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The opening of new markets TO FOREIGN ISSUERS:

what has changed in the new millennium?

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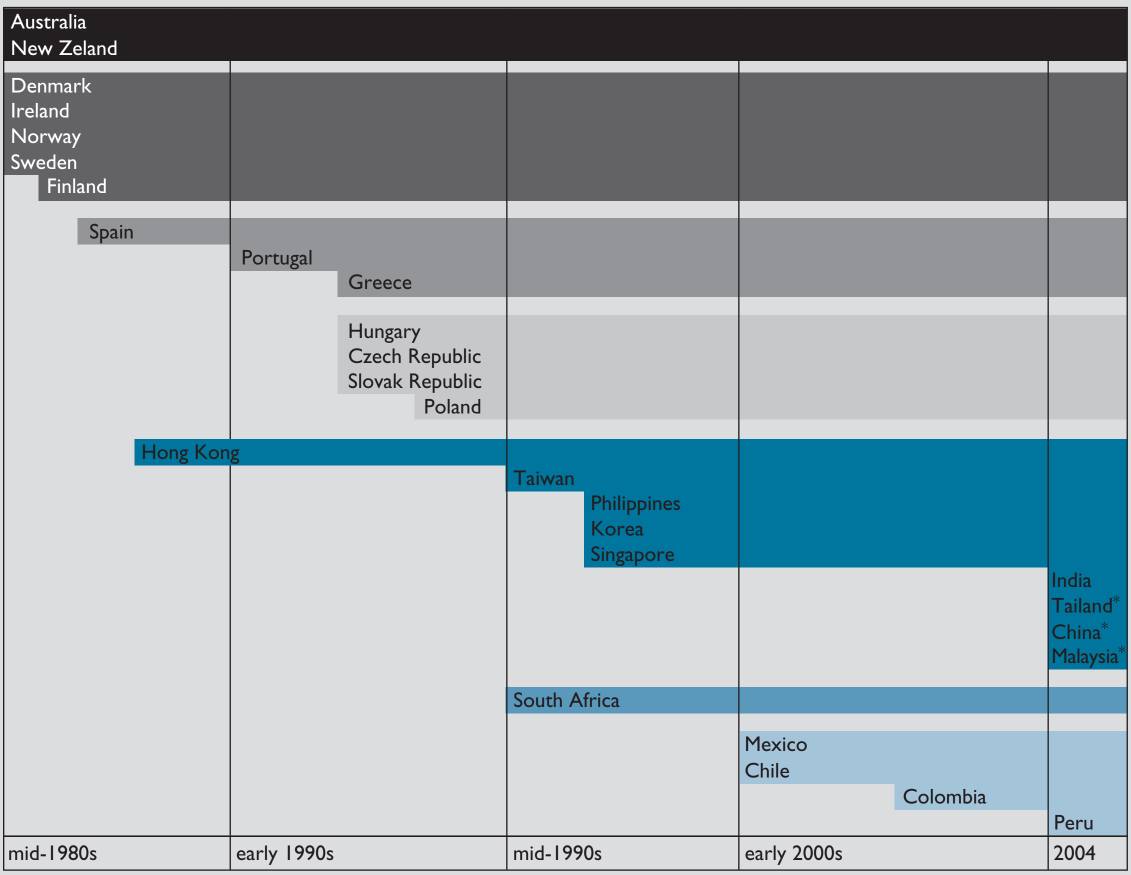
The removal of capital controls is one of the most powerful economic policy moves a government can undertake, after it has achieved a reasonable degree of macroeconomic stability, liberalised its domestic financial markets, and reduced local industry protection to get ready for international competition. It has historically been the case that governments have adopted a gradual, sequential, approach to financial liberalisation. In this sequence, one of the most important signaling steps is the admittance of foreign issuers into the market.

By enabling foreign issuers to borrow in their domestic currency, governments have been able to achieve important policy objectives. For instance, the entry of foreign issuers has helped deepen financial markets and foster innovation through the development of new asset classes and financial instruments; provided scope for portfolio diversification among local investors; resulted in efficiency gains by stimulating competition among domestic financial intermediaries and the adoption of international best practice standards; and contributed to attract foreign interest in the securities of local issuers. Foreign borrowers have moved nimbly to borrow in new markets that become open. The main attraction for foreign issuers -especially for large, frequent borrowers – has been that these markets can provide funding base diversification and cost-competitive funding as well as the establishment of a strategic presence in the local economy. Moreover, in the case of international financial institutions (IFIs) – which account for an important share of the universe of large, frequent borrowers – contributing to the development of the domestic financial market has also been an important interest.

