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Emerging Market Dynamics, Pakistan, and the Eurobond

Controversy-
The upcoming issue of another Pakistani Eurobond at the end of March 2006 is claimed to be primarily an advertising campaign. But does it make sense on a value for money basis?

Contention-
Factors such as Pakistan's economic revival, its continued geopolitical importance, falling spreads on emerging market debt and petro-dollar flushed, pro-Pakistan Middle Eastern investors promise that spreads shall be tight.

Market impact-
In the present interest rate scenario, Eurobonds are more economical than PIBs even after accounting for exchange rate risk. Pakistan seems ready to take advantage of this, through issuing a sovereign seven-year Eurobond.

Risk-
If the rupee/dollar parity depreciates by more than expectations, due to unforeseen economic or political events, the exchange rate risk on the Eurobond may more than off-set the benefit of lower yield.

Eurobond issuance- market penetration or value for money?

The Ministry of Finance (MoF) intends to issue a Eurobond in March, to follow up on the February 2004 issue, and augment the already growing foreign interest in Pakistan's economy. The MoF claims that the bond is not being issued for the cash it will generate, but to develop a benchmark in international markets. However, with the trade deficit for FY06 projected to be in excess of USD 10 billion, this contention should be taken with a pinch of salt. Yes, the Eurobond will help generate further interest about Pakistan in the international investing community and help promote the country's new "back in business" image. However, Pakistan has already made a strategic re-entry with the Eurobond issue of USD 500 million in February 2004. That bond, with maturity in 2009, continues to trade on the Emerging Markets Bond Index (EMBI), and has put Pakistan on the radar screen of the international investing community. A second bond issue cannot be rationalized solely on this market penetration argument; it must make sense on a value for money basis as well.

To be fair, the finance ministry had stated at the time of the 2004 Eurobond issuance that it intended to go to the international market every year with some form of a sovereign offering. In 2004 it was the Eurobond, in 2005 it was the Sukuk bonds, and in 2006 it seems like it shall be the Eurobond once again. The purpose of this article is to examine whether Eurobond issuance makes economic sense in the current macro-economic environment.

Eurobond Pricing

To start our analysis, it is imperative to ascertain some ballpark figure for the price of the Eurobond. There are two components of a bond's price. First is a benchmark interest rate (in this case it would be the US Treasury bond of the relevant tenor). The second component is the level of the country's economic and political risk which determines the spread above the US Treasury yield. We examine both these components to ascertain the expected yield on Pakistan's upcoming Eurobond.

US Treasury Yields have gone up

The benchmark interest rate for Pakistan's Eurobond would be the US Treasury rate of the relevant tenor. At the time of the 2004 Eurobond issue, US Treasury yields were at low levels not seen in three decades. The yield on a five year US Treasury, on which the 2004 Eurobond issue was benchmarked, stood at 3.046%. Now the five year US Treasury bond yield stands at 4.55%, a rise of 150 basis points. All else equal, this rise in the benchmark interest rate should result in a corresponding increase in the new Eurobond yield. The previous Eurobond was issued at 370 basis points above five year US Treasury, and if the 2006 Eurobond were to be issued with a similar spread and maturity, it should carry a yield of 8.25%. What is important to note is that this increase in yield is solely based on changes in the benchmark US Treasury rate and assumes the maturity profile and the economic and political risks to be the same as in 2004.

Eurobond Maturity- the case for a seven year Eurobond

However, all else is not equal. For starters, the MoF has stated that the tenor of the Eurobond shall range between 5-10 years, with a high probability of it being near the high end of that range. We feel that a ten year bond may require too steep a spread and that the seven-year Eurobond promises to be a more practical option. This would also help start the development of a sovereign yield curve, with both a five and seven-year Eurobond floating concurrently in the international market. A sovereign yield curve is usually constructed over a few years. Countries typically issue a five-year bond initially and then augment the debut point by issuing longer dated bonds ranging between 7-10 years. We feel that Pakistan's 2004 five-year Eurobond issue will be followed up by a seven-year Eurobond to establish a second point on our sovereign yield curve.

