

TRENDS IN LONG-TERM CROSS-BORDER DEBT FINANCING TO DEVELOPING COUNTRIES

International long-term debt flows are an important component of capital flows to many developing countries. Over the past decade, developing countries and their firms operating in resource-related, financial and infrastructure sectors have relied on international debt flows for project finance, trade finance and acquisitions purposes. The 2008/09 financial crisis had a severe impact on developing countries access to international debt markets—including debt with long-term maturities. While long-term debt flows have recovered since 2010, the composition has tilted more towards bond-financing as deleveraging pressures on global banks—European banks in particular—have cut into bank lending to developing countries. The current high levels of liquidity in global financial markets and low interest rates policies by high-income central banks have made the conditions for bond financing very favorable so that developing country sovereigns and firms managed to compensate for the decline in syndicated bank-loans by bond financing. That said low-income countries still have no access to bond markets.

Long-term syndicated bank lending has remained weak since the 2008/09 crisis. After a temporary recovery in 2011, flows declined again sharply in 2012, partly reflecting the intensified deleveraging pressures on European banks.

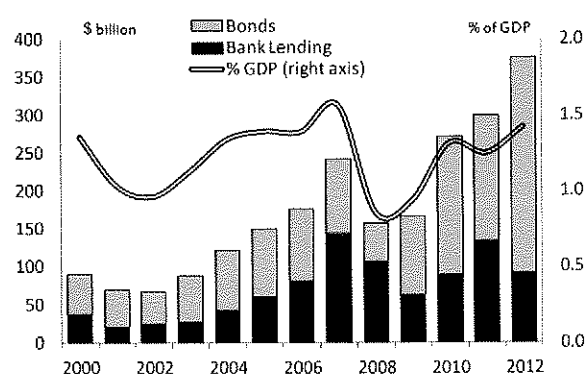
Going forward, long-term financing conditions facing developing countries may get tighter, as bond market conditions are expected to be less favorable when developed countries eventually begin to monetary policy tightening. Bank lending may rebound, although the recovery would likely be weak. While the pace of deleveraging by European banks has eased, deleveraging pressures on all international banks are expected to continue in the medium term as increasingly strict regulatory changes come into force.

This note is prepared by Dilek Aykut and Yueqing Jia, cleared by Andrew Burns all from World Bank Development Economics Prospects Group. It analyzes the trends in long-term debt flows to developing countries using the monthly data for international bond issuance and syndicated bank-lending with at least five years of maturity. Syndicated bank lending is only a portion of the international bank lending (see the annex for details). Developing countries include 136 low and middle income countries with income of less than \$12,475 per capita in 2011. The list of countries may differ from those contained in other documents.

Over the past decade, there has been a remarkable progress in emerging and developing countries' ability to access international capital markets. Developing country sovereigns and their private and publicly-owned corporations have increasingly relied on cross-border debt flows to finance investments and operations. As a result, international long-term debt flows—bond issuance and international syndicated bank-lending with at least five years of maturity—to developing countries increased from \$87 billion in 2000 to \$351 billion in 2012 (figure 1). Despite the increases, foreign direct investment (FDI) inflows, at an estimated \$600 billion in 2012, remain a more important source of long-term financing for developing countries. Despite the rapid increase (and volatility) in the USD value of capital inflows to developing countries over the years, both FDI inflows and long-term debt flows have remained around 2.8 percent and 1.4 of developing country GDP, respectively.

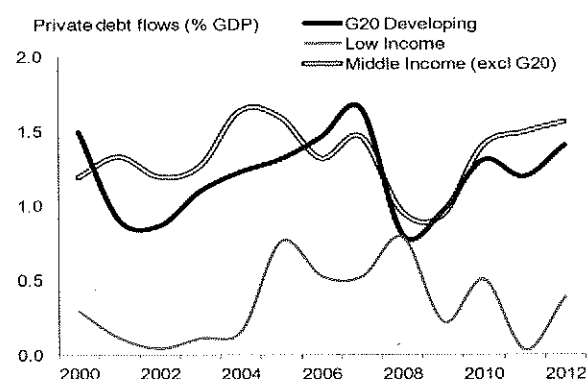
In terms of value, international long-term debt flows to developing countries (like other capital flows) are highly concentrated in large middle-income countries in terms of value: almost two-thirds of flows go to G20 developing countries (Argentina, Brazil, China, India, Indonesia, Mexico, Russian Federation, South Africa and Turkey), while the majority of the rest go predominantly to other middle-income countries. Despite accounting for a smaller share of total long-term debt flows to developing countries, other middle-income countries receive levels of international long-term debt financing similar to those received by G20 developing countries vis-à-vis the size of their economies (figure 2).¹ Low-income countries, on the other hand, continue to have a limited access to international long-term debt, receiving less than 0.5 percent of their GDP, down from pre-crisis peaks of nearly 0.8 percent but well above the level of the early 2000s.

