CO-PUBLISHED ARTICLE

# QUARTER-CENTURY PERSPECTIVE

The **World Bank** is commemorating 25 years of its use of Australian dollars as a funding currency. **Doris Herrera-Pol**, director and global head of capital markets, and **Andrea Dore**, lead financial officer, at the World Bank, take the opportunity to share the insights that come from being one of the market's most experienced borrowers.

As a large, frequent borrower, the World Bank strives to diversify its sources of cost-competitive funding as well as to establish a strategic presence in key markets. The World Bank taps different currencies, markets and maturities, and issues a variety of debt products to appeal to investors around the globe. In its nearly 65 years of history in the capital markets, the World Bank has issued bonds in 54 different currencies. The Aussie dollar was the 22nd currency tapped by the World Bank, and this year marks the 25th anniversary of the bank's first Aussie dollar bond issue.

Since 1986 the bank has issued more than A$50 billion (US$51 billion) in AUD-denominated bonds, making the currency one of the top five borrowed by the institution. Our Australian dollar funding history is marked by quite distinct phases which we recap in this article, concluding with our perspective on where the market may go from here.

## THE 1980s: THE EARLY YEARS – A ROLLERCOASTER RIDE

The AUD became a freely convertible currency in 1983, and an offshore market began to flourish soon after. The early issuers were Australian borrowers reaching out to international investors, followed by a number of non-Australian banks and, in 1985, the Swedish Export Credit Corporation.[1]

The World Bank's first transaction, a five-year eurobond launched on February 26 1986, amounted to A$75 million and carried a 14 per cent coupon. It was part of a five-currency borrowing transaction – the other currencies being Deutschmarks, Dutch guilders, French francs, and yen – aggregating about US$250 million equivalent and arranged by a group of European, Australian and Japanese cooperative banks from the UNICO Group (see termsheet on facing page).[2] This AUD bond was the first by a supranational entity. After a repeat appearance by the World Bank, EUROFIMA and Nordic Investment Bank followed with AUD bonds in early 1987.[3]

The market continued to grow quickly during the late 1980s. Thanks to the development of a buoyant cross-currency swap market, international issuers could swap the proceeds of these transactions into their home currencies and, in doing so, achieve cost savings given the tremendous pent-up demand.

European investors rushed to the sector, lured by the high nominal interest rates the currency offered – AUD rates oscillated in the 12-16 per cent range, at a time when interest rates for Deutschmarks and Swiss francs were around 5-8 per cent and 3-6 per cent, respectively.

Initially, the euro-Aussie market was the domain mostly of European retail investors – the proverbial Belgian dentists and German widows. In the case of the World Bank, Italian retail investors were also an important factor because they enjoyed a withholding tax exemption on their World Bank interest

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Doris Herrera-Pol

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income. European institutional investors, however, quickly caught on and by 1987 at least half of each of the World Bank's AUD bond deals was being sold to institutional buyers.

As was typical for a newly-developing market sector, participants often experienced the thrill of a rollercoaster ride. The AUD went through dramatic swings – virtually one currency 'crisis' per year – from the market's liberalisation in 1983 into the 1990s.

During the second half of the 1980s, the exchange rate zigzagged from US$0.60 to US$0.89 per AUD (see chart on p18). Offshore investors would quickly switch from bargain hunting, buying AUD bonds when the Aussie dollar took a dip, to profit taking, selling AUD bonds when the currency appreciated. Because of this, the primary market was often closed for weeks if not months at a time, and it had a tendency to get congested when conditions turned around.

Bob Graffam, lead officer for Australian dollar funding when the World Bank launched its second AUD eurobond in January 1987, wrote in a report: "Activity resumed at breakneck pace in the first week of January, with nine issues aggregating A$485 million launched in two days. The market showed clear signs of indigestion after the overdose of paper."

One notable trait of those early years was that the syndicate groups for bonds included as many as 40 banks, mostly European retail and regional banks. Underwriters had to use their balance sheets while the bonds trickled down the retail networks. A good deal could take about two weeks to be fully placed, a bad one could sit in underwriters' books for several months.

Many banks in the early AUD eurobond syndicates vanished through the merger and acquisition frenzy of the 1990s and other means: names like Hambros Bank – the unrivaled market leader in those years – Orion Royal Bank, ALSK-CGER Bank and NMB Postbank.

