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### **Stretching to Thirty!**

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**Last week, the Government of Pakistan announced its intention to issue 30 Years long term Pakistan Investment Bond. With this the Government aims to develop a complete cycle from three months to thirty years for the government paper.**

**Arguing for the need of long term debt securities to develop domestic bond markets and a long term yield curve, this issue appreciates the government's move while focusing on the impediments that the 30Y PIB may face in terms of liquidity in the interbank markets, and insufficient demand from investors.**

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## **Nourishing the Growing Economy**

The Pakistani economy has experienced an absolute turn in the last few years. Registering an average GDP growth of 7% for the last three years and expected to grow above 7 % for the coming year, Pakistan has successfully acquired the position of one of the fastest growing economy of the region. This healthy growth presents outstanding opportunities to business and industry, laying grounds for a take off of their new business ventures. The vitality in agriculture, industry and services sectors and the development of a new investment climate, represents all the fundamentals for sustained economic growth.

The next critical step in the development of any economic model relies heavily on a robust and liquid domestic bond market. This brings about number of significant benefits for a growing economy.

Firstly, a well performing domestic bond market ensures fine performance of interest rates that represent the opportunity costs of financing across an extensive range of maturities. These bond markets breed new grounds for financial intermediation while preventing excessive dependence on intermediation by commercial banks.

The fact that domestic bonds are issued in local currency, developing domestic bond markets will enhance financial stability, reducing the exposure to foreign exchange risks and currency disparities resulting from foreign currency borrowings. In the developed markets of the United States and Europe, domestic bond markets present the key source to government and corporations for raising long term capital. Following the suit of these developed economies, the Government of Pakistan must also discipline its spending, that is financing long term assets with long term liabilities. For instance, the development of the Basha Dam must not be funded with T bills but rather with long term debt securities.

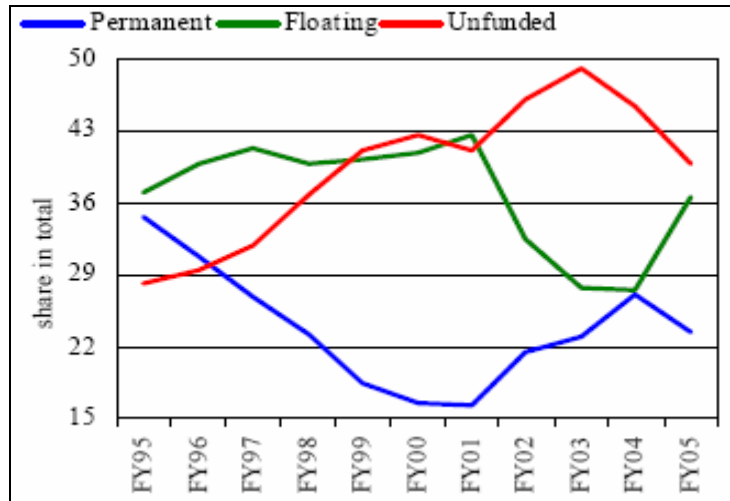
Lastly, domestic bond markets provide an additional tool for efficient execution of monetary policy to the government while indicating enhanced sustainability of government policies.

## **The Debt Tale...**

The secondary debt market in Pakistan was inactive for the last few years due to the obvious inactiveness of the primary market. The FY 05 saw an increase in the domestic debt, contributed entirely by a rise in the stock of floating debt that constitutes short term debt securities. Short term debt mounted to almost 36.5 percent of the domestic debt as depicted in figure 1. On the other hand the contribution of long term debt to total domestic debt declined significantly. This was mainly due to the fact that the government mothballed the PIB issues in FY 05. More important to note here, is the contribution of

the permanent debt to total domestic debt, that has over the years remained well below the stocks of short term debt securities.

