IPM Research Center

German Economic Team in Belarus

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Eurobonds Conference: Key Findings

1. Introduction

On December 10, 2003 the German Economic Team in Belarus and the Research Center of the Institute for Privatization and Management jointly hosted a conference, entitled: *First Time Sovereign Bond Issue in Belarus*. Motivated by plans by the government of Belarus to access international bond markets in 2004 for the first time, the conference sponsors decided that it was time to facilitate an informed discussion on the opportunities and risks associated with such a debut bond issue. Consequently, the conference in Minsk brought together international economic and financial experts as well as government officials to discuss some key considerations that Belarus should take into account before issuing bonds in international capital markets. In this respect, special attention was given to the factors determining a country's successful access to international bond markets and the desired characteristics of the debt instruments to be issued.

In general terms, a successful sovereign debut in international bond markets is usually supported by a successful macroeconomic stabilization that led to a massive reduction in inflation, reflected also in a stable currency; a high and robust rate of economic growth; and a prudent fiscal stance, with a strong record of managing the public debt. The latter point is essential for a debut borrower, since a foreign bond issue leads in effect to an increase in public debt, specifically in external public debt. Therefore, first-time sovereign issuers should normally have an excellent record in servicing their external debt in the years preceding the issue. In the case of Belarus, it is essential that macroeconomic stabilization continues and that structural reforms are intensified. Besides, the country should consider alternatives sources of foreign loans, especially from international organizations, which provide loans at favorable conditions. Only after these preconditions have been met and alternative sources of loans have been considered can international bond markets become part of a balanced sovereign debt strategy.

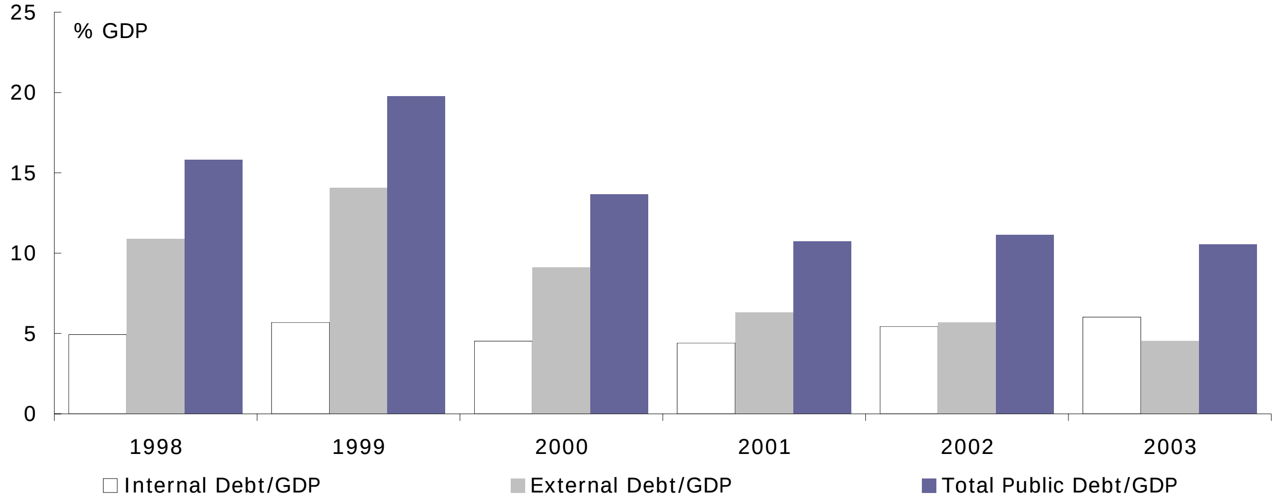
The remaining sections of this paper summarize the viewpoint of the German Economic Team and its policy recommendations against the background of the issues raised by the conference participants in presentations and discussion sessions. These policy recommendations concern in detail the following areas:

1. Bond Issue and Public Debt Level
2. Total Amount and Maturity of the Bond Issue
3. Efficient Deployment of Foreign Funds obtained by the Bond Issue
4. Technical Aspects of the Bond Issue

2. Bond Issue and Public Debt Level

A successful sovereign debut in international bond markets is usually supported by a successful macroeconomic stabilization that led to a massive reduction in inflation, reflected also in a stable currency; a high and robust rate of economic growth; and a prudent fiscal stance, with a strong record of managing the public debt. The latter point is essential for a debut borrower, since a foreign bond issue leads in effect to an increase in public debt, specifically in external public debt. Therefore, first-time sovereign issuers should normally have an excellent record in servicing their external debt in the years preceding the issue.