Japanese banks were also represented in these syndicates, including names like Sumitomo Finance and Fuji International. However, the participation of Japan in the placement of bonds was not yet significant, accounting for not more than 5 per cent of total placement of World Bank bonds. By the end of the 1980s, the World Bank had raised A$1 billion through 10 eurobond transactions.

## THE 1990s: THE JAPANESE DIDN'T WALTZ WITH MATILDA

In the early 1990s the AUD lost some momentum as a result of rising interest rates in the major European currencies. Continental European demand remained stable until the international bond market crisis in 1994.

Meanwhile, in Japan the Tokyo Stock Exchange crashed over 1990-92 and real estate prices started to collapse from their 1991 peak. The country fell into a deep recession and

### THE WORLD BANK'S FIRST EURO-AUSSIE BOND

This announcement appears as a matter of record only

March 1986

**INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT**
Washington, D.C.

**Multicurrency Financing in the Equivalent of US-$ 250,000,000 provided by UNICO-Banks**

Co-ordinated by **DG BANK Deutsche Genossenschaftsbank**

DM 250,000,000 — 6% Private Placement of 1986/1991
**DG BANK Deutsche Genossenschaftsbank**
**Genossenschaftliche Zentralbank AG** – Vienna; **Rabobank Nederland**; **Swiss Volksbank**
**Andelsbanken a/s Danebank**; **Banca Nazionale dell'Agricoltura SpA**
**Crédit Agricole**; **London & Continental Bankers Limited**
**B.E.G. Bank**; **CERA-Centrale Raiffeisenkas**
In association with **The Norinchukin Bank**

NLG 100,000,000 — 6 1/4% Euroguilder Notes of 1986/1991
**Rabobank Nederland**
**DG BANK Deutsche Genossenschaftsbank**; **Swiss Volksbank**
**Banca Nazionale dell'Agricoltura SpA**; **CERA – Centrale Raiffeisenkas**; **Genossenschaftliche Zentralbank AG** – Vienna

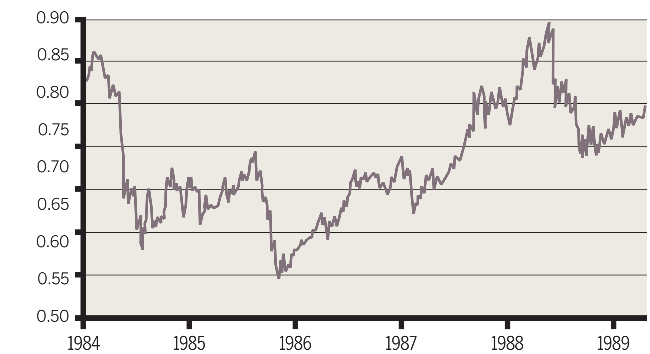
FF 200,000,000 — 9 3/4% Bonds of 1986/1996
**Crédit Agricole**
**Caisse Centrale des Banques Populaires**; **DG BANK Deutsche Genossenschaftsbank**
**Rabobank Nederland**; **Banque Fédérative du Crédit Mutuel**
**Genossenschaftliche Zentralbank AG** – Vienna; **Swiss Volksbank**

YEN 5,000,000,000 — Private Placement of 1986/1993
**The Norinchukin Bank**

Aus $ 75,000,000 — 14% Notes of 1986/1991
**DG BANK Deutsche Genossenschaftsbank**; **Rabobank Nederland**
**Genossenschaftliche Zentralbank AG** – Vienna; **Andelsbanken a/s Danebank**
**London & Continental Bankers Limited**; **Swiss Volksbank**
**CERA- Centrale Raiffeisenkas**; **The Rural & Industries Bank of Western Australia**