Figure 1. International long-term private debt to developing countries



Source: Dealogic and the World Bank

Figure 2. Long-term private debt flows by income group



Source: Dealogic and the World Bank.

Along with the benefits of improved access to international capital markets—such as lower cost of capital—comes increased exposure to global and region-wide financial crises and associated credit contractions. During crises, global investors search for safer and more liquid assets as risk-aversion escalates. Historically, this has meant a selloff of emerging-market debt that perceived to be high risk. Since 2000, long-term debt flows to developing countries experienced two significant adjustments. The first one was the mild downswing of 2001–02, which followed the dotcom bust and corporate governance issues in the United States, and Argentina's default. At that time, long-term debt flows declined by 24 percent from \$87 billion (1.36 percent of GDP) in 2000 to \$64.3 billion (0.96 percent of GDP) in 2002.

¹ See the table at the end of the paper for a classification of country groups.

The impact of the 2008/09 global financial crisis was more severe. Not only did the crisis lead to a sharper contraction in all capital flows including long-term international debt flows, but it had a much more protracted impact on the global banking system. Many banks reduced lending as they sought to restructure their balance sheets to offset large losses in their high-income portfolios accrued during the crisis. These endogenous pressures have been increased by regulatory changes that have sought to increase banking-sector resilience by raising required capital ratios and liquidity buffers.

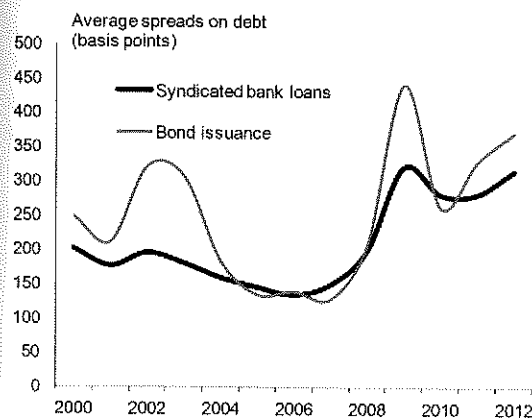
This note analyzes the trends in long-term debt flows to developing countries, during and after the 2008/09 crisis and highlights the most affected sectors and regions. It also discusses the possible issues that might need attention in the medium-term.

The global financial crisis that began in September 2008 initially severely constrained the access of developing countries to international debt markets.

Heightened uncertainty in international capital markets as the crisis took hold drove investors to shift to assets perceived as safe, such as U.S. Treasury bills, while financial institutions embarked on an intense deleveraging process, shedding assets and raising capital. These actions triggered major outflows from global markets. In October, developing-country access to external finance further deteriorated as the cost of insuring against default on international sovereign debt, as measured by credit swap spreads (CDS) spreads, surged for many developing countries.

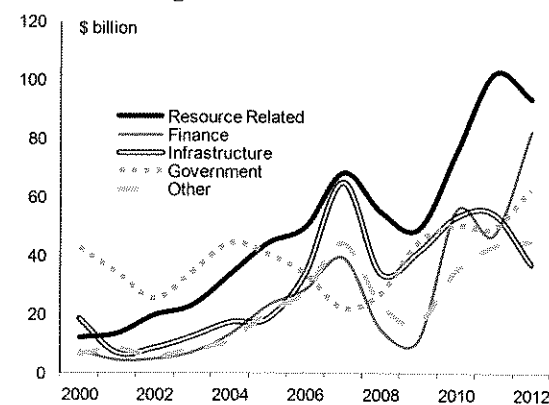
The immediate effect on international debt markets was dramatic: with the average spreads on all types of international debt widening sharply. Long-term bank loans spreads more than doubled to 320 bps by 2009 from their pre-crisis average of 150 bps, while spreads on long-term bonds more than tripled to 440 bps from 130 bps (figure 3). Despite the sharp increase in spreads, average borrowing cost actually increased less sharply and declined in the case of bank financing, because of flight-to-safety related falls in benchmark rates (U.S. 10-year Treasuries and six-month Libor). The heightened uncertainty in the financial markets continued through mid-2009 but eased slowly in the second half of the year.

