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2. The international debt securities market

Despite rising credit spreads and turbulent equity and foreign exchange markets, net issuance of international debt securities in the third quarter of 2000, at \$259 billion, was only slightly below that of the previous quarter (Table II.2.1). Even so, net issuance for the three quarters so far this year, at \$798 billion, is 21% behind the pace for the same three quarters in 1999. Gross issuance of bonds and notes announced during these quarters was \$1,393 billion (Table II.2.2), almost the same as the amount announced for the year-earlier period. The difference is that repayments have been higher this year, with 44% of the money raised offset by repayments, compared to 31% in 1999. Repayments have been distributed among the different categories of debt more or less in proportion to the amount

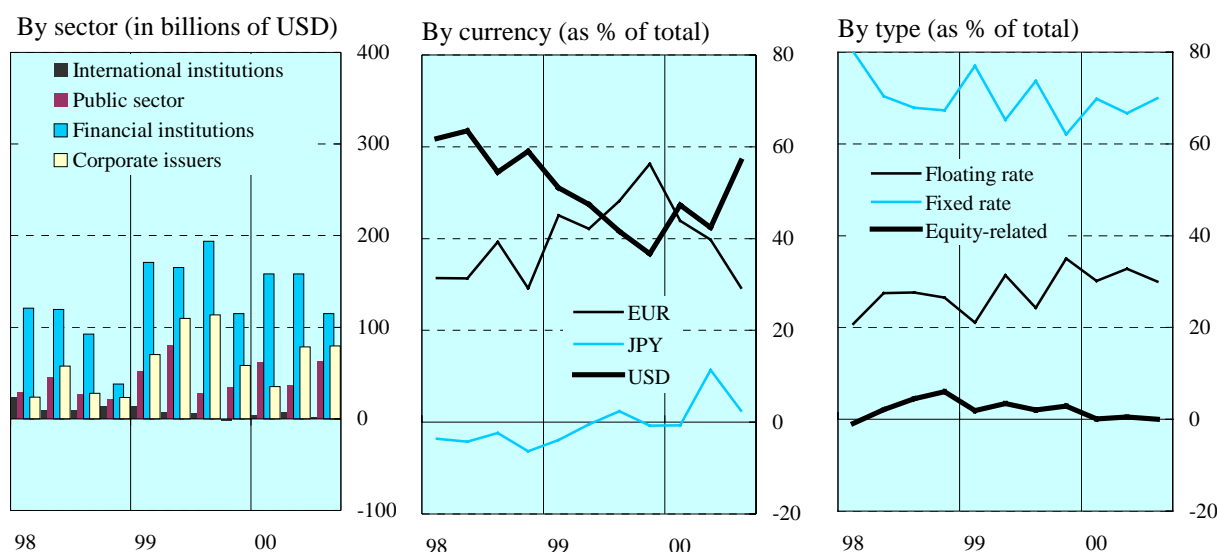
Table II.2.1
Main features of net issuance in international debt securities markets
 In billions of US dollars