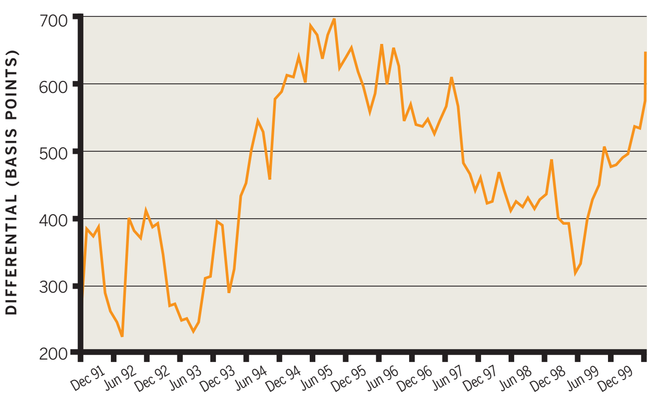
SOURCE: THE WORLD BANK

**AUD-USD EXCHANGE RATE**




SOURCE: BLOOMBERG SEPTEMBER 2011

**AUD/JPY INTEREST RATE DIFFERENTIALS**
(5YR GOVERNMENT BONDS)




SOURCE: BLOOMBERG SEPTEMBER 2011

the Japanese government eased monetary and fiscal policies to try to revitalise the economy. Domestic interest rates began to fall sharply, and Japanese retail investors – with among the highest savings rates and wealth accumulation in the world – turned massively to foreign currency bonds to enhance their investment returns. This led to the birth of the so-called Uridashi market. A substantial share of this Japanese retail demand for foreign currency-denominated fixed income assets poured into Australian dollars.

The allure of Aussie dollars for Japanese retail is easily explainable. After 1992, AUD/JPY interest rate differentials became increasingly appealing at around 4-6 per cent (see chart on this page). In addition, Japanese citizens were quite familiar with Australia – it has been one of the top travel destinations for Japanese tourism since the 1980s. And as a commodity-rich country, Australia also commanded tremendous attention among Japanese investors for diversification purposes. By 1994 Japanese buyers had taken over as the predominant investor base for Aussie dollar eurobonds.

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The switch of the main investor base in the euro-Aussie market to Japanese from European was radical. Europeans comprised the largest investor sector in five Aussie dollar eurobonds, totaling A$450 million, that the World Bank launched between 1990 and 1994. But in 1995 all AUD bonds issued by the bank were placed solely with Japanese retail investors. For the remainder of the 1990s, the euro-AUD league tables were dominated by Japanese institutions like Daiwa, Mizuho, Nomura, Tokai Tokyo, and Yamaichi International. The World Bank placed more than A$2 billion in bonds among Japanese retail investors from 1995 to 1999.

In parallel, during the 1990s the Australian authorities undertook a range of financial market reforms that opened up and institutionalised the domestic capital markets. For example, the retirement savings programme was made compulsory, foreign borrowers were allowed to issue AUD-denominated bonds in the domestic market under Australian law, and overseas investors were made exempt from withholding tax.

Foreign issuers started to tap the domestic market (during the early 1990s those bonds were referred to as Matilda bonds), and the investor base was predominantly offshore institutional investors. There was some demand from Australian accounts but a major deterrent to local investor participation was that these bonds were ineligible for the major AUD bond indices, or as prime asset ratio assets for banks.

In 1999-2000, the World Bank raised A$1 billion in the Australian market through one line that was tapped on three different occasions. These benchmark bonds benefited from demand from a broad base of fund managers, pension funds and banks from Australia, Europe, Asia, the US and Canada.

## THE NEW MILLENNIUM – GLOBALISATION OF DEMAND FOR AUSSIE DOLLARS

In this past decade, demand for Australian dollars has come from all parts of the globe. In Japan, the AUD Uridashi market continued to thrive as the factors that spurred demand in the mid-1990s remained in place. Additionally, the rapid growth of Aussie dollar money market funds in Japan provided another springboard for AUD Uridashi bond demand. It allowed Japanese investors the flexibility to time their conversion of AUD bond redemptions into yen or their reinvestment into AUD bonds instead of realising losses if the exchange rate had moved unfavorably.

From 2003 to 2006, AUD was the second-largest currency of issuance for World Bank bonds, accounting for nearly one-third of the bank's borrowing programme during the period. In all, during this past decade the World Bank has issued almost A$30 billion of Uridashi bonds.

In Australia, a diminishing supply of domestic Australian government bonds gave rise to escalating domestic demand for AUD bonds issued by highly creditworthy foreign issuers, nicknamed Kangaroo bonds. The Kangaroo market has provided an important source of local currency credit diversification for domestic investors. In 2000 the Reserve Bank of Australia broadened the eligibility criteria for market operations to include a wider range of bonds issued by foreign governments and supranational institutions, like the World Bank, and in 2005 UBS Investment Bank created a separate supranational index for Kangaroo bonds.