Exhibit 1 shows the timing of opening of various markets to foreign issuers over the last two decades. The landscape of so called "emerging markets" has changed significantly through this period, mostly as a function of the timing of countries' relaxation of exchange controls and the coming of age or disappearance of other markets – as in the case of European Union (EU) markets. In the 1980s, the "emerging" markets of the Scandinavian countries, Southern Europe, Australia and New Zealand started welcoming international borrowers. The 1990s saw a new wave of market openings from Eastern Europe, Asia and South Africa. In the new millennium,

Opening of bond markets to foreign issuers, 1985-2004 — **Exhibit 1**



This is not intended to be a comprehensive list. Excludes markets with very little issuance activity or in which the bonds issued have been currency-linked only.
*Announcement has been made by the authorities but there has been no bond issuance by foreign issuers as of 9/04

Source: Euromoney Bondware

Latin America and a second wave of Asian countries, post-crisis, are opening their doors to foreign issuers.

Through this 20-year period, we have seen a distinct change in sources of demand for bonds issued by foreign borrowers in emerging market currencies. At present, the *raison d'être* for foreign borrowers' issues in the newly-opened markets is overwhelmingly to provide assets to a largely institutional domestic investor base which is expected to continue growing exponentially in the foreseeable future. Previously, most of these bonds catered to foreign, largely retail, investors attracted by high-yielding opportunities. In the following section, we will take a closer look at the way in which foreign issuers started to participate in new emerging markets and the market context for these activities.

A RETROSPECTIVE

The early 1980s saw the convergence of two interests in international bond markets. Many governments embarked on the road to financial market liberalisation and, at the same time, investors from core markets became increasingly attracted to bond investments outside their home countries. Many governments began looking towards foreign investors as a way to achieve important capital market development objectives and complement domestic savings. Bond market investors became attracted to assets in other currencies to diversify their portfolios. In many non-core markets, high interest rates were being used as a monetary policy tool after a period of high inflation and weak fiscal positions in the late 1970s and early 1980s, and rate levels were a key attraction for foreign investors from the more traditional, lower interest rate, markets.

The Pacific

Australia and New Zealand allowed offshore bond issuance in their currencies as part of the financial market deregulation that relaxed capital controls starting in the first half of the 1980s. At the time, the governments of both countries were conducting strict monetary policies to fight inflation, and nominal interest rates were fairly high. Eurobonds in Australian dollars (AU$) and New Zealand dollars (NZ$) were the darling of European retail investors in the mid-1980s with the appeal of high coupons, high currency volatility notwithstanding.

The existence of liquid, well developed swap markets was an important factor in the popularity of AU$ and NZ$ funding among foreign issuers. The sophistication of the domestic banking systems and the funding and hedging activities of domestic public enterprises, corporates and banks accounted for the high state of development of these markets. Domestic entities financed themselves in foreign currencies and swapped into the local currency. Moreover, banks started to swap their floating rate liabilities into fixed rate to fund long-term fixed rate mortgages.

Since the early 1990s, foreign issuers have also enjoyed access to the AU$ and NZ$ domestic markets and have issued bonds in global format with multiple-zone clearing and settlement arrangements to facilitate non-resident participation. Domestic and offshore issuance by foreign borrowers continues till today. In the offshore market, most of the bond placement is currently taking place in Japan, in the form of Uridashi offerings targeted to retail investors. In turn, the domestic bond markets have enjoyed substantial foreign institutional investor participation.

Scandinavia

By the early 1980s, the governments of Norway, Finland, Denmark and Sweden authorised IFIs to use their local currencies for bond financing. Notwithstanding certain nuances in the way each of the authorities approached the listing and documentation requirements for these bonds, IFI bond issuance in these currencies followed for the most part a Eurobond format: most dealers were in London; the bonds were settled and cleared through Euroclear and Cedel, and bought by foreign investors. The majority of these bonds were acquired by European retail investors – and Japanese institutional investors in the case of Finnish markhaa - lured by the then prevailing high nominal coupons in these currencies.

Southern Europe

The next wave of market openings occurred in Southern Europe: Spain, Portugal and Greece. In these countries, the government bond market was small, illiquid and short-dated. Thus, an important role played by IFIs issuing in these currencies in the late 1980s and early 1990s was to promote capital market development and focus the attention of the international financial community on the local market in preparation for the countries' EU membership.[1]

Of the three countries, Spain undertook the most deliberate approach to make Madrid the financial centre for the Spanish peseta bond market: it allowed participation only of banks domiciled in Spain into

Matador bond syndicates; issues needed to be listed on the Madrid Stock Exchange and cleared and settled locally, even though foreigners were the purchasers. Euromarket-style prospectus, conventions, documentation and regulations were adopted -under local law – for Matador bonds. The authorities fostered the formation of a secondary market based in Madrid, not overseas; as well as a local book-entry system.