However, the investor base of a seven year Eurobond is different from a five-year Eurobond. Banks usually hold fixed-income instruments for up to five years maturity. A seven-year bond should be of greater interest to pension and insurance funds, whose preferred investing habitat is longer-term. For this reason, both the liquidity and risk premiums demanded on a seven-year bond are higher than those of a five-year bond. An IMF report indicates that seven-year bonds for "B" rated sovereign countries are typically issued at spreads that are 40-50 basis points above the spread for five-year bonds. Based on this study, issuing a seven-year Eurobond seems affordable, atleast in theory. A ten-year Eurobond is likely to require a double-digit yield, and might not be acceptable for that very reason.

Maturity, however, is only one factor that will affect the spread on the upcoming Eurobond. Spreads shall also be determined by the international investing community's perception of Pakistan's economic and political risks. In essence, spreads shall be affected by how sustainable Pakistan's recent economic upsurge is deemed to be.

Economic performance gauged by agency ratings

Pakistan's sovereign credit ratings remain B2/B, that is, B2 by Moody's and B by Standard and Poor's. These ratings have remained unchanged since the time of the previous Eurobond issue, and are a full five notches below investment grade. However, one positive development on the ratings front is that Standard and Poor's recently revised its outlook on Pakistan's B+ foreign currency ratings from stable to positive. According to them, sharp declines in the government's external debt indicators and structural improvements to enhance export capacity motivated the change in outlook.

However, both credit rating agencies are not completely satisfied with the state of the domestic economy. They cite high inflation, low tax-to-GDP ratio, insufficient monetary tightening, and fiscal indiscipline as the main causes for concern. It seems that some degree of institutional reform needs to be undertaken before the ratings are revised upwards.

On the basis of the credit ratings alone, the spread on the 2006 Eurobond should be similar to the previous issue. True, Pakistan has racked up impressive economic growth numbers in the last couple of years. However, that has been accompanied by undesirable elements such as high inflation and a worsening of the balance of payments. On the balance of risks, we feel that some degree of compression in spreads may be witnessed due to the positive view on Pakistan's foreign currency outlook but its impact would not be too significant.

Political Risks- Is Pakistan too Important to Default?

However, it has been empirically proven that changes in ratings and movement in spreads of international debt have less than perfect correlation. Ratings often tend to have a reactive bias and at any given time, they might not account for all the factors that affect a country's default risk. In 2004, Pakistan experienced this phenomenon first-hand. Our Eurobond was issued at a yield of 6.75% in 2004, which was 50 basis points below the yield on a similar debt instrument issued by the Philippines, a country that is rated three notches higher than Pakistan. If a nation can issue a bond yielding less than its risk profile merits, it is likely that the demand for the bond is being generated by factors other than the issuers fundamental creditworthiness. Ultra-competitive spreads were achieved on the 2004 Eurobond in part due to tangible financial and political support provided to Pakistan by the US in the wake of the September 11th attacks. Pakistan became a foremost ally in the war against terror and received significant hand-outs as a result. Special mention must be made of the US-led negotiation to reschedule USD 12.5 billion of Pakistan's Paris Club debt in late 2002, and the April 2003 write-off of the USD 1 billion bilateral debt owed to it by Pakistan. These actions sent a clear signal to the international capital markets that the United States judged Pakistan to be "too important to default" for geo-strategic reasons.

To a great extent, that continues to be the case today. US involvement in Afghanistan lingers on and the situation in Iraq is getting messier by the day. Meanwhile, Hamas have won a landslide victory in the Palestine general elections and Tehran's nuclear fuel research saga continues. In this hotbed of extremism, a moderate Muslim President in the form of Pervez Musharraf is a prized possession. While tangible support from the US may be less visible than before, implicit support is very much in place. In as much as the foreign investing community perceives this, Pakistani Eurobonds shall continue to be better priced than its country ratings (which are based on fundamental economic factors) dictate. Infact, Pakistan's risk profile has actually improved since early 2004. Hostilities with perennial rivals India have thawed considerably and the prospect of substantial India-Pakistan trade is now being explored.

