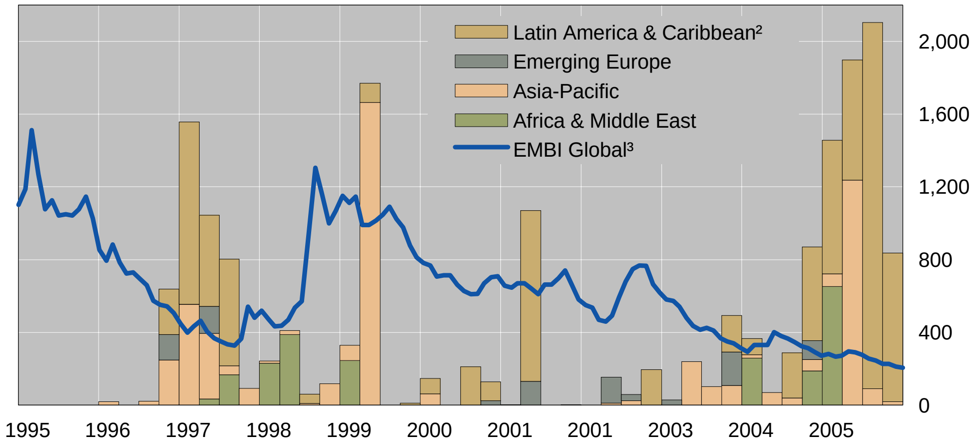
12 December, the government completed a 10-year US dollar-denominated bond with a face value of $650 million and a coupon of 9.375%. A significant portion of the issue was purchased by the government of Venezuela. While Ecuador's economy has benefited from high oil prices – Ecuador is the fifth largest producer of oil in Latin America – there are several potential risks to the government's fiscal situation surrounding the fiscal responsibility law, tax reform and the national pension fund.

Local currency issuance falters

Record year in local currency issuance ends on a soft note

In the fourth quarter of 2005, issuance of international debt securities in local currencies by emerging market entities fell for the first time in six quarters (Graph 3.3). Supply brought to the market totalled $837 million and consisted of 11 issues. Nevertheless, 2005 was an important year for this segment of the market, with total issuance of $6.3 billion far outstripping all previous years since 1995.

International debt securities issuance in local currency[1]



[1] Announced issuance by nationality of issuer in millions of US dollars. [2] Excluding issuance by the Republic of Argentina in the first quarter of 2005. [3] Adjusted for Argentina; monthly averages, in basis points.

Sources: Dealogic; Euroclear; ISMA; Thomson Financial Securities Data; BIS. Graph 3.3

Latin American entities continue to be the main force behind the resurgence in local currency issuance from developing countries in the international debt securities market. As shown in the graph, local currency deals out of this region totalled $4.2 billion in 2005, with the next most active region being Asia-Pacific, with $1.4 billion in issuance. The government of Brazil and Latin American financial institutions have been key players. In the most recent quarter, the Republic of Colombia brought the largest local currency issue to the market, a 10-year bond in the amount of 569 billion pesos ($250 million). Much of the remaining local currency issuance was by the Brazilian banks Banco Bradesco SA and Banco Votorantim SA.

Unusually busy fourth quarter for US issuers

US issuance rises again …

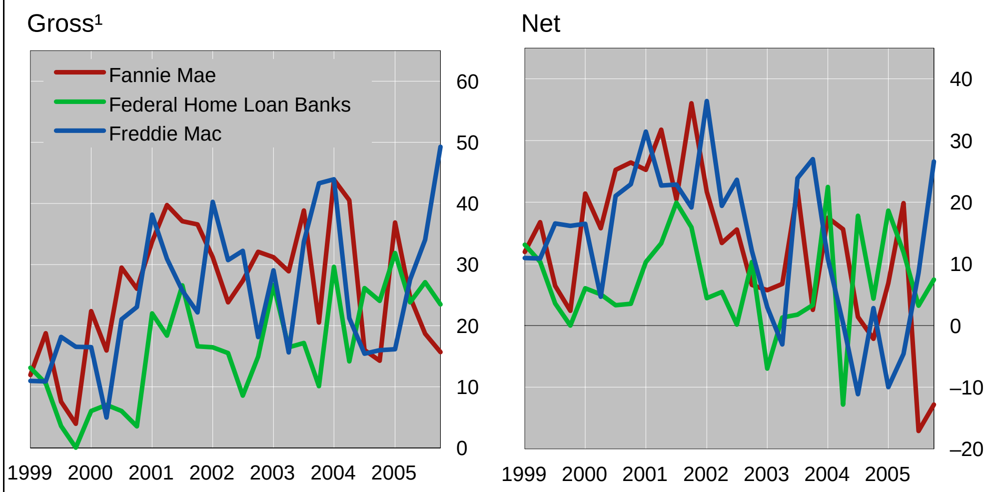
Gross issuance by US entities increased for the second consecutive quarter, following several previous periods in which the presence of US issuers in the international market had been relatively muted. Gross issuance of bonds and notes rose from $206 billion to $247 billion in the fourth quarter; judged on a year-over-year basis, gross issuance increased by 8% to $836 billion. The recent figures stand in sharp contrast to past seasonal patterns, as US gross issuance is typically about 10–15% lower than the yearly average in the fourth quarter (see this chapter of the *BIS Quarterly Review*, September 2005). Net issuance rose by a much larger percentage in the fourth quarter, almost threefold to $114 billion.