Figure 3. International long-term private debt to developing countries



Source: Dealogic and the World Bank.

Figure 4. Most companies experienced sharp declines in long-term debt flows in 2008/09



Source: Dealogic and the World Bank.

Overall, international long-term debt flows to developing countries declined by 36 percent to \$155 billion (0.85 percent of GDP) in 2008, from \$240 billion (1.56 percent of GDP) in 2007 (figure 1). Although the 2008 contraction occurred in terms of both bank lending and bond flows, the initial decline in bond flows was much larger; bond flows declined by 48 percent in 2008, while syndicated bank lending fell by 26 percent. However, long-term bank flows declined a further 41 percent in 2009, while bond flows doubled.

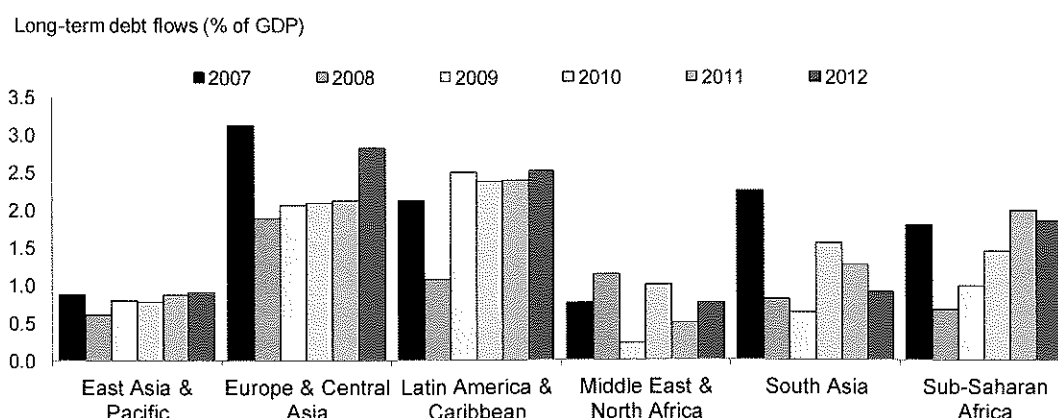
Overall, the increase in bond flows more than offset the reduction in bank lending, and as a result long-term private debt to developing countries rebounded by 5 percent in 2009.

While the contraction in debt flows to developing countries in 2008 was widespread, the impact of the crisis varied considerably across income groups, regions and sectors. The rebound in 2009, on the other hand, highly depended on the countries' access to international bond markets. Both developing G20 and other middle-income countries experienced sharp declines in 2008, 42 percent and 23 percent, respectively (figure 2). Despite the larger drop in 2008, debt flows rose for developing G20 countries by 18 percent in 2009, whereas the contraction continued for other middle-income countries by 13 percent. Contrary to this trend, low-income economies received higher flows in 2008 but experienced a contraction in 2009.

In terms of regions, with the exception of the Middle East and North Africa, which experienced a 87 percent increase in 2008, all regions experienced large contractions in long-term debt flows in 2008. The largest drop was in South Asia (64 percent). Supported mostly by increased access to international bond markets, long-term debt flows rebounded in 2009 in Latin America and the Caribbean (114 percent), East Asia and the Pacific (64 percent), and Sub-Saharan Africa (42 percent), while they declined further in the Middle East and North Africa (80 percent), South Asia (16 percent) and Europe and Central Asia (15 percent) in 2009.

In terms of sectors, all types of private companies experienced declines in 2008 and 2009. The largest drop in international long-term lending was for financial companies, with a total decline of 71 percent during two years followed by infrastructure companies by 36 percent (figure 4). Resource-related companies—oil and gas companies in particular, which usually account for the largest share of these flows (30 percent), also experienced a total of 28 percent decline in cross-border long term debt flows during 2008 and 2009. The exception to this trend was developing country governments that received higher long-term debt flows even in 2008, reflecting the large number of bond issuances in earlier months of the year. Middle-income sovereigns rely mainly on international bond markets for long-term debt, and several developing countries continued to access the international bond markets in 2009.

Figure 5. Long-term debt flows recovered in most regions



Source: Dealogic and the World Bank.