	1998	1999	1999		2000			Stocks at end- Sep 2000
	Year	Year	Q3	Q4	Q1	Q2	Q3	
Total net issues	681.1	1,215.4	341.2	205.6	259.3	279.0	259.4	5,848.0
Money market instruments ¹	10.1	66.4	22.6	17.3	1.2	24.4	14.4	285.5
Bonds and notes ¹	670.9	1,149.1	318.6	188.3	258.1	254.6	245.0	5,562.5
Floating rate issues	173.4	333.1	82.8	72.0	78.1	91.5	77.8	1,411.8
Straight fixed rate issues	491.7	851.2	251.5	127.7	181.0	186.1	181.5	4,212.0
Equity-related issues	16.0	31.1	7.0	5.9	0.2	1.4	0.1	224.3
Developed countries	573.5	1,136.3	330.7	191.5	232.4	266.1	242.0	4,957.0
<i>Euro area</i>	<i>211.5</i>	<i>490.8</i>	<i>137.1</i>	<i>93.4</i>	<i>114.4</i>	<i>138.8</i>	<i>116.9</i>	<i>1,954.0</i>
<i>Japan</i>	<i>-17.4</i>	<i>2.7</i>	<i>6.9</i>	<i>-6.7</i>	<i>-13.2</i>	<i>-2.7</i>	<i>-11.7</i>	<i>295.6</i>
<i>United States</i>	<i>280.0</i>	<i>481.8</i>	<i>131.5</i>	<i>82.1</i>	<i>86.8</i>	<i>92.2</i>	<i>120.1</i>	<i>1,583.0</i>
Offshore centres	10.5	13.5	2.8	3.1	1.2	3.4	7.3	73.8
Developing countries	41.4	41.0	2.1	12.2	21.6	3.0	7.8	450.5
International institutions	55.7	24.7	5.7	-1.3	4.1	6.4	2.2	366.7
US dollar	410.6	545.3	141.8	75.4	122.7	118.3	147.6	2,898.8
Euro ²	223.8	570.8	164.4	115.7	113.8	110.9	76.1	1,653.4
Yen	-26.8	-7.2	8.1	-1.6	-1.7	31.8	6.5	543.9
Other currencies	73.5	106.4	26.9	15.9	24.5	18.0	29.1	751.9
Private sector	503.0	996.5	307.4	173.1	193.4	236.6	194.3	4,313.9
<i>Financial institutions</i> ³	<i>370.7</i>	<i>644.8</i>	<i>193.7</i>	<i>114.9</i>	<i>158.2</i>	<i>158.1</i>	<i>114.8</i>	<i>2,838.0</i>
<i>Corporate issuers</i>	<i>132.3</i>	<i>351.7</i>	<i>113.6</i>	<i>58.2</i>	<i>35.2</i>	<i>78.5</i>	<i>79.6</i>	<i>1,475.9</i>
Public sector ⁴	122.4	194.2	28.2	33.7	61.8	36.0	62.8	1,167.3
<i>Central government</i>	<i>36.4</i>	<i>36.0</i>	<i>-3.1</i>	<i>10.7</i>	<i>14.5</i>	<i>10.1</i>	<i>2.6</i>	<i>463.2</i>
<i>State agencies and other</i>	<i>86.0</i>	<i>158.2</i>	<i>31.3</i>	<i>23.0</i>	<i>47.3</i>	<i>25.9</i>	<i>60.2</i>	<i>704.1</i>

¹ Excluding notes issued by non-residents in the domestic market. ² For 1998, total of predecessor currencies. ³ Commercial banks and other financial institutions. ⁴ Excluding international institutions.

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

Graph II.2.1
Net issues of international debt securities by sector, currency and type



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

of gross issuance in those categories. In an effort to reduce borrowing costs and to take advantage of high volatility in the equity market, telecommunications firms issued bonds that could be exchanged for equity while other corporate issuers turned to the floating rate market. At the same time, US agencies took advantage of their high credit ratings to step up their issuance of long-term fixed rate debt.

Agencies issue heavily while other borrowers pull back

Among the various types of issuers, state agencies and government-sponsored enterprises seemed least affected by the widening of credit spreads in the third quarter. Armed with triple-A credit ratings, some of these borrowers more than doubled their net debt issuance in the quarter to \$60 billion, matching their record pace of last year (Table II.2.1, Graph II.2.1¹⁵). The Federal National Mortgage Association (“Fannie Mae”) announced over \$30 billion of new issues, while the Federal Home Loan Mortgage Corporation (“Freddie Mac”) announced over \$20 billion. These two issuers accounted for 65% of gross issuance by the agency sector during the quarter.

With a view to providing alternative benchmarks to government securities, the agencies concentrated on offering very large, long-term, fixed rate issues. After floating \$28 billion of fixed rate issues of at least \$1 billion in size in the second quarter, they issued a total of \$47 billion of such securities in the third. While most of their borrowing was denominated in US dollars, a €5 billion issue announced by Freddie Mac in September signalled that issuer’s interest in expanding its presence in the euro-denominated market.

Financial institutions other than agencies accounted for \$115 billion of net issuance in the third quarter, a 27% decline from the previous one. Net issuance by this sector during the three most recent quarters is 19% below that for the same period last year, conforming to the slower pace of issuance exhibited by the international securities market as a whole. Net issuance by German financial institutions, which have been important participants in these markets in recent years, declined from \$45 billion in the second quarter to \$28 billion in the third, in part because of the less favourable

¹⁵ The figures in Graph II.2.1 differ slightly from those in Table II.2.1 because the former only refer to international bonds and notes (ie. long-term securities) while the latter incorporates data on short-term securities as well.

market conditions for euro-denominated paper. DePfa, an important issuer of Pfandbriefe, decided to postpone issuance of a much heralded €1 billion issue in September because of the impact of concerns over inflation on the euro yield curve.

