POLICY BRIEFING 07|2020

German Economic Team
BELARUS

Inflation-linked bonds in Belarus: potential for financial market development and debt financing

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Outline

I. Rationale for ILBs
II. Experience with ILBs in other markets
III. Is the introduction of ILBs desirable in Belarus?
IV. Steps in the technical preparation

I. Rationale and design of ILBs

I. Rationale from the issuer and investor perspective

- Investors seek to protect the return of principal and coupons relative to local goods priced in local currency. Where the commitment to inflation is not credible the investor will apply a risk premium to compensate for uncertainty over the inflation outcome.
- The government (as issuer) can commit to a real value in a debt contract. It assumes the inflation risk from the investor, and thereby in theory saves the inflation risk premium applied to fixed-coupon bonds.
- The introduction of inflation-linked bonds (ILBs) is a sensible strategy if the inflation targeting regime is young, or not fully trusted by investors.

Drawbacks:

- Liquidity in debt markets may be reduced, due to smaller issue size, and by cultivating ‘buy-and-hold’ investors.
- Widespread indexing in private debt contracts.

Design: which price index?

- The choice of the price index is essential for valuation and debt service payments. This requires full documentation in the bond prospectus.
- From the perspective of the government the GDP deflator would be ideal, but as the index needs to appeal to the broadest set of investors, and needs to be timely and transparent, the CPI is invariably chosen.
- ILBs are almost always based on the consumer price index as the most timely, most comprehensive and most readily available index.

Key issues in emerging markets:

- Independence of statistical office and key officials from political interference
- Integrity of the index:
  - Offer a full disclosure of the composition and statistical compilation of the index;
  - Explain and adhere to a timely publication of the index;
  - Offer reassurance against insider information or premature leaks of price data;
  - Explain the approach to revising the index or developing alternative measures in future.

The price index in Belarus

- The compilation of the Belarusian CPI meets international standards according to the IMF.
  - CPI is comprehensive;
  - Latest CPI is available on a regular date each month;
  - Methodology and changes to it are transparent.
- BELSTAT is regarded as sufficiently independent and there have been no reports of unauthorized interference in their compilation activities.
- However, 20% of the CPI basket are regulated prices, a share that is very high in an international comparison.
- The debt service due on ILBs would be subject to the government’s own actions in regulating prices. This would be a concern for investors.

Design: the mechanics of the payout

- **Which maturities**? Local investors have long investment horizon (15 yrs +), though this will come at a cost to liquidity.
- **Which lag in indexing**? Typically 3 months, though a trade-off between
  - a longer lag (allows certainty on index),
  - or shorter lag (more immediate value protection).
- **A deflation floor**? This option (to redeem at par despite a deline in the index) would affect pricing.

II. Experience with ILBs in other markets

The global ILB market

US TIP (USD 1,500 bn) and UK inflation-linked ‘gilts’ (GBP 450 bn) account for ¾ of the global ILB market

- UK deliberately used the instrument to lengthen maturities and offer an asset base to local (defined-benefit) pension funds (about 20 years ATM). Due to greater credibility of monetary policy, the instrument is going out of favour.
- In the US shorter maturities and greater liquidity.
- But several large advanced countries (Germany, Netherlands) have stopped or issued only intermittently and only small amounts of ILBs.

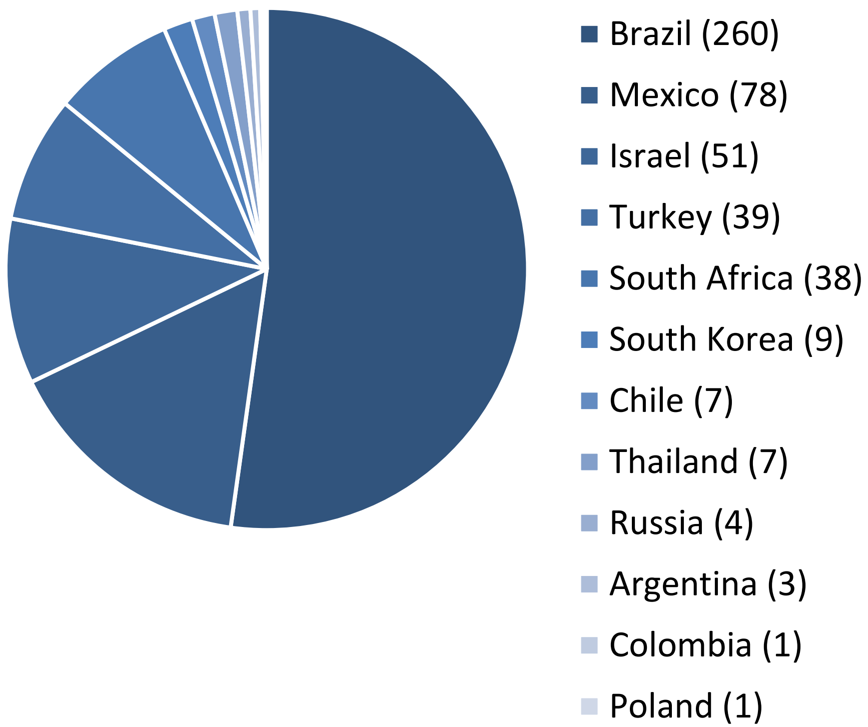
Emerging markets

- Generally introduced ILBs when high and variable inflation disrupted the main bond market.
- High concentration among the top-five issuers: Brazil, Mexico, Israel, Turkey, South Africa.