… led by several deals from Freddie Mac

The agencies were once again the most active issuers from the United States, accounting for 36% of US gross issuance. Nonetheless, there were some sharp differences in the borrowing activity across them. In particular, Freddie Mac continued to expand its participation in the international market in the fourth quarter, with gross and net issuance increasing by 45% and 212%, respectively (Graph 3.4). The agency accounted for almost 25% of total net borrowing by US entities during the quarter. By contrast, Fannie Mae continued

US agencies' issuance of international bonds and notes

In billions of US dollars



[1] Announced issuance.

Sources: Dealogic; Euroclear; ISMA; Thomson Financial Securities Data; BIS. Graph 3.4

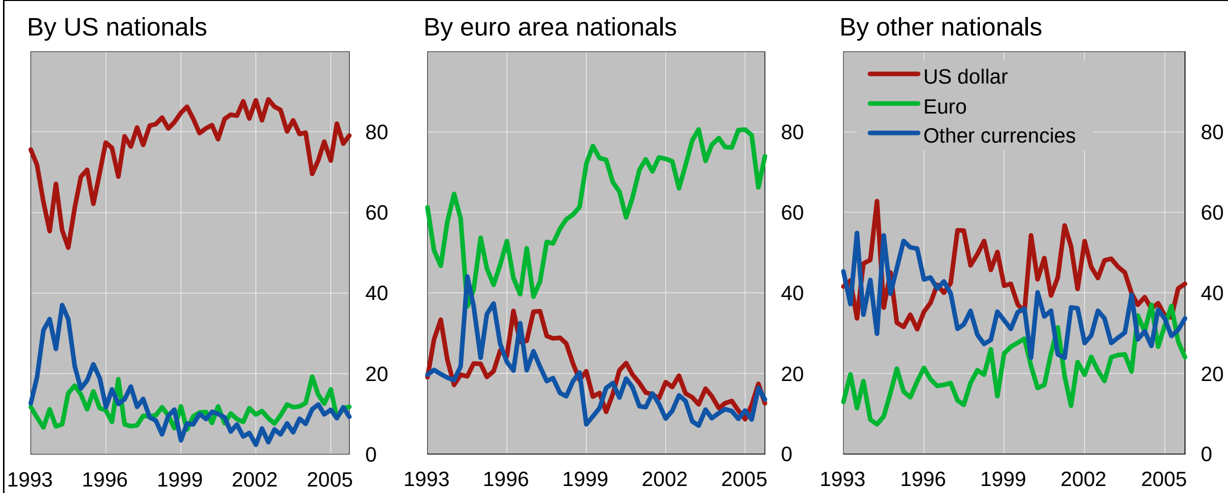
to retreat from the international bond market, with net issuance of –$12.8 billion. This was probably the result of Fannie Mae continuing to scale back its mortgage portfolio in the fourth quarter, even after meeting a capital surplus requirement for the end of September which had been imposed by the Office of Federal Housing Enterprise Oversight.

Supporting the large increase in issuance by Freddie Mac during the quarter were several deals in excess of $1 billion that spanned the maturity spectrum from 1.5 years to 30 years. For instance, Freddie Mac issued four medium-term notes with a face value of $4 billion each. The maturities of these notes ranged from two years (launched at a spread of 24.5 basis points over US Treasuries) to 10 years (at a spread of 36.5 basis points).