Figure 1. Public Debt in Belarus (Percent of GDP)



Source: Ministry of Finance of Belarus, own calculations.

Turning to total public debt in Belarus, Figure 1 displays it in relation to GDP over the last 6 years, as well as a breakdown of its domestic and external components. It shows that the ratio of total public debt to GDP is currently at 10.5%, which can be judged relatively low by international standards, with a declining trend. This is in particular the case for the external component of public debt, which stood at 4.5% of GDP in 2003. Corresponding to this stable development of the level of sovereign debt has been the maintenance of a solid fiscal stance. The budget deficit has averaged only about 1.2% of GDP in 1998-2003[1]. Furthermore, the fact that Belarus has never defaulted on its debt should further strengthen the overall positive evaluation of the planned bond issue from a public finance perspective.

Proposal 1: Belarus has a low and declining ratio of public debt/GDP, as well as no significant external public indebtedness. Against this background, a prudent increase in external public debt by means of a bond issue can be justified.

3. Total Amount and Maturity of the Bond Issue

According to sources in the Ministry of Finance, Belarus plans to issue a total amount of bonds between USD or EUR 100 m to 200 m in 2004. The amount of the bond issue should, in general, depend on:(i) the country's financing requirements;(ii) the need to establish a liquid sovereign benchmark;(iii) the overall interest burden on the required funds:

i. Belarus needs to have a clear understanding of its financing requirements both in the short and medium term. We understand that the above mentioned potential range of the issue has been derived from such fiscal considerations. As far as Belarus' capacity to service the obligations associated with the bond issue is concerned, this will be the main focus of the following section.

ii. The need to establish a benchmark bond is a key consideration in determining the size of the bond issue. The bond issue should be sufficiently large to be liquid. International investors generally prefer liquid bonds that can be traded easily in the secondary market, and hence require a lower yield. Reflecting their preference for liquidity, investors tend to prefer a minimum size of issue. Issues that are included in emerging markets bond indices (like the EMBI) can further stimulate investors' demand, leading to a compression in yields. However, the relevant inclusion criterion is usually an outstanding amount of no less than USD or EUR 500 m, a size that is for several reasons considered too large for Belarus.

iii. The experience of first-time issuers shows that bond yields at launch tend to decline in subsequent issues, lowering the interest burden of future issues. Since the issuer is expected to pay less in the future, it will try to avoid locking in relatively high interest rates

[1] Own calculations. Preliminary data for 2003 cover January to November only.

associated with a first-time bond issue. This implies a relatively small amount of the debut bond issue. If yields decline as expected, the remaining funds can be financed at better conditions.

The same goal of minimizing the interest burden of the issue should also determine the maturity of the bond. Expecting a decline in bond yields after a successful launch, it should be avoided locking in the high interest costs of a debut issue over a long maturity. As the interest on a short-term bond is also likely to be lower than that on a long-term bond, Belarus has a clear incentive to issue a debut bond with a short-term maturity. Foreign investors may also prefer to buy a bond with a short-term maturity, which tends to be less susceptible to market risk than a medium-term bond.

Taking these considerations into account, we propose to issue a total amount of USD or EUR 200 m. This size will ensure a liquid trading of the bond, while at the same time leaves the opportunity for further issues at lower interest rates. Regarding the maturity of the bonds, similar considerations favor a relatively short maturity of not more than 3 years.

Proposal 2: The total amount of the bond issue should be at the upper end of the range, i.e. USD or EUR 200 m, with a maturity of the issue of not more than 3 years.