After remaining subdued for two years, long-term debt flows recovered sharply by 65 percent to \$270 billion in 2010, surpassing their 2007 peak value of \$240 billion. Flows have continued to rise steadily since then, reaching \$352 billion by 2012. Despite the sharp increase in value, however, debt flows to developing countries vis-à-vis their GDP still remain below their 2007 levels (figure 1). The rebound in

2010 was experienced by middle-income countries (figure 2), in most regions (figure 5) and in all sectors (figure 4).

The recovery has been driven mostly by strong bond flows. International bond markets were the first to show a sign of ease in international risk aversion as Mexico managed to issue an international bond in December 2008 after they were the first to react to the crisis with no developing-country government or firm issuing a single bond in October or November of 2008. Conditions in international financial markets have been supportive for bond financing since 2009 while bank lending has been weak as global banking system remains under significant deleveraging pressures.

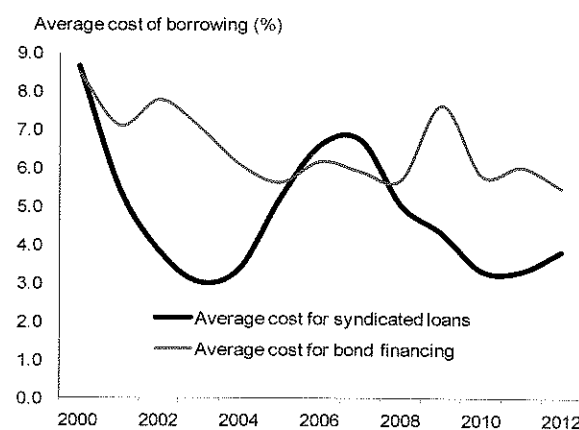
International bond markets have recovered since early 2009 supported by strong policy measures in high-income countries

International bond flows to developing countries with maturity of at least 5 years bounced back in 2009 and have increased steadily since then as conditions for bond financing have become very favorable for developing countries. Policy-induced low interest rates in high-income countries and quantitative easing efforts of high-income central banks have increased global liquidity dramatically, prompting a search for yield by global investors that benefitted capital flows to developing countries as early as 2009.

Liquidity has only been part of the story; developing-country credit quality (both in absolute and relative terms) has also been improving increasing their access to bond financing.

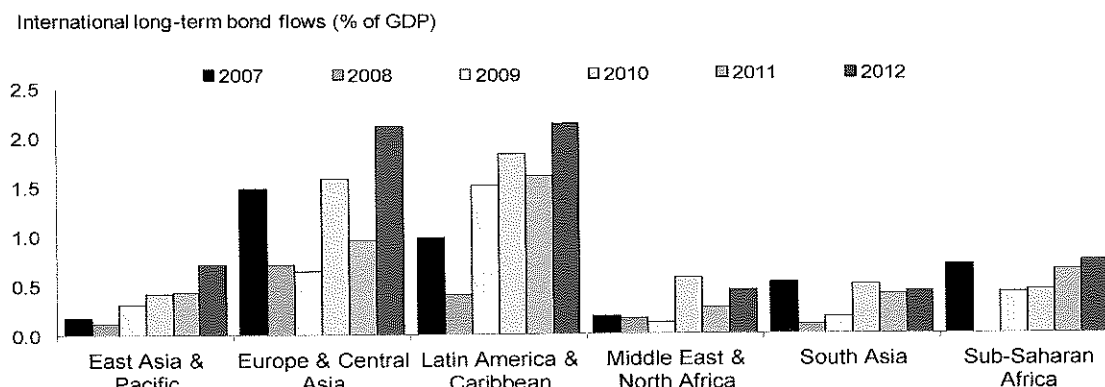
The cost of borrowing through international bond issuance has also declined considerably over time with exception of the spike in 2008 just after the crisis (figure 5). Average cost of bond financing (proxied by 10-year U.S. Treasury bond yield + average bond spread) fell to 548 bps in 2012, its lowest level ever. The initial decline in cost arose despite increased spreads, due to the fall in benchmark 10-year U.S. Treasury bond yield.

Figure 6. Cost of long-term cross-border debt has declined



Source: Dealogic and the World Bank.