Spain also followed a disciplined approach in several other respects: The opening of the market to foreign issuers followed a careful sequence, first allowing AAA supranationals (1987), followed by other non-AAA supranationals (1989), investment grade sovereigns (1990), and export credit agencies, government agencies and non-investment grade sovereigns (1991). Borrowers had to follow a strict queuing system.

The “Matador” (bonds in Spanish pesetas by foreign issuers) market grew in leaps and bounds between 1987 and 1999, and frequent and sizeable issuance by several key borrowers attracted foreign and local institutional investor participation from the mid-1990s even though, overall, the bulk of demand came from European non-domestic retail investors buying into high yield and the perspective of currency convergence.

Portugal and Greece adopted a model similar to Spain’s albeit with some flexibility. They allowed “Caravela” (bonds in Portuguese escudos by foreign issuers) and “Marathon” bonds (bonds in Greek drachma by foreign issuers) to be listed on foreign exchanges -together with the local exchange in the case of Greece. They also allowed the secondary market to establish itself in London, and a foreign-domiciled selling group and a foreign co-lead manager – which in practice conducted the placement of the bonds – were accepted, respectively, in Caravela and Marathon bonds.

Eastern Europe

Since the mid-1990s, Hungary, the Czech Republic, the Slovak Republic and Poland started welcoming foreign issuers in their currencies, interested in the signaling effect in preparation for EU accession. In Hungarian forint, IFIs were the first foreign issuers invited to the market; whereas in Czech koruna, Polish zloty and Slovak koruna the market was also opened at the onset to foreign corporates. Bond issuance by foreign entities in these currencies has been in Eurobond format with underwriting, distribution, placement, listing, clearing and settlement, as well as secondary market making, generally located offshore. Frequent issuance by some of the foreign borrowers as well as derivatives market development (due to a large extent to more mature government markets) have enhanced liquidity, extended maturities and attracted institutional investors, even though maturities remain largely short-dated and most investors are retail.

Eastern European markets stand apart from other newly opened emerging markets in that they have enjoyed the strongest patronage from foreign participants, because of the EU accession and other geographical and historical ties. Banks from Germany and Austria have taken the lead, not only in bond placement, but also actively taking risks, especially in treasury services. Retail investors from these two countries are also the main bondholders.

Asia

The opening of the different markets to foreign issuers has not followed a homogeneous pattern in Asia. Hong Kong was the first to open its doors in the late 1980s, starting with IFIs, motivated by maintaining its identity as the preeminent financial centre for Asia prior to the 1997 handover to China. It was not until the mid-1990s that other Asian countries followed suit -Philippines, Korea and Taiwan, only to see the process stalled for a number of years with the advent of the financial crisis in 1998.

In the case of Philippines and Korea, foreign exchange controls restricted bond issuance to the overseas market (i.e., eurobond issues sold to foreign investors) or led foreign borrowers to issue separate, non-fungible tranches of bond issues: one tranche for domestic investors and another tranche for offshore investors.

The Taiwanese bond market has been open to foreign issuers -only IFIs- since 1995. Domestic institutional investors drive demand and intermediaries need to have a locally approved securities vehicle. In turn, Singapore opened its market to foreign issuers in 1998. The use of the issuers' euro-MTN and global-MTN program documentation was quickly adopted for these bonds, in what has largely been a domestically-anchored market: investors are typically locally domiciled institutions, bonds are listed on the Singapore Stock Exchange and intermediaries have been primarily Singapore-based. There is a trend towards greater use of Euroclear and Cedel as international investor interest has been increasing recently.

In 2004, the opening process regained impetus in Asia, with the first IFI coming to the Indian rupee market in February 2004, and the authorities in Thailand, China and Malaysia making public their interest in welcoming foreign issuers, especially IFIs, into their markets. This new wave of country openings has in common that the aim is to allow foreign borrowers to tap the domestic investor base, and have the issues anchored in the home market with regards, not only to bond placement, but also to participation of financial intermediaries, regulation, and settlement of the bonds.