Non-financial corporations maintained their pace of primary market activity even as credit spreads widened and some large companies suffered from ratings downgrades.¹⁶ These firms raised a net \$80 billion in the third quarter, slightly more than in the second. However, corporate financing activity over the first three quarters remained 34% behind that for the same period last year, as borrowers lacking triple-A ratings began to find it more costly to raise funds in the bond market (Graph II.2.2). Issuance by telecommunications firms, in particular, slowed down sharply in the third quarter relative to the second. In the face of wide credit spreads, some of the firms turned to the syndicated loan market instead. Other corporations, particularly those involved in M&A activity, made up for the decline in telecoms issuance. The biggest corporate borrower in the quarter was Unilever, which issued \$7.6 billion of bonds and notes to finance its acquisition of Bestfoods.

Telecommunications firms as a group issued \$23 billion in the third quarter, less than half the amount they had in the second (Table II.2.2). The largest flotations from this group were \$3 billion by Hutchison Whampoa, \$5.9 billion in four tranches by Telefónica Europe, €2.5 billion by Siemens Nederland and €2.5 billion by Tecnost. All of these were dwarfed by Deutsche Telekom's nearly

Table II.2.2
Gross issuance in the international bond and note markets
In billions of US dollars

	1998	1999	1999		2000		
	Year	Year	Q3	Q4	Q1	Q2	Q3
Total announced issues	1,186.4	1,768.5	463.8	352.3	469.5	450.7	472.9
Floating rate issues	292.5	484.9	124.2	102.2	125.5	143.6	161.7
Straight fixed rate issues	846.9	1,231.5	331.9	237.5	332.3	297.5	296.5
Equity-related issues ¹	47.1	52.1	7.7	12.6	11.6	9.6	14.7
US dollar	603.0	775.4	200.0	132.0	197.6	183.1	215.1
Euro ²	335.3	676.5	178.2	139.5	169.6	146.3	147.7
Yen	75.2	118.9	37.5	36.7	48.6	75.6	49.0
Other currencies	173.0	197.7	48.0	44.2	53.7	45.7	61.1
Private sector	857.3	1,373.3	379.4	279.7	352.8	365.8	358.9
Financial institutions ³	596.1	896.8	242.1	184.7	261.2	229.6	235.6
Corporate issuers	261.2	476.5	137.4	95.0	91.6	136.1	123.3
of which: telecoms	33.6	84.3	16.2	15.7	24.4	46.7	22.9
Public sector	227.7	317.4	66.6	57.7	97.0	64.9	99.1
Central government	96.9	94.2	17.3	17.1	27.3	16.2	18.4
State agencies and other	130.8	223.3	49.3	40.6	69.7	48.7	80.7
International institutions	101.4	77.8	17.7	14.9	19.7	20.1	14.9
Completed issues	1,190.5	1,773.0	461.0	387.1	447.2	443.9	460.4
Repayments	519.6	623.9	142.4	198.8	189.1	189.4	215.4

¹ Convertible bonds and bonds with equity warrants. ² For 1998, total of predecessor currencies. ³ Commercial banks and other financial institutions.

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

¹⁶ See the box "Bond issues by European telecommunications companies" on pages 30-31.

Table II.2.3
Net issuance of international debt securities by currency and region¹