Figure 7. Bond flows increased in all developing regions in recent years

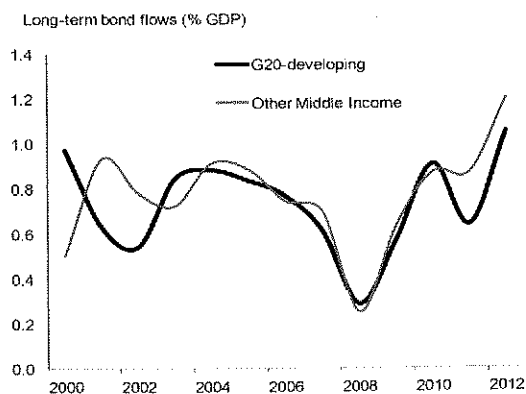


Source: Dealogic and the World Bank.

While cost of bond-financing remains higher than bank-loans, the cost difference between bond and syndicated bank loans (the underlying pricing benchmark, usually the six-month Libor rate + average spread) has also narrowed (figure 5). Even if developing countries tend to rely more on bank lending because of better access (see the discussion later), with the comparable costs and improved access, many large developing country corporate relied on bond financing as a substitute for declining bank-lending.

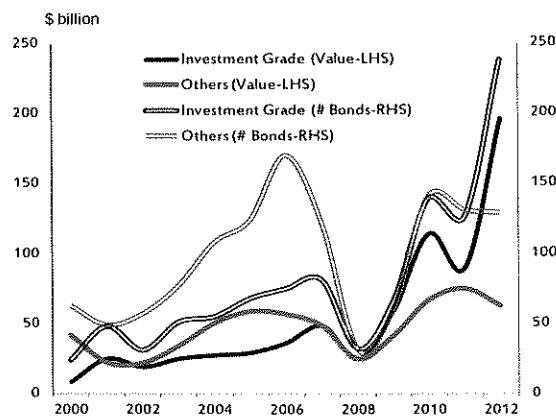
As a result, developing countries have increasingly issued long-term international bonds since 2009. Bond financing increased to \$281 billion (1.2 percent of GDP) by 2012 from \$52 billion (0.25 percent of GDP) in 2008. All regions experienced an increase in their long-term bond flows since 2009 (figure 7). Bond issuance by sovereigns and companies in all sectors increased sharply, with the largest jumps in the financial sector followed by the resource-related companies. While all the middle-income countries experienced a sharp increase in their bond flows, low-income countries still do not have access to international bond markets (figure 8).

Figure 8. Bond flows surged for middle-income countries



Source: Dealogic and the World Bank.

Figure 9. Bond flows surged for investment grade borrowers



Source: Dealogic and the World Bank.

The favorable conditions of recent years in international bond markets have mostly benefited investment grade borrowers, however (figure 9). Long-term bond flows to investment grade borrowers tripled during 2009-12 reaching \$460 billion (by 570 issuances) from \$140 billion (by 259 issuances) during 2005-08. Borrowers with credit ratings below investment grade issued about the same number of international long-term bonds in the post-crisis period as during the period prior, with a total value only 30 percent higher at \$250 billion compared to \$189 billion during 2005-08. As a result, the share of investment grade borrowers rose to 65 percent in terms of value during 2009-12 from 42 percent during 2005-2008.

Long-term syndicated bank-lending has been weak in the post-crisis period as the global banking system remains under deleveraging pressures

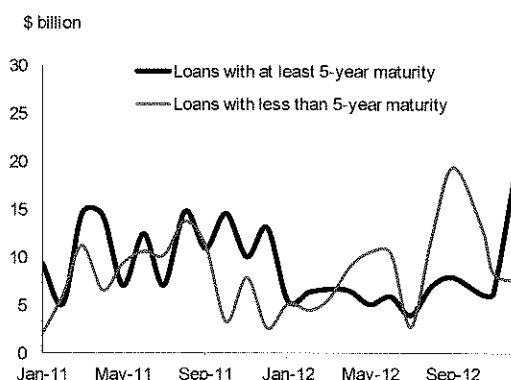
As discussed earlier, long-term syndicated bank lending to developing countries fell sharply in the aftermath of the 2008/9 financial crisis. The initial impact of the crisis was dramatic leading to a 26 percent fall in 2008 followed by 41 percent decline in 2009 in long-term lending (figure 1). The loans have remained weak since then. After a temporary recovery in 2011, flows declined again sharply in 2012.