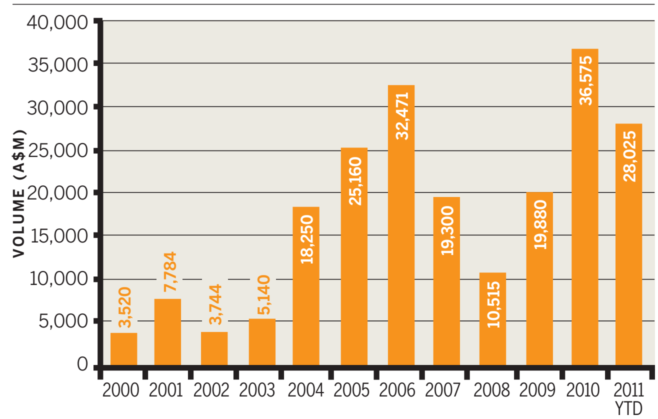
Elsewhere in the world, institutional investors took on exposure to the currency, many for the first time. The number and diversity of investors buying Kangaroo bonds has increased significantly – from fewer than 20 investors in the World Bank's 2006 AUD benchmark to more than 50 investors in some of our most recent Aussie dollar benchmark bonds. Additionally, the investor profile has changed from predominantly asset managers to a wide range of institutional investors, which includes many official institutions. The AUD, as the world's fifth most traded currency, attracts many central banks seeking diversification of their reserves.

The Kangaroo market was shaken by the global crisis in 2008 but since then it has grown exponentially (see chart on this page). The market also suffered a setback at the beginning of 2011 when the Australian Prudential Regulation Authority excluded Kangaroo bonds in its initial assessment of level one or two assets for the implementation of the new global liquidity standard – known as Basel III liquidity coverage ratio.

Since 2009 the World Bank has issued A$6 billion of Kangaroo bonds in five lines ranging in maturity from five to 10 years (see chart on this page). There is a much higher level of engagement in the sector from Australian market makers and underwriters, as well as the range of investors – both domestic and international. The global diversification of investor demand can be seen in the consolidated primary market placement statistics for the five Kangaroo bonds issued by the World Bank since 2009 (see chart on this page).

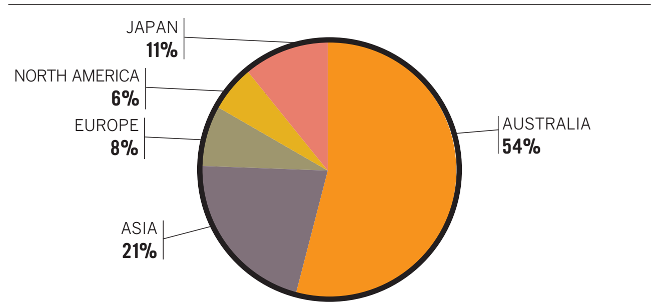
One of the notable changes in the past couple of years is the significant increase in the number of international participants in the Kangaroo bond market, which has also

