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NEWSLETTER

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BELARUS

Domestic bond markets as an alternative financing source

The Belarusian economy is currently in a recession, facing capital outflows and devaluation of its currency. The banking sector is highly exposed to state enterprises, and may be strained further as borrowers' solvency deteriorates. Over the long term, developing local currency instruments in the domestic capital markets could make the financial system more resilient, and reduce reliance on a fragile banking system. There is significant potential in the domestic bond market as many enterprises have already issued in the market. However, local currency instruments are under-developed, reflecting the wider substitution of foreign currency in the financial system, and pricing and allocation of such bonds has been largely on non-market terms.

Financing risks in the current recession

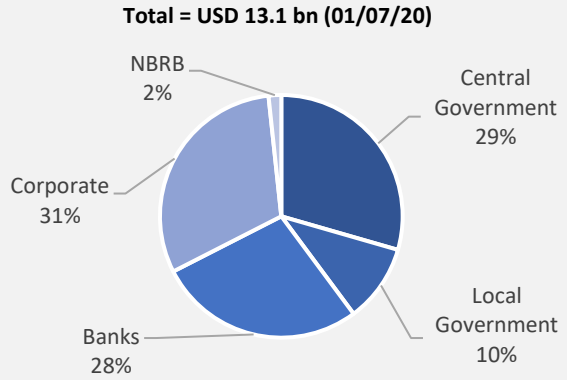
The current recession and political uncertainty have disrupted financing for enterprises and households in Belarus. The banking system has already experienced significant deposit outflows and conversions of deposits into foreign currency have accelerated. This has further reduced the central bank's low international reserves, underlining a key vulnerability resulting from the large degree of US dollar substitution in the financial system. Along with other so-called frontier markets, the risk premium on the outstanding Belarus Eurobonds has widened significantly. As more deposits are withdrawn from the banking system, the banking system liquidity in foreign currency will deteriorate further.

The financial system is heavily reliant on three banks. The share of foreign currency in bank liabilities and loans outstanding is among the highest in the region. The depreciation of the Belarusian Ruble (by about 21% against the USD since the beginning of the year) has raised credit risk in corporate loans, and may further undermine the capital position of the banks.

Development of the domestic capital market

A key question is whether the local capital markets can now act as an alternative financing source. At first glance, the bond market seems relatively deep. Total bonds outstanding from public entities, banks and enterprises amounted to the equivalent of USD 13.1 bn, or roughly 23% of GDP in July 2020. The corporate bond capitalization at 7% of GDP is relatively high in a regional context; at the end of H1 2020, 194 companies had bonds outstanding in the domestic market.

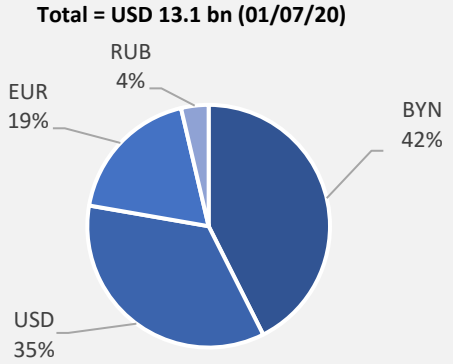
Structure of outstanding bonds by issuer



Source: Ministry of Finance

As is the case for bank lending, about 60% of bond capitalisation is in foreign currency, pre-dominantly the US dollar. Many bond positions substitute for loans, and as bonds are held to maturity, there is only very limited trading.

Structure of outstanding bonds by currency



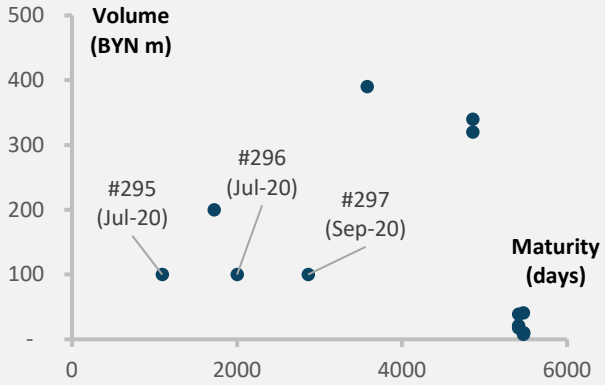
Source: Ministry of Finance

The domestic sovereign debt market typically constitutes the foundation of a domestic bond market. In Belarus, this market still suffers from distortions, non-market allocations and minimal liquidity. Moreover, even domestically issued state debt is primarily in foreign currency. In this way, the state absorbs excess FX liquidity of the banking sector. This offers lower funding costs, though at the cost of perpetuating the use of the US dollar in the financial system, aggravating the currency risks in the public sector balance sheet.

Until this year, the government closely controlled the allocation of sales of state debt in the primary market. Banks account for 80% of the domestic investor base. Three of the five largest banks are state-owned and account for over 60% of banking sector assets. Open

auctions of state debt have been used regularly only since 2018. Until that point, all bonds issued by the state in local currency, as well as most bonds issued in foreign currency, were directly placed with banks or other market participants. After a long pause, state issuance of bonds in Belarusian Rubles on the domestic market resumed in 2020 (in small sizes).

Domestic debt issued in BYN since 2015



Source: Ministry of Finance; Issuance date in brackets

A significant part of state debt issuance was therefore not allocated on market terms. Pricing of bonds may have been distorted, in particular where state banks were investors. Subsequent sales of bonds in the market would result in a capital loss for primary investors. The bonds needed to be held to maturity, diminishing incentives for secondary trades.

Next steps in market development

The state is committed to develop the local capital market further. A strategy adopted in August 2019 foresees a financial market that is more balanced between banks and debt markets, increased financing of the state in the domestic bond market, and the development of market infrastructure.

Capital markets could provide an important additional source of financing, and reduce reliance on a fragile banking system. A number of reforms would be required. A priority would be to base the sales of both state and corporate bonds on market terms. This would require risk-based pricing, possibly based on publicly available risk ratings. By extension, this would imply assigning a probability of default to issuers, many of which are state-owned. The rights of bond holders in any insolvency would need to be clarified. Issuance of state debt within domestic market would have to contend with the high degree of dollarization, and hence limited appetite for local currency instruments by banks and other investors, such as wealthy individuals.

These steps would be essential to encourage foreign investors into the market. The rapid growth of the domestic bond market in Ukraine demonstrates that such reforms can catalyse investor interest, and access can be greatly facilitated by access to international settlement mechanisms. The influx of capital considerably eased financing conditions. But liquidity and trading of government bonds in emerging markets is highly pro-cyclical: it increases in times of market stability and capital outflows may result in refinancing problems during times of risk aversion.

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The German Economic Team (GET) advises the governments of Ukraine, Belarus, Moldova, Georgia and Uzbekistan regarding the design of economic policy reform pro-cesses and a sustainable development of the economic framework. It is funded by the Federal Ministry of Economics and Energy and implemented by the consulting firm Berlin Economics.