While many factors were at play, deleveraging pressures as well as tighter regulations contributed to the weakness in international bank-lending to developing countries. Banking-sector losses associated with undue risk-taking during the boom period have been forced banks in the high-income world to strengthen their balance sheet including by reducing their loan portfolios. This deleveraging (reducing loans values relative to underlying capital) has been particularly acute among high-income European banks, because their capital positions were further weakened as the market value of sovereign debt declined (itself to a large extent a result of bailouts of banks).

Deleveraging pressures were exacerbated after October 2011, when regulations designed to increase banking-sector resilience forced banks European banks to tighten capital ratio requirements, and mark-to-market their holdings of sovereign debt. Deleveraging was achieved through a combination of reduced lending, sales of non-strategic assets, and exit from riskier businesses subject to tighter capital buffer requirements. Partly as a result, the participation rate of Euro area banks in long-term syndicated loans to developing countries declined from 66 percent in 2008 to 53 percent in 2012. The limited participation by Euro-area banks has come about when the number of banks participated in the long-term syndications also declined, possibly affecting the size of the deals (data sources do not permit identification of the exact size of individual banks' participation in syndicated deals).

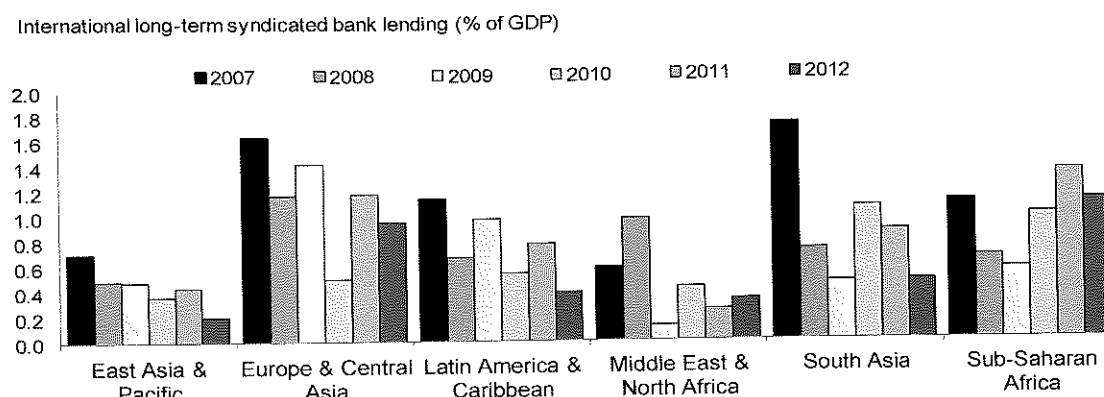
The reduced participation of European banks, appears to have been reflected in a sharp decline in syndicated loans with maturities shorter than 5-year, whereas the impact on longer-term bank deal was more gradual (figure 10). Long-term syndicated bank loans remained subdued throughout 2012 till December when two large long-term syndicated loans with the total value of \$18.6 billion to a Russian oil company led to a surge.

Figure 10. Syndicated bank lending to developing countries



Source: Dealogic and the World Bank.

Figure 11. Long-term bank loans decline in most developing regions

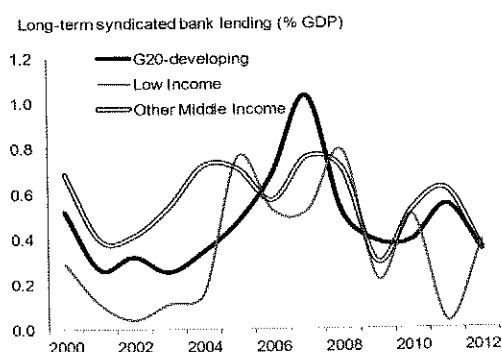


Source: Dealogic and the World Bank.

Going forward, syndicated long-term bank lending may rebound in 2013 as the pace of deleveraging appears to have slowed since the second half of 2012 (see Box: Deleveraging in the banking sector). Nevertheless bank lending at all maturities is expected to remain under pressure in part due to a gradual tightening of regulations.