Petro Dollars- spread compression could result due to a shift in investor base

Pakistan's Eurobonds may be issued at even more competitive spreads this time given that the recent surge in oil prices have left Middle Eastern investors flushed with petro dollars. Traditionally, Middle Eastern investors attribute a reduced level of country risk to Pakistan- lower than western countries at any rate. The upcoming Eurobond issue could derive significant demand from this Arab market, which is now actively looking for higher returns outside of the stale and unprofitable US Treasury market. The petro-dollar play combined with Pakistan's eminent geo-political status implies that spreads could be much tighter than sovereign country ratings would suggest. It could also mean that a compression in spreads could be on the cards due to a change in the investor base, a shift in the buyers per se, not just in their willingness to pay.

Bond Crazy

However, competitive spreads are not a phenomenon peculiar to Pakistan. Ultra-tight spreads can be seen across the board in emerging markets today. Mexico is borrowing money at only a percentage point higher than US treasury yields. Spreads on J.P. Morgan's emerging markets bond index (EMBI) have fallen below 2.3%, the lowest level on record. It seems as if any fixed-income investment with the "emerging market label" is in demand. Maturities of emerging market bonds are also lengthening; Poland has actually issued a fifty year bond!! Pakistan wants to emulate this trend as well, hence the eagerness to issue a bond of greater maturity than five years. From the point of view of emerging markets, going this route makes sense. They want to lock-in longer-term debt given the competitive rates they are able to attract. What seems less rational is that international investors are giving an overwhelming vote of confidence to countries with histories of dubious economic policies.

Initially, this emerging market bond fetish was justified on the grounds of abnormally low interest rates in the developed world. An IMF survey indicates that a 1% fall in American Treasury yields leads to spread reduction of 0.78% on emerging market bonds. However, yields on emerging market bonds have been falling as US Treasury yields have continued to rise. The Fed Funds Rate has been raised 14 consecutive times and now stands at 4.5%. Yields on US Treasuries are no longer abnormally low, and reduction in bond spreads of emerging markets cannot be explained through the interest differential argument anymore. It seems that international capital markets are more and more willing to bet on the "emerging markets" despite the fact that their robust economic performance has not yet withstood the test of time. Risks are being taken without adequate rewards, and the fundamentals of finance are getting precious little attention in the heat of this irrational exuberance.

For Pakistan this means that is good news. It is in a position to achieve the dual objective of picking up international debt at fairly competitive rates and at the same time enhancing its presence in the international capital markets. Of course, the exact yield on the Eurobond will be a function of both demand and supply. Analysts have predicted that Pakistan may be able to pick up funds at 200 basis points above LIBOR, which would translate into a coupon yield of around 7%. However, a relevant clarification made by the Ministry of Finance is that pricing of long-term international debt is not benchmarked to LIBOR, as the maximum tenor is twelve months. Rather, they are based on the US Treasury bond yield of the relevant maturity. If Pakistan is going to issue a seven year Eurobond, its base is going to be the seven year US treasury which currently trades at a yield of 4.6%.

As far as the spreads are concerned, we feel that the 200 basis points is a little optimistic. As a guide to ascertain the possible spread we could attain, we looked at Brazil, a country with the same sovereign ratings as Pakistan's B2/B. Brazil's bond spreads over US Treasuries was around 300 basis points in 2005 and we expect Pakistan's seven year Eurobond to have a slightly higher spread (around 350 basis points) due a longer maturity. That would mean a coupon payment in the vicinity of 8-8.5%. In itself, issuing long term international debt at these levels seems to be a hell of a bargain, and in some ways, it is. However, that is not the end of the story.

Interest rate and exchange rate risk could negate the benefit of tight spreads

Current dynamics of the international capital market indicate that the issuance of Eurobonds will not be a major problem. What promises to be more challenging is effective handling of the interest rate and exchange rate risks that may arise in later years. In Pakistan's present context the exchange rate risk is more important so we discuss that first.

Perils of an overvalued exchange rate

Currently, the rupee/dollar parity seems to be artificially overvalued as the State Bank of Pakistan is unwilling to allow exchange rate deprecation for fear of fueling cost-push inflation. However, given the country's external imbalances, currency depreciation will take place at some point in the future. Locking into dollar denominated debt at an artificially high exchange rate certainly has its perils. If and when the rupee does depreciate against the dollar, the rupee burden of Eurobond debt shall correspondingly increase. For example suppose that the rupee/dollar parity depreciates by 5% in 2007. This implies that the rupee amount of coupon payments from 2007 onwards as well as the bullet payment at maturity shall increase by 5%. In its 2004 report, IMF predicted a 12% deprecation in the rupee/dollar parity over the next five years. If that holds out to be true, the coupon yield on the Eurobond shall grossly understate its true cost to the exchequer. For more on this issue, take a look at Box 1 below.

