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2. The international debt securities market

After a slowdown in the final months of 1999, net issuance of international debt securities enjoyed a modest recovery in the first quarter of 2000 and was on track to approach the record levels reached during 1999 as a whole (see the table below). Total net issuance rose to $266 billion from $212 billion in the final quarter of 1999, when activity had been dampened by concerns about possible market disruptions related to the millennium changeover. Compared with the first quarter of 1999, however, total net issuance in the first quarter of 2000 was down by 14%. Virtually all of this decline resulted from lower net issuance of money market securities; net issuance of international bonds and notes in the first quarter was roughly unchanged from a year ago. Securities issuance was dominated by financial institutions and state agencies rather than non-financial corporations, and by fixed rate rather than floating rate or equity-linked structures. Both the preference for long-term, fixed rate securities

Main features of net issuance in international debt securities markets[1]

In billions of US dollars

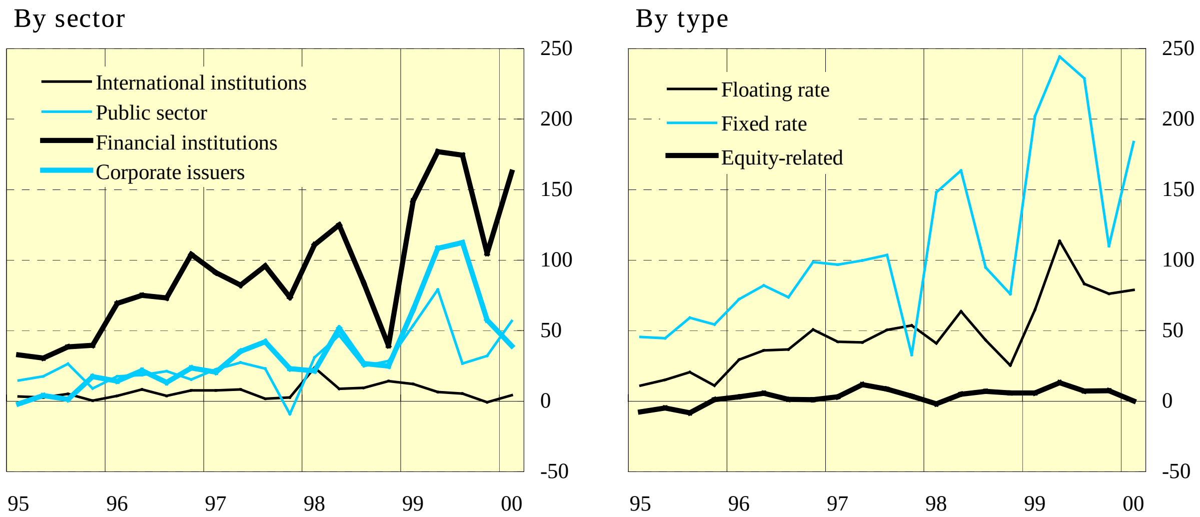
	1998	1999	1999				2000	Stocks at end-March 2000
	Year	**Year**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	
Total net issues	**681.5**	**1,225.2**	**307.8**	**363.1**	**342.0**	**212.2**	**266.0**	**5,580.0**
Money market instruments[2]	9.8	68.6	35.1	– 8.0	22.8	18.7	3.4	263.0
Bonds and notes[2]	671.1	1,156.5	272.7	371.1	319.2	193.5	262.7	5,317.0
Developed countries	575.3	1,149.3	284.2	333.9	331.3	199.9	241.1	4,701.1
Euro area	*211.0*	*493.9*	*116.2*	*143.7*	*137.4*	*96.5*	*119.8*	*1,840.6*
Japan	*– 17.4*	*4.1*	*0.0*	*2.4*	*7.0*	*– 5.3*	*– 13.2*	*322.3*
United States	*280.4*	*484.5*	*129.8*	*141.1*	*131.5*	*82.1*	*88.1*	*1,394.5*
Offshore centres	10.0	15.7	7.4	0.9	3.0	4.5	0.7	75.3
Other countries	40.2	35.5	2.6	21.7	2.0	9.1	20.0	425.8
International institutions	56.0	24.7	13.6	6.7	5.7	– 1.3	4.2	377.8
US dollar	410.4	546.2	157.2	172.2	142.1	74.7	122.1	2,634.2
Yen	– 26.8	– 5.8	– 11.9	– 1.8	8.1	– 0.2	– 1.2	531.6
Euro area currencies	224.2	576.0	138.5	152.5	164.8	120.3	121.4	1,650.5
Other currencies	73.6	108.8	24.1	40.2	27.1	17.4	23.8	763.7
Private sector	503.2	1,011.6	242.2	278.5	310.1	180.9	201.0	4,094.4
Financial institutions[3]	*370.0*	*658.9*	*171.7*	*168.3*	*196.3*	*122.5*	*162.4*	*2,717.1*
Corporate issuers	*133.2*	*352.7*	*70.4*	*110.1*	*113.8*	*58.3*	*38.6*	*1,377.4*
Public sector[4]	122.3	188.8	52.1	78.0	26.2	32.6	60.8	1,107.8
Central government	*35.6*	*37.6*	*7.2*	*21.9*	*– 2.9*	*11.5*	*15.6*	*483.8*
State agencies and other	*86.7*	*151.2*	*44.9*	*56.1*	*29.2*	*21.1*	*45.3*	*624.0*