The risk of an adjustment to the US dollar seems to have had little negative impact on dollar-denominated bond issuance in the international

Currency shares in gross issuance of international bonds and notes

In per cent



Sources: Dealogic; Euroclear; ISMA; Thomson Financial Securities Data; BIS. Graph 3.5

market. The share of issuance in US dollars held fairly steady throughout 2005. In the fourth quarter, the proportion of bonds and notes denominated in US dollars issued by US entities actually rose slightly, from 77% to 79%; the fraction issued by nationals from other countries excluding the euro area was unchanged, while the fraction of issuance in US dollars by euro area entities declined somewhat in the midst of a strong rebound in the issuance of euro-denominated bonds and notes by euro area nationals (Graph 3.5). One factor potentially favouring the demand for US dollar issuance in recent months was that government bond yields continued to be higher in the United States than in the euro area.

Global US dollar issuance holds steady

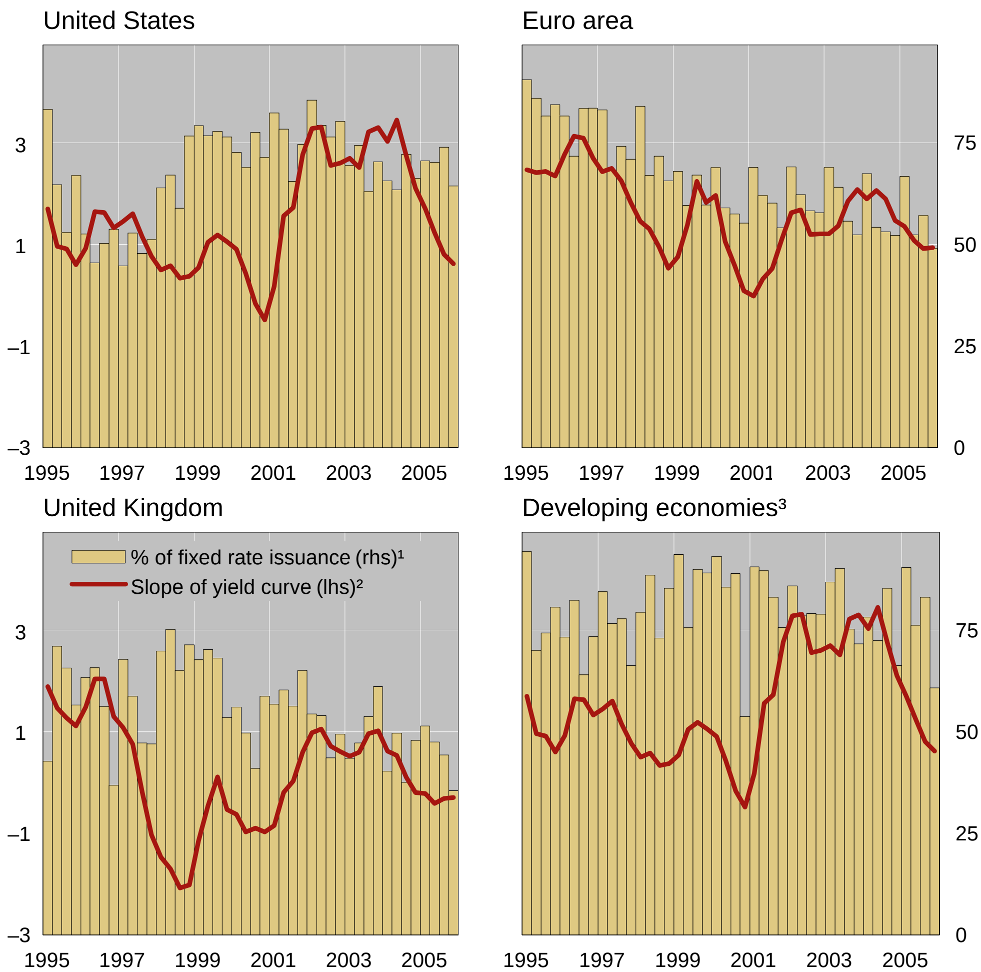
Proportion of US fixed rate issuance drops amidst curve flattening

The slope of the yield curve is potentially one factor that determines the relative amount of fixed and floating rate bond supply observed in the market. In fact, with the slope of the US Treasury curve continuing to flatten in the

Growth in floating rate issuance as Treasury curve flattens

Fixed rate bond issuance and the yield curve

In per cent



[1] Announced issuance of international bonds and notes. [2] Difference between 10-year and three-month government bond yields. [3] Slope of yield curve based on US Treasury yields.