Box 1 – PIBs versus Eurobonds

What cannot be denied is that government debt has become dangerously front-loaded and relying exclusively on T-bills as a means of financing involves substantial roll-over risks. Thus, the need for long-term debt financing definitely exists. However, the MoF has the choice of issuing either rupee denominated PIBs or dollar denominated Eurobonds. What debt is more economical to issue?

On the face of it, the question seems to have an easy enough answer. Domestic interest rates have moved up by much more than US interest rates. The 3 month T-bill yield has increased from just 1.49% in February 2004 to 8.1% in February 2006. That is a rise of 661 basis points. (Reporting the yield on PIBs makes less sense, due to the conspicuous absence of fresh PIBs.) Suffice it to say; even if monetary contraction has not been sufficient in real terms, it has been significant in terms of nominal rates of interest.

On the other hand, the US Fed Funds rate increased from a low of 1% and currently stands at 4.5%. That is a rise of 350 basis points, much less in magnitude than the increase in domestic interest rates. This variance in changes between domestic and international interest rates has meant that domestic debt vis-à-vis international debt has become increasingly expensive to issue. Case in point, we believe that a seven-year Eurobond can be issued at a maximum yield of 8.5%. However, if the MoF were to issue a seven year PIB at this stage, the coupon payment promises to go into healthy double-digits and it comes as little surprise that Eurobond issuance is taking precedence over PIBs.

We are however, overlooking one important aspect of debt issued in foreign currency and that is the associated exchange rate risk. PIBs are rupee-denominated and thus carry no exchange rate risk. Eurobonds, on the other hand, would be issued in US$ and both the coupon payments and the bullet payment at maturity are subject to exchange rate risk. If the rupee dollar parity is expected to depreciate in the coming years, the coupon payment of 8.5% understates the true cost of the Eurobond debt.

We make a few rudimentary calculations to account for this exchange rate risk (details are in Appendix 1). Assuming that a seven-year Eurobond will be issued, we estimate seven year targets for both US and Pakistan inflation. Our underlying assumption is that the Real Effective Exchange Rate between Pakistan and the US shall remain constant over the seven years. What this means is that if inflation in Pakistan is greater than in the US, the nominal exchange rate (rupee/dollar) shall depreciate exactly by the differential in inflation numbers.

We assume Pakistan inflation to be above US inflation for all of the seven years of the Eurobond's life. What this means is that the nominal rupee dollar parity shall depreciate every year by the magnitude of the inflation differentials. The rupee burden of the Eurobond's coupon payments shall correspondingly rise each year. The repayment of the principal amount shall rise by the cumulative depreciation over the course of the seven years.

Calculations in the appendix indicate that according to our inflation projections, a 12% yield on PIBs and a 8.5% yield on the Eurobond would result in the same rupee burden of debt. Admittedly, the inflation numbers are our projections and the Real Effective Exchange rate may not remain constant over the seven years. However, what is important to note is that paying even a significantly higher yield on PIBs relative to Eurobonds may be desirable as long as the rupee/dollar parity is expected to depreciate significantly. However, it seems unlikely that seven year PIBs could even be issued at a yield of 12%. Thus, even after accounting for exchange rate risk, the Eurobond provides better value for money.

To hedge or not to hedge, that is the question-

International debt may also be subject to exchange rate risk. Pakistan's Eurobond is most likely to be issued on a fixed interest rate, which means that it shall not be vulnerable to fluctuations in interest rate cycles. However, with the previous Eurobond, the Pakistani government has engaged in an interest rate swap in April 2004, effectively transforming its fixed Eurobond coupon payments into floating. The swap meant that Pakistan would pay six month LIBOR plus 323 basis points over the life of the bond. At the time, because LIBOR was low, the interest rate swap resulted in coupon payments of less than the fixed yield of 6.75%. However, ever since LIBOR went above 3.52%, this interest rate swap has had a negative carry; as it meant coupon payments of more than 6.75%. Currently, six month LIBOR is at 4.91%, implying that our 2004 Eurobond coupon payment must be close to 8.14%. This is 139 basis points above the fixed coupon payment; going to show that achieving competitive spreads is not an end in itself. Appropriate hedging is also vitally important.