[1] Flow data for international bonds, money market instruments and notes. Changes in amounts outstanding excluding exchange rate valuation effects. [2] Excluding notes issued by non-residents in the domestic market. [3] Commercial banks and other financial institutions. [4] Excluding international institutions.

Sources: Bank of England; Capital DATA; Euroclear; ISMA; Thomson Financial Securities Data; BIS.

Net issues of international bonds and notes by sector and type

In billions of US dollars



Sources: Bank of England; Capital DATA; Euroclear; ISMA; Thomson Financial Securities Data; BIS.

and the slowdown in corporate issuance appeared to reflect an uncertain environment for interest rates and credit spreads during the quarter (see page 7 of the Overview for a detailed discussion). Despite this uncertainty, structural aspects of the market continued to evolve, as illustrated by the advent of online underwriting of international bonds (see the box on page 21).

Activity by banks and housing agencies offsets the slowdown in corporate issuance

Commercial banks and other financial institutions were once again, and by far, the most active issuers of international bonds and notes in the first quarter of 2000, with 62% of net issuance (see the graph above). Fund-raising by this group of issuers has proceeded at a particularly strong pace in recent years, generally accounting for more than 50% of aggregate net financing activity in international securities markets. German and US financial institutions have been the busiest issuers, and at the end of March accounted for 24% and 23% respectively of outstanding securities launched by such entities. German state banks have been particularly active, capitalising on their high credit ratings to obtain wholesale financing. While such high ratings are in part the result of various forms of state support, German banks have also benefited from the financial strength of mortgage-backed structures (Pfandbriefe in particular). In contrast, the bulk of issues by US financial institutions have been launched by non-banks. Securitisation vehicles have accounted for about one third of activity by such entities, with the rest coming from securities firms and insurance companies.

Announced issues of international bonds and notes by US state agencies rose to record levels in the first quarter of 2000. Repayments were exceptionally strong, but net issuance was still nearly twice as high as during the final quarter of 1999. The US housing credit agencies, most notably Freddie Mac and Fannie Mae, offered several multi-billion dollar issues at key maturities in an attempt to create alternative US dollar benchmarks to US Treasuries. Both of these agencies have expanded their balance sheets considerably in recent years. The international portion of their debt has grown particularly quickly as the two agencies have pursued a strategy of funding diversification.