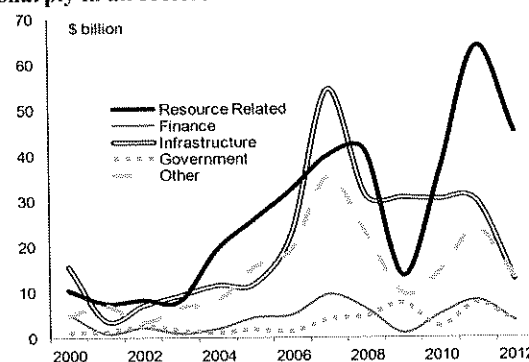
In terms of regions, with the exception of the Middle East and North Africa region—that experienced a 47 percent increase, all regions experienced contractions in the long-term debt flows in 2012 with the largest fall in the East Asia and the Pacific (49 percent), the Latin America and Caribbean (47 percent), South Asia (39 percent). Europe and Central Asia and Sub-Saharan Africa regions experienced a more subdued fall around 10 percent in 2009. Interestingly, when all maturities are taken into account, the decline in syndicated bank lending was much smaller for East Asia and the Pacific and Latin America and Caribbean regions, 6 percent and 8 percent respectively and much sharper for the Sub-Saharan Africa region with 40 percent decline in 2012.

Figure 12. Long-term bank lending has declined sharply in all developing countries



Source: Dealogic and World Bank.

Figure 13. Long-term bank lending has declined sharply in all sectors



Source: Dealogic and World Bank.

Box: Deleveraging in the banking sector: progress has been made but pressure to do more remains

The more comprehensive yet less-up-to date data on bank-lending (discussion in the text is on only syndicated bank lending portion) indicate that the pace of deleveraging slowed down earlier this year. Total international claims—including all cross-border and local claims in foreign currency—by Bank of International Settlements (BIS) reporting banks declined by \$616 billion (3.2 percent) in the second quarter of 2012. While the cut reversed the short-lived rebound of \$956 billion (5.2 percent) in the first quarter supported by ECB's large liquidity provision in December 2011 and February 2012, the reduction was still much lower than \$1.3 trillion (7 percent) decline in international claims in the fourth quarter of 2011. In addition, international claims on developing countries only decreased by \$8 billion during the second quarter, with the entire decline coming from short-term claims (debt with an original maturity of one year or less). The fall in short-term debt—most part trade finance in developing countries—partly reflects the sharp decline in trade activities in the second quarter of the year and partly confirms the tension in trade financing market.

Several factors helped to curb the pace of deleveraging process earlier this year. An important factor is the completion of the process of meeting the capital ratio requirements by European Banking Authority (EBA) by June 2012. The deleveraging by European banks intensified in October 2011 after EBA introduced 9 percent capital ratio requirement after adjustments for sovereign risk holdings. In fact, most banks announced that they fulfilled the requirement earlier than the deadline. According to EBA's October review report, more than 75 percent of the banks reached the required capital ratio by June 2012 mostly through assets disposal and deleveraging.^{FN2} Second, extraordinary liquidity injection by the ECB LTOR operations in December 2011 and February 2012 eased the funding pressures through boosting confidence in interbank market and helped European banks to reduce their dependence on US money market funds. Several European banks were faced with dollar funding challenges during the second half of 2011 after US money market funds withdrew some of their investment as the European debt crisis escalated.

There are some indications that the slowdown of the deleveraging process has continued also later in the year. First, cross-border syndicated bank-lending with all maturities to developing countries was 47 percent higher in the second half of 2012 compared to the first half of 2012. In fact, flows in December 2012 were the highest monthly flows since 2009. Second, the recent IIF Emerging Market Bank Lending survey indicates sharp improvement in funding conditions for 2012 Q3, for the first time since 2010 especially in Emerging Europe.

Nevertheless, deleveraging pressures on all international banks are expected to continue in medium-term with strict regulatory changes ahead. Global banks will soon start operating under Basel III (which will gradually be phased in through 2019) with a range of provisions and tightening of conditions including higher capital requirements and the introduction of a non-risk weighted leverage ratio. Most banks have been deleveraging to adjust their balance sheets in response to the enhanced recognition of counterparty risk that will lead an increase in risk-weight of certain line of business (fixed income trading businesses) and to reach capital ratios faster in response to market and regulatory pressure. Concerns have been raised about possible unintended consequences of Basel III on developing countries. According to a recent report prepared for G-20 countries, in addition to higher capital requirements some Basel III rules related with counter-party credit risk, the measurement of risk between a parent bank and its subsidiary and capital requirements for certain business activities may exacerbate deleveraging and increase the costs of global banks operating in developing countries, thereby reducing credit and financial market liquidity.