In billions of US dollars

		1998 ²	1999	1999		2000		
		Year	Year	Q3	Q4	Q1	Q2	Q3
Europe³	US dollar	77.5	55.4	11.8	0.4	33.0	36.0	39.4
	Euro	170.6	487.9	142.0	99.0	100.1	97.2	63.6
	Yen	- 9.1	6.2	7.9	2.5	3.6	31.1	7.5
	Other currencies	42.0	77.7	20.5	12.0	19.5	14.6	21.9
North America⁴	US dollar	262.1	435.4	117.8	72.9	68.4	71.4	102.6
	Euro	32.6	45.6	14.2	7.4	8.9	8.7	10.7
	Yen	- 4.1	- 1.3	0.7	0.3	5.2	4.6	2.5
	Other currencies	14.6	15.1	1.8	2.5	2.3	0.8	3.3
Others	US dollar	71.0	54.5	12.2	2.1	21.3	10.9	5.6
	Euro	20.6	37.3	8.3	9.3	4.7	5.0	1.9
	Yen	- 13.7	- 12.1	- 0.5	- 4.3	- 10.5	- 3.8	- 3.5
	Other currencies	16.9	13.6	4.6	1.4	2.6	2.5	3.8
Total	US dollar	410.6	545.3	141.8	75.4	122.7	118.3	147.6
	Euro	223.8	570.8	164.4	115.7	113.8	110.9	76.1
	Yen	- 26.8	- 7.2	8.1	- 1.6	- 1.7	31.8	6.5
	Other currencies	73.5	106.4	26.9	15.9	24.5	18.0	29.1

¹ Based on the nationality of the borrower. ² For the euro, total of predecessor currencies. ³ European Union countries, Iceland, Liechtenstein, Norway and Switzerland. ⁴ Canada and United States.

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

\$17 billion of bond and note issues during the second quarter. A credit downgrade of Deutsche Telekom's bonds in July and subsequent volatility in credit spreads dissuaded other telecommunications firms from following the German firm's lead in the fixed rate primary market. As explained in the box "Bond issues by European telecommunications companies" on pages 30-31, such spreads reflected the perceived risks resulting from their increased leverage and the fact that they are undertaking large-scale investments in new technologies.

The strong US dollar attracts increased issuance

Net issuance in the US dollar rose to \$148 billion in the third quarter, a 25% increase over the previous quarter, while that in the euro fell to \$76 billion, a 31% decline. This marks a return to a long-standing pattern in the international debt securities markets, whereby borrowers tend to issue in relatively strong or strengthening currencies. For example, in 1995, when the US dollar was at record lows against several currencies, only 26% of net issuance was in dollars, while by 1998, after several years of dollar appreciation, net issuance in dollars had grown to 60% of the total. In 1999, however, net issuance in euros exceeded that in US dollars despite the euro's weakening trend, constituting a departure from the usual pattern. This may have been due to a desire by large issuers to "establish a presence" in the market for bonds denominated in the new currency. During 2000, and particularly in the third quarter, borrowers reverted to their former tendency; dollar-denominated net issuance was 57% of the third quarter total.

The strength of issuance in the US dollar only partly reflected the fact that US issuers were more active overall. While the tendency to issue in their home currency remained strong for North American borrowers, the tendency for European borrowers to issue in euros has weakened. In the third quarter, North American borrowers raised 86% of their funds in dollars, the same proportion as the average for the six quarters since the introduction of the euro (Table II.2.3). In contrast, the third quarter saw European borrowers raising only 48% of their funds in euros, compared to 71% during the six

preceding quarters. Europeans instead used the dollar for 30% of their net issuance, after six quarters when it accounted for only 13% of their net financing. One reason for the increased dollar issuance by Europeans issuers was the large number of European acquisitions of US companies in the quarter, such as Unilever's acquisition of Bestfoods for \$20 billion.

Despite the rise in dollar issuance by Europeans, most of the large issuers in dollars continued to be companies based in the United States, particularly Fannie Mae, Freddie Mac, Ford Motor Credit and Morgan Stanley Dean Witter. Similarly, the largest issuers in euros were European firms, such as Siemens Nederland and Tecnost International, both based in the Netherlands and each one issuing €2.5 billion. German banks remained faithful to the euro, including Deutsche Hypothekbank for €3 billion, Württembergische Hypothekbank for €2 billion and Allgemeine Hypothekbank for €2 billion. Among large European issuers borrowing in dollars were Telefónica of Spain (\$5 billion in three tranches) and KPN of the Netherlands (\$3.5 billion in three tranches). Outside Europe, Hutchison Whampoa of Hong Kong went to the dollar market for its \$3 billion issue as did Celestica, a Canadian electronics engineering firm, for a \$1.8 billion high-yield convertible bond.