The return of emerging market borrowers to international markets continues

Net issuance by emerging economies continued to expand in the first quarter of 2000, rising to $20 billion from $9 billion in the final quarter of 1999. Central governments remained the most active borrowers in international markets, though after two quarters of net repayments net issuance by private sector borrowers also turned positive. Improving credit fundamentals, such as robust growth in Asia and Latin America, lay behind the increase in securities flows to emerging markets. Ongoing structural reforms also helped boost investor confidence.

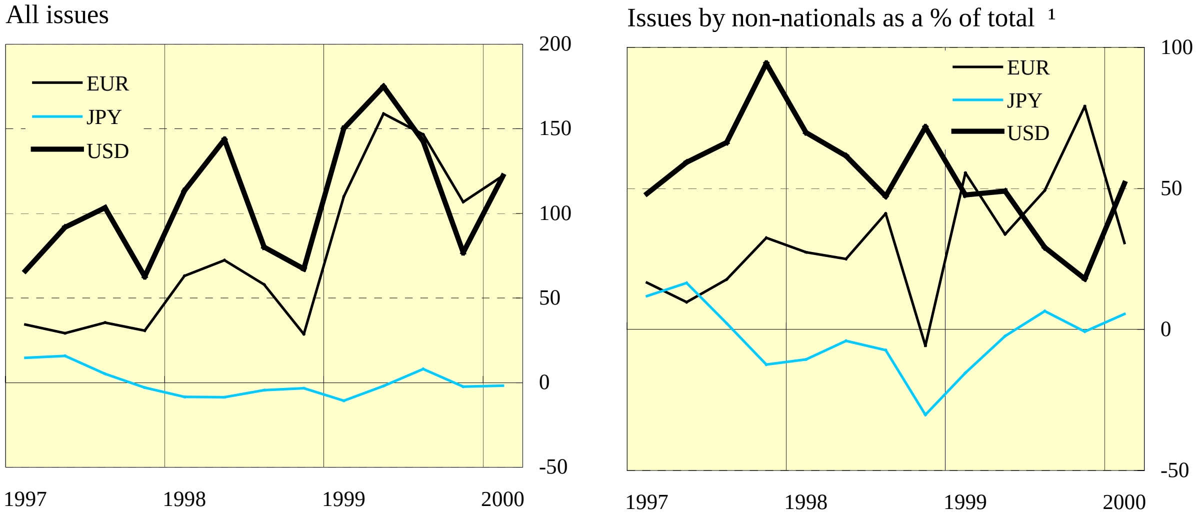
Latin American issuers were especially active, raising $16 billion. Net issuance by public sector borrowers rose to record levels, with the Argentine and Brazilian governments raising $3.9 billion and $3.4 billion respectively. Private sector issuance, which had been relatively subdued since autumn 1998, also picked up in the first quarter, led by Brazilian and Mexican borrowers. As Latin America rebounded from its 1998-99 slowdown, widening current account deficits - which remained large even last year - supported demand for increased foreign funding. Recent upgrades of Mexico's credit rating, most notably Moody's decision to give the country an investment grade (Baa3) rating, are also expected to support inflows.

Another noteworthy development in the first quarter of 2000 was Asia's return to international debt markets. Repayments by Asian borrowers (excluding Japan) had exceeded new issues by $3.2 billion in 1999 as a whole, but in the first quarter a marked increase in private sector issuance caused the situation to reverse. Flows to Korean financial institutions rose to their highest level since the Asian crisis, indicating growing confidence in the financial sector reforms undertaken to date in that country. Among public sector borrowers, new issues by the Philippine government were more than offset by repayments by other sovereign issuers, most notably Korean agencies.

Issuance by eastern European borrowers remained relatively subdued, despite a gradual narrowing of credit spreads. Countries preparing for accession to the European Union, such as Poland and Hungary, met most of their external financing needs through foreign direct investment. Countries less advanced in the transition process have had irregular access to international debt securities markets. Ukraine defaulted on bond payments due in the first quarter of 2000, but made up the payments after successfully exchanging securities maturing in 2000-01 for bonds with a longer maturity. Russia reached an agreement in principle with its London Club creditors in February, which is expected to set the stage for Russia's return to bond markets in time to refinance a $1 billion eurobond falling due in November next year.