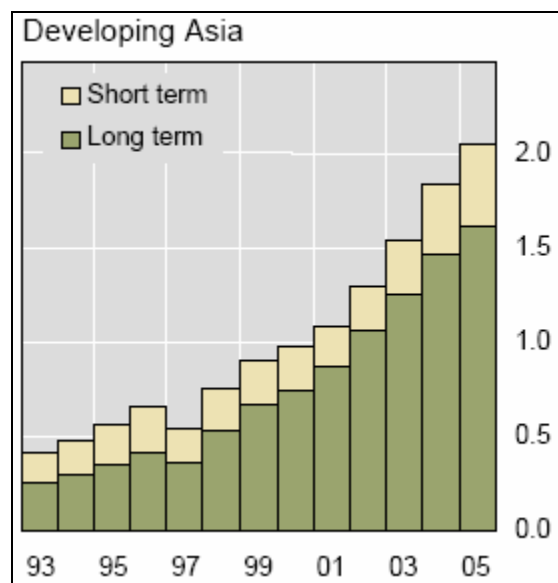
**Figure 1: Composition of Domestic Debt**



Source: State Bank of Pakistan Annual Report FY 05

This places Pakistan clearly in contrast with the other emerging markets of Asia that over the years have seen the contribution of long term debt to the total outstanding domestic debt increase substantially as represented in figure 2.

**Figure 2: Domestic Debt Securities Outstanding (In Trillions of U.S. dollar)**



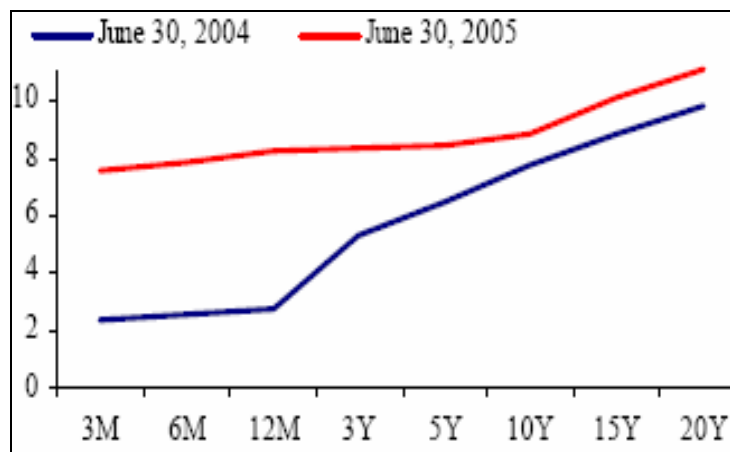
Source: BIS

This incites the need for the government of Pakistan to shift its borrowing pattern towards long term debt securities and consequently develop a long term domestic yield curve. However with the successful issuance of the ten year and the thirty year Eurobond in the last financial year, Pakistan has already set ground for developing a dollar denominated borrowing yield curve of up to thirty years.

Realizing that it is imperative to build a yield curve for the domestic market as well, the government has lately reentered the market and issued Pakistan Investment Bonds (PIBs) of different maturities.


The PIBs act as vital tools for the government to offer benchmark rates to the market for medium to long term lending. In the previous financial year, in an attempt to align bond market with the international best practices, the State Bank of Pakistan demanded the banks and other financial institutions to categorize PIBs into a) held to maturity, b) held for trading and c) held for sale. This move however shrank the liquidity in the secondary market as in order to avoid revaluation losses as a consequence of rising yield, most financial institutions placed their securities in held to maturity accounts. With the yields rising on the market Treasury Bills, investors expected higher yields on the fresh issues of PIBs but to evade higher costs of borrowing, government decided otherwise and focused on short term borrowings for raising capital. This caused the yield curve to flatten as no PIB issues took place in that year as depicted in figure 3.

**Figure 3: Yield Curve Dynamics**



*Source: State Bank of Pakistan Annual Report, 2005.*

Though the yields on the government bonds in FY 05 reveal rising trends as compared to FY 04, the yield curve tends to flatten over increasing maturity. Hence the yields on PIBs failed to correspond to the rising yields on Treasury Bills. The structure of the above yield curve was attractive for investment at the shorter end with particularly no appetite for long term assets. This forced the government for immediate new PIB issues for



developing a domestic bond market and guaranteeing credibility of long term yield curve which would act as a reference rate for private sector to raise long term funds as well.