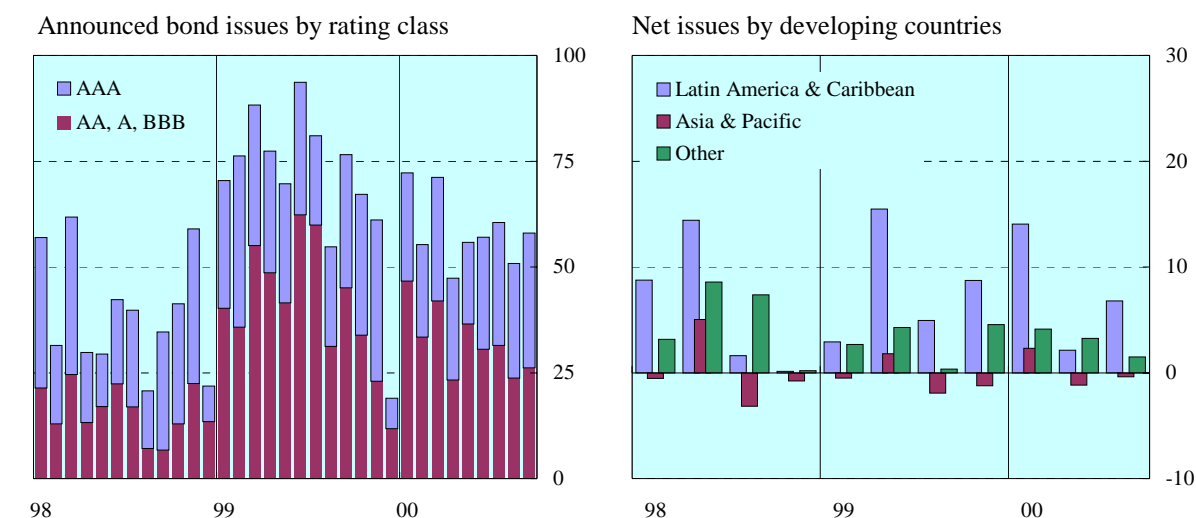
Activity in the yen continued to show signs of revival, after two consecutive years of negative net issuance, with \$6.5 billion in the third quarter following \$31.8 billion in the second. While borrowing in this market in the second quarter was dominated by global telecommunications firms, the most prominent issuers in the third quarter were financial institutions, including Citigroup, which announced ¥175 billion in three tranches, and Deutsche Ausgleichsbank with a ¥100 billion issue. Borrowers from the developing world, including the Republic of Argentina (¥61.5 billion), the Brazilian bank BNDES (¥40 billion) and the Pohang Iron and Steel Company of Korea (¥35 billion) were also active in the Samurai market.

Floating rate issuance continues to grow

While the share of floating rate structures in total issuance declined in the third quarter relative to the second, such issuance over the first three quarters of 2000 continued to be relatively more prominent than during the comparable period of 1999. During the first three quarters of 2000, net issuance of

Graph II.2.2
International bond and note issuance ¹

In billions of US dollars



¹ Based on the nationality of the borrower.

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

floating rate instruments amounted to \$247 billion, or 5% less than issuance in the same period last year (Table II.2.1). In the case of fixed rate debt, net issuance of \$182 billion in the third quarter and similar amounts in the two earlier quarters represented a 24% drop relative to 1999. The uncertain inflation and credit environment during most of the period may have contributed to borrowers' continued preference for floating rate obligations, especially corporations without triple-A ratings. In the third quarter, for example, A/A1 rated Unilever turned to the floating rate market for its \$6 billion and €1.5 billion issues, as did A/A2 rated Ford Motor Credit for its \$2 billion issue.

Some corporations facing wide credit spreads attempted to reduce their borrowing costs without immediately diluting their already weak equity values by issuing convertible bonds. Volatile equity markets, by increasing the value to investors of the conversion option, reduced the direct cost to borrowers of issuing these bonds and thus helped to compensate for the increase in credit spreads. Telecommunications firms in particular, including such borrowers as Hutchison Whampoa, Siemens Nederland and Tecnost, took advantage of these conditions by issuing large amounts of convertible debt. However, while new equity-related securities issuance approached nearly \$15 billion in gross terms, the highest amount since the second quarter of 1999, a high level of repayments, early redemptions and conversions meant that net issuance was virtually flat during the quarter.

Activity by US government-sponsored agencies in the third quarter was an important exception to the shift from fixed to floating rate issuance exhibited by other borrowers. For issues of at least \$1 billion in size, these agencies arranged more than four times as much fixed rate as floating rate issuance (consistent with their benchmark objectives), while for the market as whole the ratio was less than 3:1.