Net issues of international bonds and notes by currency

Quarterly totals, in billions of US dollars



[1] Share of non-US borrowers in US dollar issuance, non-euro zone borrowers in euro issuance and non-Japanese issuers in yen issuance.

Sources: Bank of England; Capital DATA; Euroclear; ISMA; Thompson Financial Services; BIS.

The dollar outpaces the euro

The rebound of net issuance in the first quarter of 2000 relative to the fourth quarter of 1999 was largely confined to US dollar securities, which narrowly surpassed issuance in the euro-denominated instruments (see the graph on page 19). The pickup in US dollar issuance seemed largely to reflect a move towards more diversified funding sources by European issuers. Europeans issued $34 billion of dollar-denominated securities, after less than $1 billion in the dollar in the fourth quarter of 1999. Another factor promoting issuance in dollars was the above-mentioned growth in activity by emerging market borrowers, who continue to prefer the US currency.

As indicated in the graph on the previous page, borrowers from outside the euro zone had stepped up euro-denominated issuance in early 1999 relative to issuance in the legacy currencies. Since then, no clear trend in the use of the euro by such issuers has emerged. Towards the end of 1999, the proportion of net issuance in euros by non-euro area borrowers rose sharply, in conditions of generally subdued market activity in advance of the millennium changeover. The relatively slow pace of euro-denominated issuance in the first quarter of 2000 could similarly have reflected transitory market conditions. In particular, the continued weakness of the euro/dollar exchange rate may have suppressed investor interest in euro-denominated securities. Volatile credit and swap spreads could also have influenced the currency choices of issuers and investors. Given these conflicting short-term pressures, longer-term trends in the relative international issuance of euro and dollar liabilities may only become clear once foreign exchange and credit market conditions have stabilised.

Online underwriting breaks into the international bond market

Serge Jeanneau

The new year witnessed the emergence of electronic underwriting in the international bond market. The Federal Home Loan Mortgage Corporation ("Freddie Mac") launched the first international offering, a $6 billion issue of reference notes, marketed partly through the lead manager's proprietary online system. Several other issuers conducted similar syndications during the first quarter (see the table below).

Although these transactions attracted a great deal of publicity, the electronic underwriting of securities is not a new phenomenon. Borrowers in the US commercial paper and municipal bond markets have sold their securities over the web for some time. Even so, the development of electronic underwriting and trading has not been as rapid in fixed income markets as in some other major financial markets such as the foreign exchange, equity and derivatives markets. This lag can be attributed to the structure of fixed income markets: while they are large in the aggregate, they remain fragmented due to the large number of issues outstanding and the wide variety of specifications (in terms of maturities, coupons, credit quality and technical features). Moreover, trading has remained largely decentralised because transactions are conducted bilaterally by dealers outside organised exchanges.

Given that online primary market systems are in their infancy, actual benefits so far seem to have been modest. As is the case with other technological innovations, electronic underwriting systems create the potential for improved economic efficiency. However, the benefits of such systems will not be shared equally by all market participants. For example, the likely enhancement of market transparency in underwriting may be beneficial to issuers and investors but prove a mixed blessing for intermediaries, who may have benefited in the past from privileged market information. Some of the potential impacts of online underwriting on the various groups of market participants are considered below.

Large international bond issues launched over the internet in the first quarter of 2000