Lessons from EM issuers

- ILBs have longer maturity than regular fixed-rate bonds, for instance in Brazil extending to up to 30 years.
- The primary holders are domestic pension funds with longer holding periods.
- EM ILBs are less susceptible to changes in investor sentiment
- ILBs show less yield volatility than nominal (fixed coupon) bonds as yields strip out variations in inflation expectations.
- Pricing and real yields evident in market prices reflect investor views on the sustainable long-term real rate of interest in the economy.

Emerging market ILBs (USD bn), April 2019



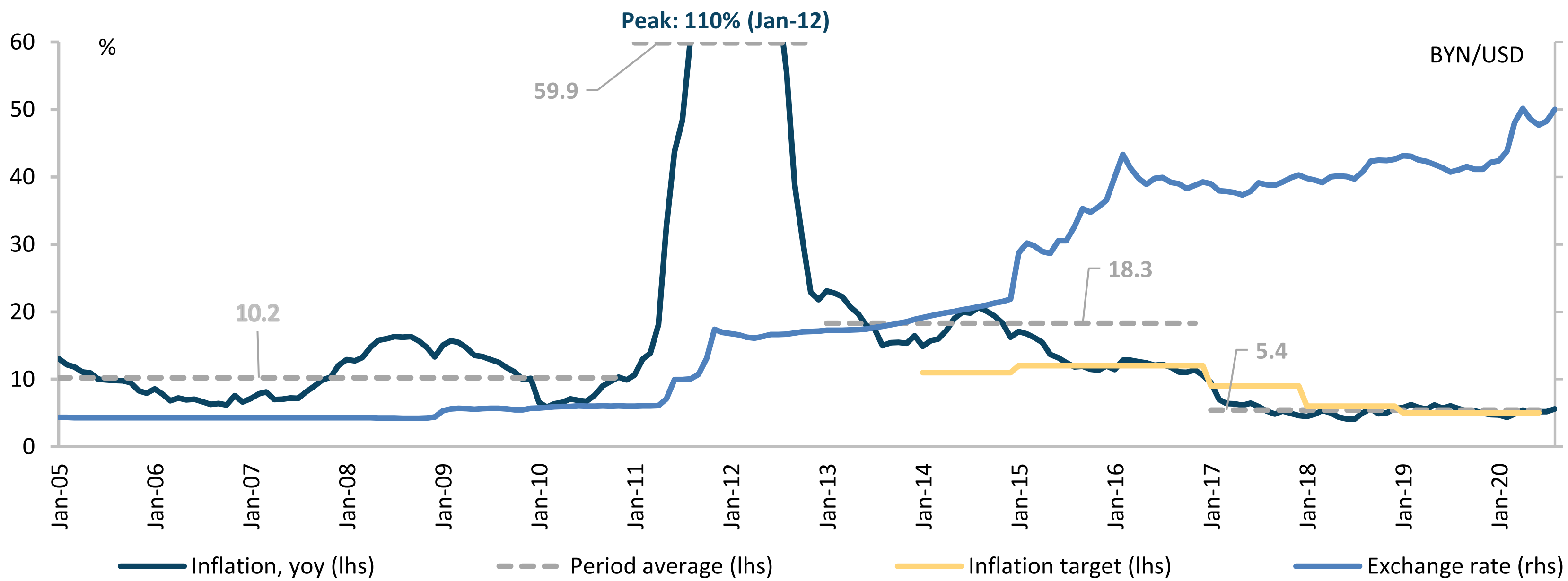
Source: HSBC, based on Barclays.

III. Considerations for Belarus

Policy considerations: supportive factors

- Inflation risk remains significant, given dollarization, fiscal dominance, and regulated prices. It has risen further in the current recession.
- Investors will likely demand a risk premium in excess of what is justified by commitment to stable inflation by the NBRB and a a case for ILBs.
- ILBs could also be a useful tool in the effort to reduce the role of the USD in the financial system.

Figure 1. Inflation and the BYN since 2005, NBRB targets and averages for corresponding periods



Source: IMF IFS, NBRB, GET calculations

Policy considerations: constraints

- There is still a significant share of regulated prices in the CPI. Investors would buy an asset whose return the issuer controls indirectly.
- The typical domestic investor base – pension funds with a long term investment horizon – is underdeveloped in Belarus.
- The domestic BYN issuance of state bonds is very limited (<7% of GDP outstanding). The priority should be a more significant issuance of BYN bonds, based on market prices and a transparent auction mechanism. A separate instrument would undermine this objective.

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About the German Economic Team

The German Economic Team (GET) advises the governments of Ukraine, Belarus, Moldova, Georgia and Uzbekistan regarding the design of economic policy reform processes and a sustainable development of the economic framework. As part of the project we also work in other countries on selected topics.

In a continuous dialogue with high-level decision makers of the project countries, we identify current problems in economic policy and then provide concrete policy recommendations based on independent analysis.

In addition, GET supports German institutions in the political, administrative and business sectors with its know-how and detailed knowledge of the region's economies.

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