Developing countries concentrate on debt exchanges

While international debt issuance by developed country borrowers appeared to be slowing, issuance by developing countries remained close to last year's pace through the third quarter (Graph II.2.2). Developing countries raised a net \$7.8 billion from the international debt securities market in the third quarter. Net issuance by developing countries for the first three quarters totalled \$32.4 billion, slightly more than the \$28.8 billion for the corresponding period in 1999. Latin American issuers were especially active in the third quarter, particularly Argentina (\$2.2 billion), Brazil (\$1.4 billion) and Mexico (\$2.1 billion). Brazil's ability to access international capital markets was further demonstrated by the successful sale of \$4 billion of shares in the state-run oil company Petrobras on the New York Stock Exchange in August. Asian and eastern European issuers continue to be relatively inactive, and focused on buying back or refinancing existing debt.

Developing country debt issuance benefited from a generally narrowing trend in sovereign spreads through August. These spreads started to rise in September before widening sharply in October, which may portend a slowdown in the current pace of issuance in the fourth quarter (Graph I.3 in the Overview). Argentina, Brazil and Mexico announced eurobond issues in July, before secondary market spreads on emerging market debt started to widen. Besides issuing new debt, Latin American borrowers also took advantage of benign market conditions to exchange Brady bonds for less expensive, longer maturity eurobond issues. Brazil successfully issued some \$5 billion of 40-year debt in exchange for an equivalent amount of Brady bonds in August. Other countries were said to be exploring similar exchange offers.

Bond issues by European telecommunications companies

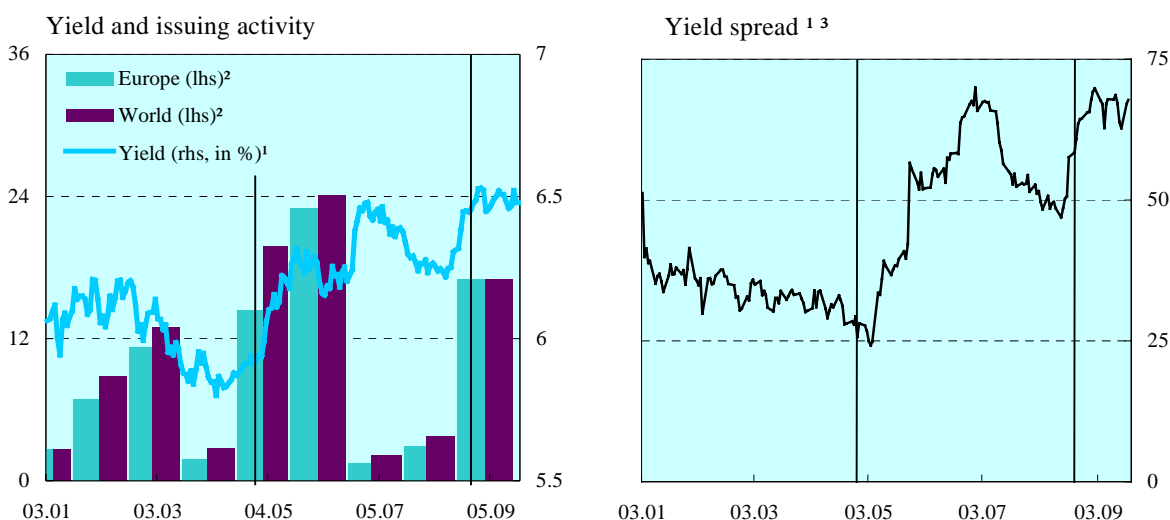
Dietrich Domanski

Telecommunications companies have issued unprecedented amounts in the international debt securities market in recent months. These issues totalled \$94 billion from January to September, with the bulk occurring in May, June and September (left-hand panel of the graph). This was equivalent to 27% of international gross issuance of corporate debt securities worldwide in the first three quarters of 2000. European firms accounted for 85% of all telecom issues. The European telecommunications sector faces very large financing requirements as a result of takeover activity and, even more importantly, the purchase of third-generation mobile phone licences. These licences were auctioned in the first three quarters of this year in the United Kingdom, the Netherlands and Germany, with bids amounting to €38.6 billion (or 2.5% of GDP), €2.7 billion (0.6% of GDP) and €50.8 billion (2.6% of GDP) respectively.