Issuer	Announcement date	Amount	Lead managers
FHLMC	5 January	$6bn	Warburg Dillon Read, Merrill Lynch, Salomon Smith Barney
FNMA	12 January	$10bn	Morgan Stanley Dean Witter, Goldman Sachs, Merrill Lynch
IBRD	18 January	$3bn	ABN Amro, Lehman Brothers, Goldman Sachs
Lehman Brothers Holdings	21 January	$2bn	Lehman Brothers
Abbey National Capital Trust 1	1 February	$1bn	Goldman Sachs, Lehman Brothers
FHLMC	15 February	$5bn	ABN Amro, Credit Suisse First Boston, JP Morgan Securities
Finland	15 February	€3bn	ABN Amro, Deutsche Bank
Compagnie de Financement Foncier	15 February	€1.3bn	CDC Marchés, Deutsche Bank
KfW International Finance	23 February	$2bn	Merrill Lynch, Morgan Stanley, Warburg Dillon Read
IBRD	29 February	$2bn	Warburg Dillon Read, Charles Schwab, Credit Suisse First Boston, Goldman Sachs, Paine Webber
Republic of Argentina	6 March	$1bn	Morgan Stanley
CIT Group	7 March	$1.3bn	Lehman Brothers, Warburg Dillon Read
Ford Motor Credit	9 March	$5bn	Chase Securities, Credit Suisse First Boston, JP Morgan Securities
Republic of Portugal	14 March	€1.5bn	ABN Amro, Merrill Lynch, Salomon Smith Barney

Source: Capital DATA.

For investors, the potential benefits of such systems include easier and cheaper information gathering, with the ability to compare prices across intermediaries and instruments, and the opportunity to issue orders online in real time.

From the point of view of issuers, a major potential benefit is the ability to broaden the investor base. Underwriters have traditionally focused on the largest institutional investors. The sale of securities through the internet will enable borrowers to access smaller institutional and retail investors directly. A broader investor base could in turn help lower borrowing costs. This potential, however, has yet to be fully exploited because the online underwriting of international securities has so far remained largely restricted to the biggest market participants. Most systems are proprietary and consist of sophisticated book-building facilities that are either operated centrally by the lead manager or jointly with the co-lead managers. They generally cater to other dealers and institutional investors rather than to retail investors. Although some underwriters have allowed individual investors to send orders online, few are in a position to allow such orders to be executed automatically.[1]

For intermediaries, however, the impact of such systems is less clear-cut. One obvious advantage is the lower cost of information dissemination. Another is the real-time monitoring of book-building, which should help them better determine the size and pricing of transactions, as well as their potential risk exposure. However, the ability of investors and issuers to "shop online" could increase their price sensitivity and shift the balance of power away from intermediaries. This could put downward pressure on underwriting commissions. Online systems might also lead to greater contestability of underwriting. The dominant position of the major underwriters could be challenged by the introduction of a successful system by a broker, data vendor or software developer. In fact, the threat of new entrants has been a driving force behind investment banks' creation of online systems for fixed income markets. Many investment banks are involved in several facilities at the same time in order to hedge their bets should some of the systems not live up to expectations. So as to encourage client loyalty and discourage new entrants, some investment banks have decided to cooperate in the provision of certain services. For example, a number of them have formed joint internet ventures in which investors have access to proprietary market research, new issue information and market prices.[2]

Reduced labour costs could help underwriters to maintain profit margins, but there has so far been little evidence of this type of cost saving. Investment banks have had to make heavy initial investments in online systems and have required extra staff to educate the various parties involved in their use. As a result, they have operated traditional and online underwriting systems in a parallel and complementary fashion. In addition, most online underwriting systems are not yet designed to conduct real-time auctions, so human intervention is still required for allocation and price setting.[3] In any case, human intervention is unlikely to be totally replaced by computer terminals since some issuers and investors will continue to value technical and investment advice, marketing expertise and support for secondary market trading. Nevertheless, the expanded use of online facilities over the medium term and the development of auction-based systems is likely to free up human resources in what has traditionally been a labour-intensive process.

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[1] See page 3 of *eCommerce in the US Fixed Income Markets*, The Bond Market Association, New York, November 1999. [2] For example, in March this year six US investment banks established Securities.Hub, a portal supplying institutional investors with proprietary research and pricing information on secondary market trading. [3] Internet upstarts such as Muniauction Inc, which allow investors to bid for new bonds directly from issuers, have already introduced such systems (which were used in the sale of City of Pittsburgh bonds in 1999).