Bond market primer

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THE American Founding Fathers were an exceptional group, men of intellect and practical wisdom. Among them was Alexander Hamilton, who in recent years has become a cult figure with the Broadway musical Hamilton. Born in the West Indies, he moved to New York at a young age, qualified as a lawyer and became aide de camp to George Washington during the American War of Independence. When Washington became the first US president, he appointed Hamilton the first secretary of the treasury. Hamilton is the architect of the American financial system, the most vibrant the world has known.

The foundation for this system is the government bond (debt) market. When Hamilton took over the treasury of the new, war-ravaged country, he committed to pay every cent of the heavy war debt, even assuming the debt of the constituent states. There was considerable political opposition to this, especially from arch-rival Thomas Jefferson. (The story goes, he got Jefferson's consent in return for his own consent for making Washington, D.C. the capital, as Jefferson desired). *"The debt of the United States ... was the price of liberty"* Hamilton said. He set in stone the credibility and stature of US government debt, backed, as they say, by the **'full faith and credit'** of the US government. Two centuries later, global investors still see the US government bond market as the safest financial haven.

Pakistan has an active government bond market. Its government, like most, runs a fiscal deficit and therefore resorts to borrowing. This is done through the issuance of bonds, whereby the government promises to pay back the borrowed amount plus a specified return, at a specified date. The Pakistani bond market is closely modelled on US market practices and conventions. Various bonds are issued — Treasury bills for short-term borrowing of three, six and 12 months and Pakistan Investment Bonds (PIBs) for tenures of three, five, 10 and 20 years. There is a primary market for fresh issuance. Once issued, the bonds can be traded further in a secondary market.

Government bonds are the lodestar in global financial markets. This preeminence is due to two factors. Since government borrowing is generally large, government bond markets are large, liquid and efficient — **a benchmark for other markets**. Also sovereign debt has a special status. It is considered risk-free i.e. governments don't default on their home currency debt. The theoretical basis for this is that governments can resort to taxation or, in a worst-case scenario, print money, to pay back debts. So governments become the lowest-cost borrower because they are the lowest-risk borrower. That cost sets the benchmark for other borrowers.

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The value of a bond market for any economy is fully realised only if it extends beyond the government's borrowing needs. For a healthy, growing economy, corporates must have adequate access to finance. One avenue is equity financing. The second is debt financing. In Pakistan, bank borrowing dominates debt financing and the corporate bond market is insignificant. A key lesson from the US is that a vibrant government bond market provides the base for a vibrant corporate bond market. In Pakistan, there is thus a need to continue improving the former to stimulate the latter over time.

In recent years there have been some positive developments. The introduction of Sukuks (Sharia-compliant bonds) was one. It is a response to the evolution of the Islamic finance sector. The introduction of 'floating rate' PIBs was another. The return on these PIBS changes over time with the level of interest rates in the economy. This reduces the rate risk for investors, facilitating the issuance of longer-term bonds.

The next logical developments require work on the demand side. The market must open up to different types of investors. Today, it is dominated by the banks who hold disproportionate power, even over the government, in the terms of issuance of bonds. Globally, insurance and asset management companies and pension funds are very significant players in bond markets. In Pakistan, all these institutions remain small, though growing.

A striking development in 2019 was the influx of 'hot money' into the government bond market. The influx, peaking at $3 billion in February 2020, became controversial, less for reasons of economic merit than economic nationalism. True, there are risks associated with international hot money, but there are tangible benefits also. It stands to reason that if a borrowing requirement exists then the borrower benefits if there are more potential lenders available. The market, in the aggregate, benefits from the additional liquidity.

Finally, the last two years have seen the principal financial regulators, the State Bank and SECP, become more proactive and engage more constructively with the regulatees. This bodes well for the strengthening of financial markets in general and the bond market in particular.

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Published in Dawn, March 23rd, 2021