Sources: Dealogic; Euroclear; ISMA; Thomson Financial Securities Data; BIS. Graph 3.6

fourth quarter, the fraction of straight fixed rate international bond issuance by US entities fell from 74% to 64% (Graph 3.6). The fraction of fixed rate issuance also dropped sharply in developing countries along with the decline in the slope of the US Treasury curve. The percentage share of fixed rate issuance in total global issuance of international bonds and notes fell from 65% to 53% (Table 3.1).[4]

Several factors affect the choice of fixed vs floating rates

Looking back over the past couple of years, however, the fraction of US fixed rate issuance has been fairly stable, even though the US Treasury curve has been flattening over this longer period as well. For instance, the difference between 10-year and three-month Treasury yields has fallen from a recent high of 3.5% in the second quarter of 2004 to 0.7% in the fourth quarter of last year. Standard term structure models imply that term premia on longer-maturity bonds have been at extraordinarily low levels, which suggests that issuers could have obtained relatively cheap financing by issuing longer-dated fixed rate paper. But several factors determine the fraction of fixed rate bond supply observed in the market, of which the slope of the yield curve is only one. The bargaining positions of borrowers in the international bond market will depend upon the conditions they face in domestic bond markets, as well as for other forms of financing. Moreover, it is not obvious a priori whether issuers or investors should have stronger preferences about exposure to interest rate risk on a given security. This will depend upon the comparative advantage, including cost, to borrowers versus investors in hedging this risk.

Rebound in euro area issuance

Fivefold increase in euro area net issuance, driven mainly by Germany

After a very weak third quarter, gross issuance of international bonds and notes by euro area entities rebounded strongly in the fourth quarter, rising from $298 billion to $442 billion. As with issuance in the United States, euro area issuance in the international market tends to be much lower in the second half of the year. Most euro area governments, for instance, attempt to front-load their borrowing in the first part of the calendar year.[5] Since redemptions by euro area entities in the fourth quarter were relatively small, there was an almost fivefold increase in net issuance. This was propelled by significant jumps in all of the large euro area countries, with net borrowing rising by a factor of 24 in Germany, seven in France and three in Spain (see Table 15B in the Annex); net issuance in Italy increased from –$9.7 billion to $27.3 billion. Smaller economies in the region also experienced tremendous growth in net issuance.

There are several possible factors that might explain the large amount of euro area issuance in the fourth quarter. One could be an attempt by borrowers to secure funding before the anticipated rate hike by the ECB on 1 December

[4] By contrast, the yield curve steepened slightly in the euro area and United Kingdom, yet the proportion of fixed rate issuance by entities in these economies also fell during the fourth quarter (see Graph 3.6).

[5] Valuation effects do not account for much of the change in issuance expressed in US dollars: the exchange rate of the euro vis-à-vis the dollar depreciated by only 2% during the quarter.

and the possibility that financing conditions would become less favourable as a result. Alternatively, it may simply be one of several signals that have surfaced recently indicating that a stronger recovery in the euro area economy is under way.

The largest issue in the international market in the fourth quarter was completed by the government of Italy for €6 billion ($7.2 billion). Smile 2005 Synthetic BV, a Dutch special purpose vehicle, issued a six-tranche €6.8 billion collateralised loan obligation secured on a pool of euro-denominated loans issued by bank ABN Amro. The bulk of the deal was placed in the most senior tranches (€6.3 billion), which were rated AAA/Aaa by the three major rating agencies. The Class A1 tranche was launched at a spread of 14 basis points over three-month Euribor.

UK issuance surges, Japanese borrowing fades

UK borrowers end a strong year on a high note …

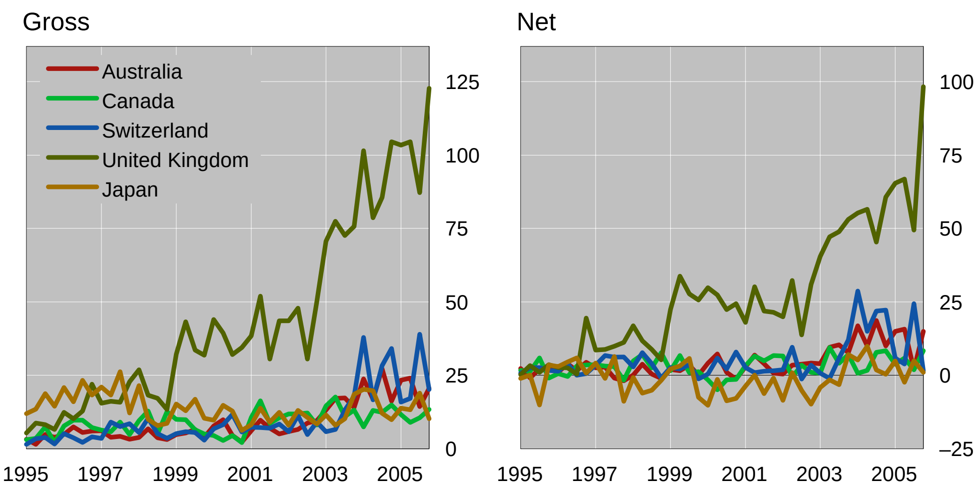
Amongst other developed economies, borrowers from the United Kingdom were particularly active in the international debt securities market in the fourth quarter. Gross borrowing by UK entities was up by 40%, with net borrowing almost doubling (Graph 3.7). The vast majority of UK issuance was by financial institutions, including two large multi-tranche issues by Gracechurch Mortgage Funding plc and Holmes Financing (No 9) plc for $7.9 billion and $6.5 billion, respectively. Net issuance also rose significantly in Australia and Canada. By contrast, net issuance fell by 94% in Switzerland and 80% in Japan.

