2 - 2

Strategic Considerations for First-Time Sovereign Bond Issuers

Udaibir S. Das, Michael G. Papaioannou and Magdalena Polan[*]

The recent round of debt relief that restored debt sustainability in many low income countries (LICs), along with continued search for yield and desire for portfolio diversification, has increased the range of viable financing options, including international bonds, for many emerging market economies and LICs. This paper presents some of the advantages and disadvantages of international debut bonds, within a debt sustainability framework. It outlines key preconditions and discusses strategic considerations that countries need to take into account when contemplating bond issuance in international markets for the first time. In this context, the paper discusses some typical pitfalls in accessing international capital markets, including excessive issue size relative to the intended use of bond proceeds, issuance of bullet bonds, and inadequate preparation for accessing the markets. It also attempts to quantify the benefits of certain features of debut bonds that should ensure large investor base and liquidity in the secondary markets, such as issuance of bullet bonds without complex enhancements or inclusion in a bond index.

Over the last decade, a growing number of emerging market and LIC sovereigns entered the international capital markets for the first time (Ghana, Gabon, Sri Lanka, and Georgia are the latest examples). Improved domestic macroeconomic conditions, including debt sustainability, enhancements in debt management frameworks, ample international financial liquidity, and strong investor appetite for new asset classes and higher-risk instruments, have allowed many debut sovereign bond issuers to access international financial markets with increasingly higher sizes and relatively lower coupon rates. The proceeds of these bonds have been used for a variety of purposes, including funding of infrastructure development projects, easing budget financing pressures, and financing in part the country's repayment of existing debt.

The main benefit of issuing international bonds is to augment domestic savings. When done in the context of a sustainable debt framework, it can significantly enhance a country's available resources and, hence, its prospects of sustainable growth and prosperity. Other benefits include the impetus for macroeconomic discipline and structural reform engendered by the resultant intense scrutiny of the domestic economy by international market participants; establishment of the sovereign's presence in the international capital markets (with the possibility of future access to those markets for local corporates); and substantial broadening of the country's investor base.

But there are risks. International investors' confidence in many emerging market and low income countries is often fragile and quickly reversible. To ensure creditworthiness, it is crucial for all sovereign bond issuers, including first-time issuers, to maintain sound macroeconomic policies, especially fiscal sustainability. In deteriorating market conditions with increasing risk aversion, sovereign bond issuers with unfamiliar profiles or lower credit ratings will face increased scrutiny and possible worsening of issuance terms (being able to issue only small amounts, or not being able to access the markets at all, and higher spreads). To maintain the international community's confidence and ensure quick access to international capital markets when international financial conditions improve, first-time sovereign bond issuers from these economies will need to persevere with prudent macrofinancial policies and necessary preparations to institute appropriate debt management systems.

In this light, countries contemplating a debut issue should carefully consider its benefits and associated risks, and prepare well ahead, before attempting to raise funds in the international markets. Factors to be considered range from broad macroeconomic considerations to details of the market access mechanics. Market access is a multi-faceted process, not a single event, and governments should plan their actions within a timeframe that extends

[*] Sovereign Asset and Liability Management Division, Monetary and Capital Markets Department, IMF.

beyond the date of first-time market access and contemplate a bond issue within a wider, medium-term debt sustainability framework. These considerations are especially important for small economies, with potentially less sophisticated settings for fiscal and debt management.

Most sovereigns that have successfully accessed capital markets have made preparations with a primary focus on issuing and using the proceeds of a debut bond without compromising the sovereign's creditworthiness. Before a debut bond was issued, its balance sheet implications were carefully examined within a medium-term macroeconomic framework, to safeguard against additional fiscal and debt-related vulnerabilities, or adverse effects on international reserve dynamics. In this process, specific strategic considerations of a debut issue – size, maturity, choice of fixed versus flexible interest rate, currency of denomination – and tactical issues – choice of legal and financial advisors, underwriters, and jurisdiction of issuance – were of paramount importance.

Further, issuers who want to establish a debut bond's presence in international markets or create a sovereign benchmark, should opt for a bond with characteristics that would ensure a large investor base, liquidity in the secondary market, and, if possible, inclusion in at least one of the major bond indices used by investors and asset managers. This can be achieved if the country issues a standard instrument (a global bond or a Eurobond), without enhancements or complex optionality features, targeted to a wide range of institutional investors. To attract a large demand, the use of proceeds should be well specified, and the ensuing returns sufficiently high, to guarantee a timely service of the bond. And to improve liquidity in the secondary markets, the agreement with lead managers could include provisions for post-issue support.