Thus this year, the recent PIB auction last month, saw the issuance of the 3Y, 5Y, 10Y, 15Y and 20Y bond, accommodating bids worth PKR 15.03 billion with a face value of PKR 3.35 billion, PKR 1.1 billion, PKR 3.575 billion, PKR 3.0 billion and PKR 4.0 billion respectively. The auction partially presented a reopening of May 19, 2006 bond issue in 3, 5 and 10 years tenors, with an effective cut-off of 9.85%, 9.95% and 10.42% respectively to provide liquidity in a particular issue. On the other hand the auction for 15 years and 20 years was for fresh issue and was offered for the third time since January 20, 2004 with the effective cut-off of 10.92% and 11.25% respectively.


With the successful completion of the long due PIB auction, the government now intends to issue a thirty year long term PIB. With this, the government aims to complete the cycle of government paper from 3M to 30Y, paving way for building the long term yield curve for the domestic market. The establishment of this long term yield curve is very critical to the development of the financial markets. It will not only stimulate secondary market opportunities in Pakistan but will allow the economy to compete against the other emerging economies in the housing finance market through stimulation of mortgage and long term finance.

However, considering the low levels of liquidity in the secondary market, what is more important for the Government of Pakistan is promotion of liquidity in this issue. Hence it is vital to question if issuing the 30Y PIB in current circumstances alone shall do us the good that the government is aiming for.

### **Unveiling the flaws....**

It is important to note that even with the recent PIB the domestic bond market of Pakistan still remains a small part of the total financial assets. This has caused a lack of secondary market liquidity which is defined as the capacity to carry out market transactions cheaply and quickly without altering the price. Additionally, the recent reopening of National Saving Schemes (NSS) to the corporate sector has not helped this cause either as this move has shifted the liquidity further from PIB issues towards NSS.

Hence, presenting a key constraint to further development of the bond markets, this lack of liquidity adversely affects the efficiency and the general role these domestic bond markets have to play. Liquid bond markets are highly imperative as they allow the market participants to regulate their portfolios economically. Consequently, in absence or dearth of this liquidity, the market investors shall demand compensation which will in due course cause the borrowing costs to rise for the government. Even more importantly, a lack of liquidity from the secondary markets would prevent the government from



achieving its primary objective of developing a long term yield curve as liquid secondary markets are crucial to establish a credible yield curve.

However, before presenting the solutions to counter this lack of liquidity in the domestic bond markets, it is important to analyze the factors that provoke this dearth of liquidity.

In terms of the supply side, liquidity is not only diminished by the small volume of the individual issues but also the small size of the bond market as a whole.


On the other hand, in terms of the demand side, liquidity is often reduced due to a slender investor base constituting largely of the local banks and organizations. This is especially the case when these investors pursue buy and hold strategies. As compared to the case of developed countries, most emerging economies of Asia have on an average more than half of their domestic debt securities held by banks. Hence in order to predict the extent of the success of the planned 30 year PIB issue, it is most important to measure the scope of the demand that exists in Pakistan for domestic long term bonds.

### **Conventional Wisdom Not so Wise!**

Where financial economics has little to say about the demand for long term bonds, popularly held notion assumes that long term bonds are most suited to conservative long term investors who seek a stable income. Consequently, it is often argued that investors would logically prefer to hold short term bonds as opposed to long term bonds and would only hold the latter if they are compensated by a term premium.

Conversely, it is argued that some investors might have a long term *preferred habitat* and hence would hold a preference for long term bonds. Such investors would then require a premium to go short and not a premium to go long. In terms of this preferred habitat theory, all investors have different investment horizons and they demand substantial premium to buy bonds with maturities outside their preferred maturity. This implies that longer term rates do not necessarily have to be higher than short term rates. However, most theorists are often vague about the characteristics of investors that would result in a long term preferred habitat.

Whatsoever, demand for long term bonds is best explained in terms of two factors. Firstly, investors may hold long term bonds for speculative reasons if they offer a term premium, in order to augment their expected portfolio return at the expense of additional short term risk. Often termed as the *myopic demand*, this segment of the demand for long term bonds tends to be large when risk aversion is small. This is due to the fact that long term bonds offer higher return per unit of risk. Secondly, long term investors may hold long term bonds for hedging purposes. In this case, they value the fact that, regardless of their short-term fluctuations in prices, bonds offer a safe stream of cash flows that is their



coupons, and their principal at the end of the life of the bond. Hence, these investors might want to hold bonds in their portfolios for their ability to hedge their spending needs. In the extreme case where the investor is infinitely risk averse so that the myopic demand for long term bonds does not exist at all, the demand then comes entirely from the hedging demand.

