



Implementation of GDP-Linked Bonds

An Emerging Market Perspective

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Background

- ❖ GDP-linked bonds seem to hold several important benefits for emerging market (EM) issuers
- ❖ The higher volatility displayed by GDP growth in EM should in principle also appeal to certain categories of capital market investors
- ❖ Yet aside from the issuance of GDP warrants, there has been no momentum
 - this is especially the case for countries with challenging debt dynamics
- ❖ What are the factors that explain this apparent puzzle?

Obstacles to GDP-Linked Bonds in EM

1. Cheap fixed income debt
2. High growth and volatility
3. Poor data quality / independence
4. Question mark over whether demand truly exists amongst capital market investors

Cheap 'Plain Vanilla' Debt

- ❖ Discussions over GDP-linked bonds has coincided with a bull market in EM fixed income
 - Since 2015, EM has seen consistent inflows and yield-tightening
- ❖ The yields that investors are willing to accept virtually eliminates the incentive for non-distressed sovereigns to consider *any* alternative to traditional debt
 - Dominican Republic, a country that restructured all of its external debt following a major currency / banking crisis just over a decade ago, is yielding 4.6% (10-year)
 - Angola, a single 'B'-rated country which earlier this month devalued its currency and announced a restructuring of its bilateral loans, yields 6.7% (10-year)
 - Tajikistan, a war-torn, donor-dependent, 'B'-rated, country with a long history of default and arrears accumulation, issued a debut bond in September 2017 with a 7.25% coupon (10-year)

High Growth and Volatility

- ❖ Linking interest and / or coupon payments to growth is a difficult sell in countries with high growth—or at least high expected growth
 - Over the last 20 years, real annual GDP growth has averaged a robust 4.2% in EM (defined here as countries outside the top quartile of per capita income levels)
 - This is nearly three times the level found in G7 countries over the period
- ❖ Although proposals for GDP-linked bonds of course offer issuers downside protection in the event that growth slows, we often find in discussions with policymakers a bias on the positive side

High Growth and Volatility (cont)

- ❖ The volatility of GDP growth in EM is also much higher
 - Over the last 20 years, real GDP growth in EM has had a 4.3 percentage point average standard deviation
 - This is slightly more than the average annual growth level in EM, and again a multiple of the level of G7 countries over the period
- ❖ For investors, EM growth volatility complicates ability to price / trade GDP-linked debt, although some investors will find this attractive
- ❖ For issuers, the prospect of volatility driving large swings in interest payouts could undermine political support for GDP-linked bonds
 - Even if a high annual payment is a one-off and / or compensated for by low payments in later years, it could trigger local criticism of a government's decision to forego a traditional fixed-interest instrument

Data Problems

- ❖ The Argentinian experience may limit investor demand for EM GDP-linked paper which lacks a neutral third party data provider / verifier
- ❖ On the other hand, EM issuers with highly independent statistics offices may be reluctant to link payments to GDP data which they have little visibility over
- ❖ Material GDP revisions / out of date methodology may present another obstacle

Encouraging Signs

- ❖ Discussions amongst EM issuers over the benefits of countercyclical debt have significantly increased in recent years
- ❖ The dedicated EM buy-side world is relatively small, institutional investors speak with each other frequently, and many appreciate the potential benefits of reducing the frequency of restructurings with upside / downside protection
 - Lack of inflation-linked market for most of EM may benefit the development of GDP-linked bonds
- ❖ Official sector has ability to have large impact on EM space if it chooses to lead
 - MDBs / bilateral lenders / ECAs could introduce GDP-linked repayment profiles to familiarise issuers with benefits
 - Agence Française de Développement already has pilot countercyclical options available

Encouraging Signs (continued)

- ❖ Partial MDB guarantees could be used to address new issue premium and provide comfort on data issues
 - Attractive pricing and measurement against country ‘ceiling’ of guarantee product could be introduced as incentive for first movers
- ❖ IMF’s WEO is already widely accepted amongst EM investors, could act as central data provider
- ❖ Restructuring situations provide unique opportunity for issuers and investors to get comfortable with each other and a particular outlook
 - Policymakers increasingly wary of ‘kickers’ such as warrants without downside protection
 - Incentive to issue a GDP-linked instrument via special official sector loan / grant likely to be attractive in restructuring situation

Uncertainty Over Demand

- ❖ Whilst the potential benefits of GDP-linked bonds for sovereign issuers are clear, there are still question marks over whether the demand is really there amongst traditional EM fixed-income investors
- ❖ Almost universal agreement that restructurings are, on the whole, costly for both issuers and lenders does not necessarily mean that private sector creditors are prepared to shift their investment approach simply to reduce the *probability* that sovereign debt restructurings will occur [here I can talk about that creditors eager to protect their downside already have]
- ❖ GDP-linked bonds are much more akin to equity investments, and may therefore hold more appeal to equity investors in EM
- ❖ Reinforces need for official sector to play catalytic role

Open Questions

- ❖ Is the official sector willing to take the steps required to kick-start a GDP-linked bond market in EM?
- ❖ Should EM GDP-linked bonds have any special features to address concerns over higher growth and volatility levels (ie. initial caps and floors; call options; etc.)?
- ❖ Would the emergence of a GDP-linked debt market in EM contribute to the development of a similar market amongst OECD and other developed countries?

Annex

Example: Grenada, 2015

- ❖ In 2015, Grenada restructured its Eurobond after extensive discussions with a sophisticated, supportive group of institutional investors
- ❖ Both sides were looking for ways to share upside / downside risk in the structure of the new bonds to be issued
- ❖ The Government was in an IMF programme which had a forecast for steady nominal GDP growth over the medium-long term of circa 5%
- ❖ Although the authorities were willing to use third party figures (such as the IMF's), they had concerns over the volatility of growth and imperfect correlation of growth and fiscal revenues
 - They cited their 2004 experience where the island was devastated by a hurricane yet was estimated to have posted material positive nominal growth (1.4% in 2004 and 16% in 2005)

Example (continued)

- ❖ Ultimately a deal was reached to share a new and key fiscal revenue source: citizenship by investment proceeds
 - A third party bank acts as a calculation agent; failure to comply with the agent's payment requests is an event of default under the bonds
 - Inflows to the programme exceeded the sharing threshold in 2017 and are set to start paying out this year
- ❖ The two sides also proactively planned for storm-related revenue disruptions through a 'hurricane clause' which capitalises interest and delays principal payments if triggered
 - Again, trigger determined by a third party (insurer)
- ❖ What if Grenada had instead issued a GDP-linked bond at a level equivalent to the 7% fixed coupon agreed (ie, 2% + nominal growth linked to the preceding year WEO)?
 - Grenada would have faced an 11.4% coupon in 2016—a year in which revenues were still weak and recovering