South Africa

From the time of the first bond issuance by a foreign borrower in 1995, the South African rand captured the attention of European retail investors and issuers in the same way that the AU$ and NZ$ had done so in the mid-1980s. German and Swiss retail investors had familiarity with the country and were attracted by double-digit coupon levels at a time when interest rates in their home markets were on a steady decline. The popularity of these currencies among foreign issuers was due to the availability of a well developed swap market, since most issuance is swapped back into US$. The high degree of development of the swap market stems from the funding activities of the government, the hedging activities of domestic corporates and investors, and the sophistication of the domestic banking sector. So far, the euromarket remains the only segment used by foreign issuers.

Latin America

Latin American countries are among the most recent additions to the list of countries that welcome foreign issuers in their currencies. As in the case of several of the newest entrants in Asia, countries like Chile, Colombia, Mexico and Peru have experienced tremendous growth in the institutionalisation of domestic savings largely through mandatory pension fund systems, which has resulted in an imbalance between the supply of, and demand for, local currency investment grade bonds. IFI local currency issuance has started to provide important portfolio diversification benefits to domestic institutional investors. Most of the recent bonds issued by IFIs in Colombian pesos, Mexican pesos and Peruvian soles have been placed by locally-domiciled intermediaries entirely among local institutional investors, and are governed by local law, listed on the local stock exchange, and cleared and settled domestically, with links to international clearing systems in the case of Mexican pesos.

A COMMON THREAD

While the opening of markets to foreign issuers has followed many diverse paths as we saw above, the virtual common denominator is that IFIs have played a leading role in the liberalisation process.

Why has this been the case? IFIs have had a long standing presence in international bond markets – the World Bank, the oldest of the IFIs that raise funding in bond markets, did its first bond issue in 1947. Moreover, it is often the case that, when foreign investors first consider investing in a new market, they prefer initially to decouple the credit risk decision from the currency risk decision. Thus, the high creditworthiness of IFI bonds make them a safe vehicle for new currency investments and contribute to enhance the confidence of new investors in the local currency fixed-income markets. On the domestic investor front, IFI bonds in local currency can provide a highly creditworthy, low beta, means of credit diversification.

THE CHALLENGE AHEAD

As it is evident in Exhibit 2, the attraction of high yields as a reason for international investors to go into emerging bond markets is not there anymore. However, the key reasons for the decline in emerging market bond yields have been positive ones: governments' efforts to control inflation, achieve fiscal discipline, and reduce the foreign currency risk in their debt portfolios. This has led to significant improvements in the credit quality of governments and other local issuers. At the same time, the authorities of today's emerging markets continue to implement important regulatory changes to further expand the institutionalisation of domestic savings and enhance investor confidence.

The size of local currency emerging bond markets has doubled over the last 10 years. Yet, foreign investor participation in the demand for bonds in emerging market currencies - issued by foreign borrowers, the domestic government or local corporates- is far from significant. Consolidated data on foreign investors' participation in emerging bond markets does not exist, but individual country statistics indicate that the share of local currency government bonds in the hands of foreigners is in the single digits. Moreover, the bulk of this demand remains short-term focused and exchange rate-performance driven.

Alluring yield differentials may not exist anymore, but the pitfalls of one-sided markets and other concerns

How Yields have come down — **Exhibit 2**

Currency	First bond by a foreign-issuer in select currencies		Current yield on comparable-maturity government bond*
	Year	Coupon	
Portuguese escudo	1988	13.50%	4.23%
Greek drachma	1994	17.50%	3.51%
Czech koruna	1995	10.50%	3.91%
Korean won	1995	12.15%	3.81%
Taiwanese dollar	1995	6.28%	2.26%
South African rand	1995	15.00%	7.62%
Slovak koruna	1996	12.00%	4.25%
Polish zloty	1996	17.00%	7.52%
Singapore dollars	1998	4.50%	1.59%
Mexican peso	2000	15.88%	2.58%
Chilean peso	2000	6.60%	2.92%

* as of September 2004

Source: Euromoney Bondware and Bloomberg

foreign investors may have had in the past are also disappearing with the increasingly robust domestic anchoring among emerging markets. Many countries have embraced international market standards, are increasing the efficiency of investment vehicles, eliminating regulatory and fiscal impediments, and improving custody, clearing and settlement arrangements to facilitate non resident participation in their domestic markets. Thus, the potential for stability, liquidity and depth in emerging bond markets is higher than ever, and foreign investors are now on more solid grounds than ever before to increase and sustain their presence in these markets.

Note:

1. The Single Market for Financial Products and Services directive of the European Union called for full financial market liberalisation by January 1, 1993.

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