### **Insufficient Appetite**

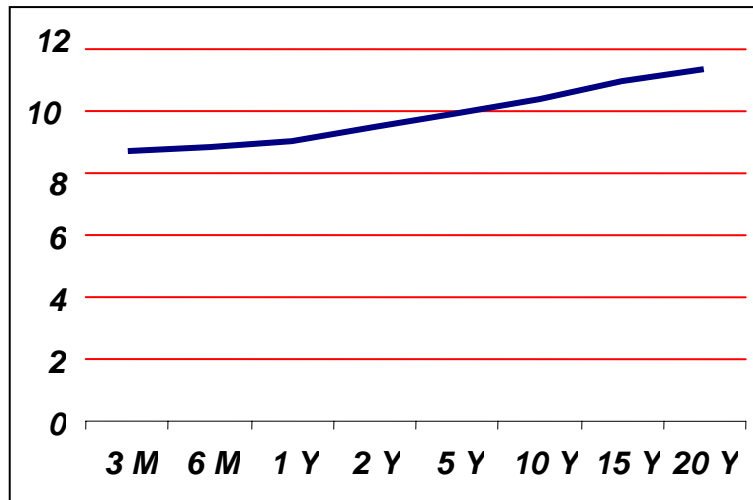
With regards to the two principle components of demand for long term bonds, as explained above, we are cynical about the existence of sufficient appetite for a 30Y PIB issue in Pakistan.

In terms of the myopic demand for long term bonds, the investors shall expect a higher yield to compensate for the higher risk they have to bear due to the longer maturity of the bond. However, the fact that the yields of the PIBs issued so far have always been pre determined by the government rather than the yields being aligned to the market rates have always resulted in considerably low yields. This indicates that the yield on the 30Y PIB issue may not be as high as most investors would wish for. The following yield curve depicts the yields on the 3M, 6M, 1Y, 2Y, 5Y, 10Y, 15Y and the 20Y bond. The increase in the yield with the rising tenors is extremely small as shown by the relatively flat yield curve in figure 4. This opens room to the popular debate of *interest rate conundrum*: Though the economy of Pakistan is growing at a healthy rate, the yield curve is flat, i.e. short term rates are almost as high as long term rates. Hence the myopic demand for the 30Y bond will be sufficiently low. Additionally it is important to note that a flat yield curve signals that the economy is heading in the direction of an inverted yield curve; a point where short term rates shall exceed the long term rates. This is usually regarded as the precursor to a recession. This is because financial markets function more profitably when the spread between long-term and short-term interest rates is higher. When short-term interest rates are as high as long-term rates or even higher, it tends to discourage investment activity. It is beyond the scope of this issue to analyze this interest rate conundrum but in order to avail the full advantage of a long term bond and prevent the economy from receding, it is important that the yield for the 30Y PIB is set significantly higher than the shorter term bonds introduced so far.

The other component of the demand for long term bonds arises from hedging purposes of the investor. This demand is most strong amongst investors who have long term liabilities and therefore seek a stable inflow of income over a long period of time. Hence it is the pension funds and insurance companies that are most eager to buy long term bonds to match their long term liabilities. For instance in Europe due to a large size of aging population, pension funds are particularly hungry for long-term bonds. France issued a 50-year bond successfully earlier last year, followed by Britain. The absence of

significant pension funds and lack of a well developed insurance sector in Pakistan, consequently points towards a fairly low demand for long term bonds.


**Figure 4: Yield Curve, 2006.**



#### **....Resolving the flaws**

In presence of the liquidity shortage and a slim investor base, issuing the 30Y PIB shall do us hardly any good. Hence it is highly imperative to overcome these setbacks to allow the Government of Pakistan to achieve its intended aims.