… while Japanese issuance remains weak

Indeed, the fourth quarter ended a very soft year for Japan in the international bond market. Net issuance of international bonds and notes by Japanese entities was only $8.5 billion in 2005; this compares with $215 billion from Germany, $268 billion from the United States and $280 billion from the United Kingdom. Almost 80% of net borrowing by Japanese issuers in the international market in 2005 was attributable to financial institutions, with

International issuance by nationals of selected countries[1]

In billions of US dollars

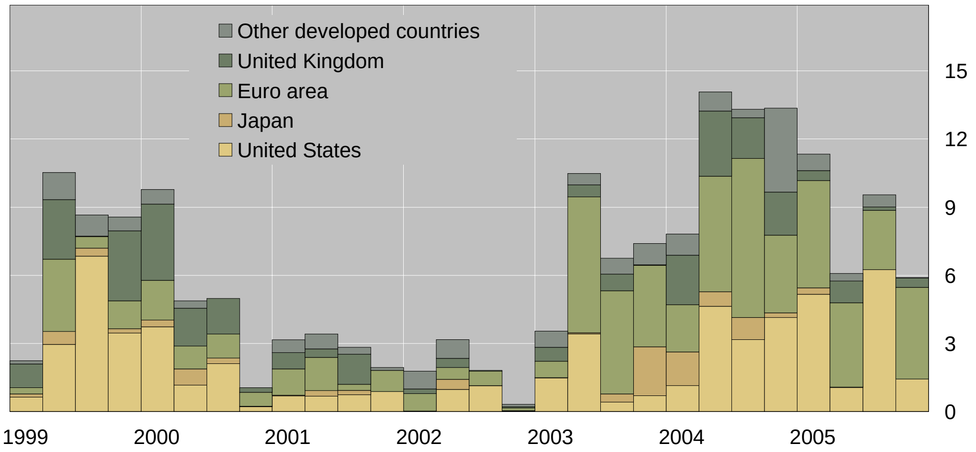


[1] Gross announced and net issuance of bonds and notes.

Sources: Dealogic; Euroclear; ISMA; Thomson Financial Securities Data; BIS. Graph 3.7

Issuance of non-investment grade international bonds[1]

In billions of US dollars



[1] Issues rated BB+/Ba1 or lower.

Sources: Dealogic; BIS. Graph 3.8

nearly all of the remainder due to corporates. The largest issuers were the financial arms of Toyota, Bank of Tokyo Mitsubishi and Resona Bank Ltd.

Cooldown in high-yield market

High-yield issuance falls in Q4 to end a roller-coaster year

Gross issuance of high-yield international bonds and notes by entities in developed economies fell in the fourth quarter by 39%, although the drop in issuance was not as large as in the second quarter of 2005 at the time of ratings downgrades in the US auto sector (Graph 3.8). The cooling-off in the primary market occurred despite secondary market spreads remaining range-bound during the period. For 2005 as a whole, high-yield issuance fell by 32% from 2004, but was higher than in any other previous year.

In the euro area, however, high-yield issuance rose in the fourth quarter, and in 2005 was only 14% below the record level of the previous year. Growth in the European high-yield market was sparked by the advent of the euro in 1999, and the market expanded significantly in 2003. Amongst the deals completed by euro area entities in the fourth quarter was a three-tranche deal by TUI AG, a German travel services company, in the amount of €1.3 billion ($1.53 billion). Two of the tranches were rated BB/Ba2 and the other B1 by Standard & Poor’s and Moody’s. Wind Acquisition Finance SA, an Italian firm, issued two bond tranches, one denominated in euros for €825 million ($976 million) and the other in US dollars for $500 million. Both tranches were rated B–/B3 by Fitch and Moody’s.