4. Efficient Deployment of Foreign Funds obtained by the Bond Issue

In accessing international capital markets for the first time borrowers could: (i) smooth consumption;(ii) take advantage of investment opportunities; or (iii) increase foreign exchange reserves to establish a cushion against adverse external events. The decision to invest or to consume from borrowed funds is the most fundamental one. It is at the same time of crucial importance to possible creditors, since the debt service and the repayment of principal is strongly associated with the proper deployment of foreign funds:

i. Increasing consumption trough the proceeds of the bond issue (like importing luxury items such as cars and consumer goods, etc.) should be completely avoided. In such a case, the ability to service the debt and repay the principal is clearly in danger and hence foreign investors' confidence low.

ii. As long as the government uses the borrowed funds for productive investment, economic growth should increase. Specific investment projects or schemes should be efficiently designed to yield large expected returns; these returns signal to foreign creditors that the debt service can be easily performed. Major questions arise concerning how a credible link between the funds borrowed and their subsequent use could be established. One possibility would be to form a separate legal entity that oversees and takes full responsibility for the investment process. The relevant share of national output in which to invest is tradable output, since it generates (or saves) foreign exchange. Non-tradable goods and services (e.g. infrastructure projects) cannot generate foreign exchange earnings. However, there are special cases where indirect incentives for the production of tradables could be set by financing public investment, resulting in higher exports, i.e. foreign exchange inflows. Thus, special emphasis has to be placed on the export sector since expanding foreign exchange earnings is critical for the country's future ability to meet external debt-service requirements. Beside its immediate effect on the generation of foreign exchange, the stimulation of exports brings more benefits to the country, like higher long-run economic growth. The strategy of building a large and diversified export sector could be further supplemented by encouraging FDI in this sector.

iii. Another purpose of the bond issue could be motivated by the wish of the authorities to expand the official foreign exchange reserves. Broadly, there are at least two reasons why countries choose to accumulate foreign exchange reserves. First, in the context of a floating exchange rate, reserves can be regarded as a form of insurance policy against the impact of unforeseen domestic or external shocks. A second reason for holding reserves concerns countries that try to maintain some form of exchange rate stability by means of direct intervention in the foreign exchange market. However, holding reserves also entails certain costs, as the return on reserve assets (e.g. US-treasury or Euro-area bonds) is likely to be well below the costs of international borrowing for Belarus. This can shake confidence in the ability to repay the external debt. Even more problematic is the case in which reserves are used for resisting a prevailing weakness in the domestic exchange rate, since this will lead to continuing reserve losses. If no other sources of foreign exchange can be found, a default is likely.

Proposal 3: The foreign funds obtained by the bond issue should be intended primarily for:

(i) investment, not consumption;

(ii) high-yielding investment projects, not reserve accumulation;

(iii) projects linked to the tradable sector, since this is strongly associated with the capacity to service the bond issue.

5. Technical Aspects of the Bond Issue

Currency of denomination: USD or EUR

The currency of denomination of a new bond issue depends on many factors, including the use of the proceeds from the issue; the ability to generate foreign exchange earnings in this currency; the target investor base; and the prevalent market situation. From the issuer's point of view, the first two factors can be neglected, since it is possible to issue a bond in one currency and convert the funds obtained to another currency via a foreign exchange swap with an international bank. However, with respect to the target investor base, strategic considerations play an additional role. On the background of the current process of Eastern European integration into the EU, the choice to issue bonds in EUR could serve as a positive signal to investors about the intention of Belarus to strengthen links with the EU. As discussed above, due to the need for a liquid bond issue, we recommend to issue in one currency, either USD or EUR, with a special focus on the actual market conditions.

Proposal 4: The bonds should be issued in one currency, i.e. USD or EUR, and this decision should be taken at the last moment.

Timing of the issue

Favorable external as well as domestic conditions are generally necessary for a successful bond issue by first-time sovereign issuers. Due to the on-and-off or binary nature of international bond markets for emerging market borrowers, these countries are typically cut off from international markets in times of financial turmoil. The success of a debut bond issue therefore hinges on a favorable international backdrop. In this connection, volatility and spreads in mature markets should be low, and investors should possess a low degree of risk aversion, leading to a strong overall performance of emerging market debt. Furthermore, there are also domestic factors that should be considered for the right timing of the issue. Since investors generally prefer stable political and economic domestic environments, it is not advisable to issue a bond in times of high political and/or economic uncertainty (e.g. during budget debates in the parliament).

Apart from these considerations, the borrowing activity of competing issuers should be taken into account when planning the market access. A timing that concentrates foreign investors' interest on Belarus can be considered optimal.

Proposal 5: The bond issue should take place under favorable external and domestic conditions, in particular taking into account the borrowing plans of competing issuers.

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