¹ EBA reports states that of 37 banks with initial shortfall, 24 of them have achieved the capital requirement and EBA initiated backstops only for four banks. They excluded three banks for further action since they are already going through deep restructuring. Also six Greek banks are excluded since their issues are being addressed by the Greek program.

² "Identifying the Effects of Regulatory Reforms on Emerging Market and Developing Economies: A Review of Potential Unintended Consequences" prepared for G20 Finance Ministers and Central Bank Governors by the Financial Stability Board in coordination with Staff of the International Monetary Fund and the World Bank, 19 June 2012. (http://www.financialstabilityboard.org/publications/r_120619e.pdf)

Annex:**Definitions of the long-term debt flows:**

- **International bond issuance:** Bonds with at least five years of maturity issued on international market or in countries other than the issuer nationality, denominated in currencies other than the currencies of the issuer's nationality, including Euro-market offerings, global bonds, and foreign offerings (i.e., bonds issued by firms and governments outside the issuer's country, denominated in currencies other than that of the issuer country's).
- **Syndicated bank lending:** The data entail lending by syndicates with at least five years of maturity that the nationality of at least one of the syndicate banks is different from that of the borrower. The data exclude domestic, bilateral, and superinternational institution led deals. The syndicated bank lending is only one portion of international bank lending reported by other institutions including Bank of International Settlements. The main differences come from the fact that syndicated bank lending data do not include bilateral and intrabank lending.

Country coverage:

For the purpose of this note, developing countries category includes 136 low- and middle-income countries with income of less than \$12,475 GNI per capita in 2010. The list of countries for the region may differ from those contained in other World Bank documents.

World Bank FY13 analytical classifications by income

| Low income (\$1,025 or less) | Middle income (\$1,026 to \$12,475) | | | G20 Developing Countries |
|---------------------------------|-------------------------------------|-----------------------|------------------------------|-----------------------------|
| Afghanistan | Albania | Iran, Islamic Rep. | Senegal | Argentina |
| Bangladesh | Algeria | Iraq | Serbia | Brazil |
| Benin | American Samoa | Jamaica | Seychelles | China |
| Burkina Faso | Angola | Jordan | Solomon Islands | India |
| Burundi | Antigua and Barbuda | Kazakhstan | South Africa | Indonesia |
| Cambodia | Armenia | Kiribati | South Sudan | Mexico |
| Central African Republic | Azerbaijan | Kosovo | Sri Lanka | Russian Federation |
| Chad | Belarus | Lao PDR | St. Lucia | South Africa |
| Comoros | Belize | Latvia | St. Vincent & the Grenadines | Turkey |
| Congo, Dem. Rep. | Bhutan | Lebanon | Sudan | |
| Eritrea | Bolivia | Lesotho | Suriname | |
| Ethiopia | Bosnia and Herzegovina | Libya | Swaziland | |
| Gambia, The | Botswana | Lithuania | Syrian Arab Republic | |
| Guinea | Bulgaria | Macedonia, FYR | Thailand | |
| Guinea-Bissau | Cameroon | Malaysia | Timor-Leste | |
| Haiti | Cape Verde | Maldives | Tonga | |
| Kenya | Chile | Marshall Islands | Tunisia | |
| Korea, Dem. Rep. | Colombia | Mauritius | Turkmenistan | |
| Kyrgyz Republic | Congo, Rep. | Micronesia, Fed. Sts. | Tuvalu | |
| Liberia | Costa Rica | Moldova | Ukraine | |
| Madagascar | Côte d'Ivoire | Mongolia | Uruguay | |
| Malawi | Cuba | Montenegro | Uzbekistan | |
| Mali | Djibouti | Morocco | Vanuatu | |
| Mauritania | Dominica | Namibia | Venezuela, RB | |
| Mozambique | Dominican Republic | Nicaragua | Vietnam | |
| Myanmar | Ecuador | Nigeria | West Bank and Gaza | |
| Nepal | Egypt, Arab Rep. | Pakistan | Yemen, Rep. | |
| Niger | El Salvador | Palau | Zambia | |
| Rwanda | Fiji | Panama | | |
| Sierra Leone | Gabon | Papua New Guinea | | |
| Somalia | Georgia | Paraguay | | |
| Tajikistan | Ghana | Peru | | |
| Tanzania | Grenada | Philippines | | |
| Togo | Guatemala | Romania | | |
| Uganda | Guyana | Samoa | | |
| Zimbabwe | Honduras | São Tomé and Príncipe | | |