In order to ensure a successful completion of 30Y PIB, it is important to enhance liquidity in domestic bond markets. The savings market in Pakistan has been largely segmented due to issues of different securities like the NSS and the PIBs. This results in decreased liquidity as the two instruments have distinct structures. Therefore, what the government needs to do is to structure a unified bond solution for the savings markets to replace the current parallel saving institutions in place. We would recommend making PIBs the primary instrument being offered through the NSS, replacing the Defence Saving Certificates (DSC). This move would enhance the depth of an individual bond issue by helping PIBs to move out from the current slender investor base and penetrate through to the saving public. The schemes targeted at subsidizing the impoverished classes such as the *Behbood* scheme can still remain in place. This way government would be able to restructure the NSS, removing the distortions from the long term debt market while at the same time subsidizing the targeted public classes.



Additionally, non-banking financial institutions can play a critical role in promoting liquidity in the bond markets by mobilizing long-term resources through bond markets, and accommodate the growing financing requirements chiefly for the infrastructure projects in the region.

Apart from making efforts to stimulate liquidity in the secondary market, the government also needs to maintain a sustained stream of PIB issues following the first issue. This is especially important to meet the aim of building a long term yield curve. As mentioned earlier, when the government mothballed PIB issues in the previous years the yield curve was seen to flatten and failed to present a credible picture. Consequently, the Government of Pakistan needs to make sure that such events do not repeat themselves so that the 30Y PIB achieves what it is here for.

### **The End...**

The Government's plan to issue the 30Y PIB is undoubtedly a remarkable move. However we have highlighted various issues in this paper that we feel need to be considered by the concerned authorities in order to let this move achieve its intended objectives: enhancing liquidity and a consistent issuance of the PIB being the primary ones. Ultimately, we believe that the success of the 30Y PIB issue would not be judged by the cosmetic pickup of the offered bond but rather by the achievement of the stated objectives, namely the establishment of a credible benchmark yield curve for the Pakistani financial markets.



## Economic Snapshot

Fiscal year 06																
Units	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April	May	June	July	Aug	Sep	Oct	
<u>Inflation</u>																
Headline Inflation	%	8.41	8.53	8.27	7.89	8.51	8.76	8.05	6.91	6.16	7.12	7.65	7.63	8.93	8.73	8.11
Core inflation	%	7.55	7.58	7.81	7.59	7.36	7.34	7.00	6.67	6.43	6.58	6.29	6.28	6.20	6.16	5.70
Food inflation	%	7.82	7.52	6.41	5.84	8.1	8.17	7.48	5.42	3.64	5.59	7.78	7.44	11.08	11.26	10.54
Non-food inflation	%	8.83	8.25	9.61	9.38	8.8	9.18	8.44	7.98	8.01	8.21	7.55	7.77	7.43	6.98	6.41
<u>T-bill (Wgt Avg)</u>																
3 month	%	7.99	8.10	8.10	bid rej	8.09	8.10	8.10	8.10	8.10	8.10	8.29	8.32	8.63	8.64	8.64
6 month	%	8.12	8.14	8.14	bid rej	8.25	8.29	8.29	8.29	8.29	8.29	8.45	8.49	8.81	8.81	8.81
12 month	%	8.78	8.79	8.77	8.79	8.77	8.75	8.78	8.79	8.79	8.79	8.79	8.79	9.00	9.00	9.00
<u>External Sector</u>																
Export	Mln US\$	1,360	1,318	1,317	1,205	1,451	1,252	1,287	1,536	1,432	1,498	1,512	1,350	1,383	1,420	n.a
Import	Mln US\$	2,056	2,037	2,021	2,024	1,929	2,037	1,854	2,269	1,664	2,299	2,626	2,370	2,292	2,450	n.a
Trade balance	Mln US\$	(696)	(719)	(704)	(819)	(478)	(785)	(567)	(733)	(232)	(801)	(1114)	(1020)	(909)	(1030)	n.a
Remittances	Mln US\$	348	341	373	309	336	391	339	444	401	507	464	376	435	422	n.a
Forex reserves	Mln US\$	12,124	12,000	11,715	11,341	11,669	11,505	11,516	12,487	13,021	13,003	13,137	12,725	12,631	12,512	n.a
n.a = Not Available																



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