**ANNUAL TOTAL KANGAROO BOND ISSUANCE**



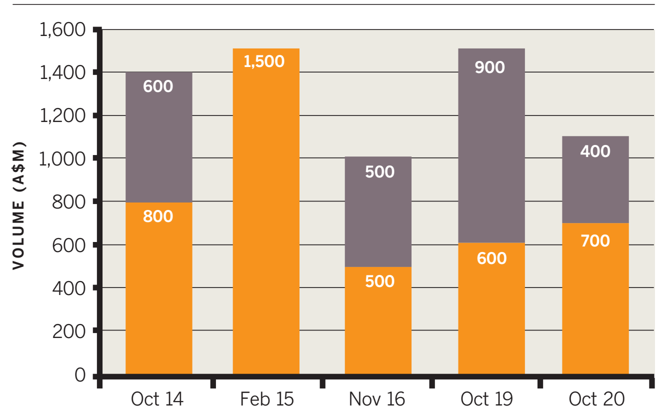

SOURCE: KANGANEWS OCTOBER 19 2011

**THE WORLD BANK'S OUTSTANDING AUD DISTRIBUTION**




SOURCE: THE WORLD BANK OCTOBER 2011

**THE WORLD BANK'S OUTSTANDING KANGAROO BONDS**
(SHOWING INCREASES)




SOURCE: KANGANEWS OCTOBER 19 2011

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contributed to the globalisation of demand for Aussie dollar bonds. The number of active intermediaries has increased from about 10 in 2006 to more than 20 today. Indeed, for the World Bank, there have been more banks providing us advice on the AUD market than for any other currency, including US dollars, over the past few years. Because of these additional market participants, turnover in Kangaroo bonds has increased significantly. According to data published in the Australian Financial Markets Association's 2011 financial markets report, turnover in Kangaroo bonds was at its highest in 2010-2011, at A$142 billion.

As the globalisation of Aussie dollar demand continues, the World Bank's goal has been to provide quality assets in this currency, to meet that demand. We make timing, pricing, maturity and other decisions on the terms of our bonds based on investors' preferences and our funding requirements. We have strived to maintain a full yield curve, increasing the sizes of our AUD benchmark bond issues over time so that our outstanding lines are at least A$1 billion in size.

## WHERE TO FROM HERE?

Australia's economy is expected to continue being one of the fastest-growing advanced economies in the world. The positive outlook is underpinned by a well-diversified economic base – including not only natural resources but also the manufacturing and service sectors, exports to the growing emerging markets in Asia, favorable terms of trade, and planned investments in infrastructure projects.

The government strives for fiscal discipline and has one of the lowest debt-to-GDP ratios in the world, and the lowest among industrialised nations. Over the next decade, the fiscal position is expected to evolve from a moderate deficit to a surplus. The government has proposed to maintain a government bond market equivalent to 13-15 per cent of GDP. The financing needs of the states are also expected to remain relatively stable as a percentage of GDP in light of the commitment to fiscal discipline across the whole government sector.

Meanwhile, Australian dollar bonds are very likely to remain one of the key currencies of focus in the diversification efforts of global central banks. Other international investors will also be attracted to the market by Australia's sound economic fundamentals. Australian investors are also likely to have growing demand for highly creditworthy investable assets. Thus, although the Australian government has committed to maintain a liquid Commonwealth bond market, its liquidity is likely to become under pressure simply by virtue of the sheer size of prospective demand.

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Supranational bonds can help fill this gap and continue playing an important role in domestic investors' portfolios in Australia, including those of bank treasuries. Bonds issued by the World Bank and other supranational issuers carry low credit and market risk and have traditionally enjoyed flight-to-quality status. Our bonds offer a means of diversification for domestic investors due to their low correlation with domestic market alternatives. The primary and secondary market activity in our bonds is supported by a large group of committed market makers, and the broad international investor franchise that also buys our bonds serves to enhance our bonds' ability to perform well during times of volatile general market conditions.

Australia is one of the key World Bank shareholders and one of its largest development partners. Over the past decade we have worked closely with the Australian government across a range of sectors including climate change, food security, gender, education, and public financial management. We have an office in Sydney, opened in 2000, which serves as the hub for our operations and projects in 12 Pacific nations. Side by side with the development partnership, maintaining a significant presence in the Australian capital markets is and will remain strategically important. •

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(*) The authors would like to thank Huy-Long Le, Heike Reichelt, George Richardson and Vanita Dewan (World Bank Treasury), Cathryn Carver (ANZ), Peter Christie and Simon Ling (Commonwealth Bank of Australia), Enrico Massi and Daniel Chandler (RBC Capital Markets), and Adrian Bell for their inputs, comments and research.

### ENDNOTES

**(1)** Robert McCauley, *Internationalising a currency: The case of the Australian dollar*, BIS Quarterly Review, December 2006.
**(2)** UNICO is an acronym for the Union of International Cooperatives. It was formed in 1977 as a network of cooperative banks by six major European cooperative banks. In addition to these banks, the UNICO group had a number of affiliated cooperative institutions in other European countries, Australia, Japan and Canada. At the time of launch of the World Bank's first AUD bond, the Rural & Industries Bank of Western Australia was affiliated to UNICO.
**(3)** Source: Dealogic DCM Analytics database.