The yields on European telecommunications bonds and the spreads against swap rates have increased significantly since May. In the autumn, the average yield on euro-denominated bonds issued by Aa2-rated companies (Deutsche Telekom, France Telecom and KPN) with a residual maturity of approximately eight years was 70 basis points above swap rates, compared to 30-35 basis points in the spring. Spreads have also doubled relative to US telecommunications bonds (from about 15 to 30 basis points). Spreads of bonds issued by other large companies such as British Telecom and Telefónica followed the same pattern (although they are not fully comparable owing to differences in rating and maturity). Spreads widened in two “waves”, the first increase following the auction of third-generation mobile phone licences in the United Kingdom in April, and the second immediately after the German auction in August (right-hand panel of the graph).

The wider spreads suggest that market participants believe that the credit risk of European telecommunications companies is now substantially higher than a couple of months ago. The pattern of spreads across issuers reflects two main factors. First, many telecommunications companies have become more vulnerable to shocks because their leverage has increased sharply. In the first half of 2000, the debt to equity ratio for the Aa2-rated companies considered here jumped from 110% to almost 145%. The widening of spreads in May when a first batch of telecom bonds was issued partly reflects this. The leverage of telecommunications firms increased further in the second half of 2000, as the funds required to pay for the German licences were to a large extent raised in the syndicated loan market and subsequently refinanced by bonds. Since investments in third-generation mobile phone infrastructure have yet to be financed, funding needs are expected to remain high.

Telecommunications bonds in Europe



Note: The vertical lines indicate the end of the third-generation mobile phone licence auctions in the United Kingdom (27 April) and Germany (18 August).

¹ Unweighted average of the yield on bonds issued by Aa2-rated telecommunications companies with a residual maturity of seven to eight years. ² International bond issues in billions of US dollars. ³ Against euro Libor swap rates, in basis points.

Sources: Bloomberg; Capital DATA; Datastream.

Second, the wider spreads may indicate a changing perception of the risks that telecommunications companies are exposed to in undertaking large-scale investments in new technologies. As providers of the information technology infrastructure, they face the same types of hazards and risks as other “new economy” firms. Such firms are at a very early stage of the product cycle, investing in markets that are perceived to have a high growth potential with considerably higher expected long-run earnings than those in the “old economy”. At the same time, these earnings prospects are subject to considerable uncertainty. Rapid technological progress may quickly depreciate the capital stock; innovation in information technology may further reduce barriers to market entry and affect competition in unforeseeable ways; and the demand for many products based on new technologies is only surmised. Together, the risks that telecommunications firms are taking with these investments appear significantly larger than those of “traditional” infrastructure providers operating in more established markets. Against this background, the Financial Stability Forum and national regulatory bodies have expressed concerns that the large-scale borrowing by telecommunications firms might excessively expose the financial system to these risks.

The uncertainties associated with the huge investments in new technologies are also highlighted by the jump in spreads immediately after the German auction (right-hand panel of the graph) and by the announcements of possible downgrading of telecommunications firms by major rating agencies. Such downgrading is even more relevant since several large telecommunications issues this year contained coupon enhancement clauses offering an increase in interest paid if the issuer’s rating were to decline below a certain grade. Though coupon enhancement clauses or similar arrangements in loans may provide a built-in hedge for deteriorating credit quality, and therefore protect lenders against unforeseeable events, they tend to make the cash flow of telecom firms more vulnerable to potential shocks. This may be one reason why such clauses have recently become less popular and issuers have instead accepted higher spreads.

This large-scale telecommunications issuance is occurring at a time when bond markets are undergoing other fundamental changes. As the supplies of some major government bonds level off or shrink, private sector issues are becoming more important, not just in quantitative terms but also qualitatively, and in some areas they are now competing with government bonds as investments. In Europe, telecommunications bonds have played a prominent role in this process. At end-September, such bonds made up about one quarter of non-financial corporate bonds outstanding in the region as a whole, and around the same proportion in the euro area. Although their share of the overall European bond market is small (less than 6%), the weight of telecoms in the corporate bond segment, and the relatively high concentration of credit risks associated with such bonds, suggest that the performance of the telecommunications sector might be a significant factor for the future development of this nascent financial market.