The logic of moving from a fixed to floating rate in early 2004 stands to reason. At the time, US interest rates were extremely low. The only way for them to go was up. Thus hedging from a fixed to floating rate made little intuitive sense. For the upcoming Eurobond, we feel it would actually make more sense to hedge from fixed to floating. The Fed Funds rate, and correspondingly LIBOR are currently at relatively high levels. Few analysts are betting against the Fed Funds rate to go above 5%, while some feel it might not even reach that level. The upside risk in these international interest rates seems limited while the downside potential seems greater, particularly over the long-run. While an interest rate swap may imply a negative carry in the initial period, it should be beneficial in the long-run when short-term interest rates have a high probability of coming down. It remains to be seen if the Pakistani government concurs to this view; it remains a strong possibility that the Eurobond may not be hedged at all and payments would be made at the fixed coupon rate.

In conclusion, it seems safe to say that from the MoF's point of view, Pakistan's new Eurobond promises to be another "resounding success." However, proper debt management is needed to ensure that the happy marriage does not turn sour if and when macro-economic indicator takes a turn for the worse. The history of emerging markets is littered with currency crisis followed by defaults on sovereign debts. One would be well advised to not rush our judgment on this Eurobond issue either. 2013 may be a better time for that kind of opinion!!

Appendix 1

Years	Pak CPI	US CPI	differential	exchange rate depreciation	exchange rate	coupon payment in mln US$	total payment in mln US$	total payment in mln PKR		present value of payments
0					59.90					
1	7%	3%	4%	4%	62.30	42.5	42.5	2,648		2,365
2	6%	3%	3%	3%	64.16	42.5	42.5	2,727		2,176
3	6%	3%	3%	3%	66.09	42.5	42.5	2,809		2,002
4	6%	3%	3%	3%	68.07	42.5	42.5	2,893		1,842
5	6%	3%	3%	3%	70.11	42.5	42.5	2,980		1,695
6	6%	3%	3%	3%	72.22	42.5	42.5	3,069		1,559
7	6%	3%	3%	3%	74.38	42.5	542.5	40,354		18,311
			PV of Euro	29,950					PV of PIB	29,950
			Yld where PV PIB = PV Euro	12%						

Economic Snapshot

		Fiscal year 06							
	Units	July	Aug	Sep	Oct	Nov	Dec	Jan	July-Dec
Inflation									
Headline Inflation	%	8.99	8.41	8.53	8.27	7.89	8.51	n.a	8.43
Core inflation	%	7.62	7.55	7.58	7.81	7.59	7.36	n.a	7.59
Food inflation	%	9.73	7.82	7.52	6.41	5.84	8.1	n.a	7.57
Non-food inflation	%	8.47	8.83	8.25	9.61	9.38	8.8	n.a	8.89
T-bill (Wgt Avg)									
3 month	%	7.69	7.99	8.10	8.10	bid rejected	8.09	8.10	n/a
6 month	%	7.97	8.12	8.14	8.14	bid rejected	8.25	8.29	n/a
12 month	%	8.69	8.78	8.79	8.77	8.79	8.77	8.75	n/a
External Sector									
Export	Mln US$	1,272	1,408	1,499	1,329	1,120	1,421	n.a	8,049
Import	Mln US$	1,997	2,235	2,322	2,328	2,300	2,420	n.a	13,602
Trade balance	Mln US$	(725)	(827)	(823)	(999)	(1,180)	(999)	n.a	(5,553)
Remittances	Mln US$	313	348	341	373	309	336	n.a	2,020
Total Foreign Investment	Mln US$	130	161	183	208	323	458	n.a	1,463
Forex reserves	Mln US$	12,613	12,124	12,000	11,715	11,321	11,211	11,525	n/a
Key									
n.a	not available								
n/a	not applicable								

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