



FYR Macedonia Policy-Based Guarantee: Supporting the Development Agenda and Strengthening Access to Capital Markets

Evgenij Najdov

Key Messages

- The ongoing global economic turmoil is seriously impeding client countries' access to capital markets, with relatively little regard for the fundamentals of the countries involved. Growing risk aversion among investors has triggered a "flight-to-quality" that is affecting all but the safest assets (AAA-rated).
- Small, open, and developing economies in Europe and Central Asia, including FYR Macedonia, are being exceptionally hurt.
- Despite its history of prudent macroeconomic policies and progress on structural reforms, FYR Macedonia's access to capital markets has been virtually closed or available only on very unfavorable terms.
- Policy-Based Guarantees (PBG) help well-performing clients with a track record of macro stability and structural reforms mitigate market access risks while advancing a country's development policy dialogue. PBGs also have the added benefit of catalyzing private capital flows by alleviating critical risks.
- The PBG extended by the World Bank to FYR Macedonia ensured the country's access to markets in a virtually closed market environment and at highly competitive terms.

Introduction

FYR Macedonia is a small, open, and developing economy closely integrated with the European Union (EU) through trade, capital flows, and migration. Consequently, growth performance in the country is strongly affected by developments in the EU, including

by the current turmoil originating from the Eurozone. Output growth underperformed in response to the instability, affecting labor markets and business sentiments and putting pressure on fiscal accounts.

Yet despite its small size, FYR Macedonia has established a robust track record in prudent macroeconomic management and structural reforms. As a result, FYR Macedonia appears to be one of the few countries in the region that has some fiscal space to respond to the global slowdown, and its macroeconomic policies remain supportive of medium-term fiscal and external sustainability. With fiscal deficits typically under 3 percent of GDP and a public debt of about 29 percent of GDP, FYR Macedonia has generally managed its public finances well.

Nevertheless, despite sound fundamentals, the continued turmoil was constraining the ability of fiscal policy to adequately respond to the crisis. Moreover, the country's access to international capital markets was severely limited, and with capital "flight to quality," its sovereign spreads had risen to high levels, making the financing of the modest deficit levels very challenging. FYR Macedonia thus turned to the World Bank for a Policy-Based Guarantee (PBG).

FYR Macedonia Development Agenda

On the economic front, FYR Macedonia has demonstrated sound macroeconomic management and improved structural and social policies. The country restored macroeconomic stability early in the transition process and has maintained it for almost two decades. The size of the public sector is relatively modest by regional standards, and prudence in fiscal policies has

ECA Knowledge Brief

resulted in low public debt levels and debt servicing costs. At the same time, monetary policy has been responsive and adequately adjusted to avoid pressures over the pegged exchange rate.

The authorities also remain committed to reforms toward a sustainable and robust recovery. There has been a strong focus on improving the investment climate and as a result, the country now ranks 22nd on the “Ease of Doing Business” indicator of the World Bank’s *Doing Business* rankings (a dramatic improvement from 92nd in 2006). Efforts were also undertaken to promote competition in many sectors (banking and telecommunications), strengthen property, creditor, and contract rights (judiciary reforms and cadastre), and attract foreign direct investments. Moreover, government authorities have initiated a comprehensive reform agenda to build human resources, including by revamping the social safety net, reforming the health system, and modernizing the education sector.

Still, the 2008-09 global financial crisis and its aftermath adversely affected the economy of FYR Macedonia. The economy weathered the crisis relatively well, however, and its recovery gained momentum in the first half of 2011, when real GDP grew by about 6 percent year-on-year. However, the renewed turmoil in the Eurozone since the second half of 2011, this time triggered by concerns regarding the health of sovereign balance sheets, created strong headwinds for FYR Macedonia’s economy, and growth weakened to less than 1 percent in the second half of 2011. Export demand suffered, business sentiment fell, and the labor market deteriorated.

In response, the Government’s policies were adjusted, giving a stronger focus on: i) reducing future risks by strengthening the sustainability of public finances and the resilience of the financial sector; ii) supporting improved protection of the most vulnerable; and iii) enhancing incentives for formal labor market participation. Fiscal policy remained supportive of macroeconomic stability and also of the nascent growth recovery. At the same time, the de-linking of the free health insurance provision from administrative unemployment registration and the introduction of an income test for the provision of free health insurance increased incentives for formal labor market participation. Moreover, the adoption of bylaws for the

functioning of the health sector’s Single Treasury Account as well as a program to improve the overall efficiency and sustainability of the health sector are expected to gradually result in more effective health sector spending.

In addition, social protection reforms have been adopted to ensure that future growth is more inclusive, by improving the targeting of social spending (through the roll-out of the Cash Benefits Management Information System) and increasing the spending on those targeted programs. Actions taken in the financial sector contributed to a more independent and accountable monetary authority through the adoption of a new Central Bank law, and reduced risks through establishment of a Financial Stability Committee.

Access to Capital Markets

Despite the sound fundamentals and strong track record, FYR Macedonia faced significant market access challenges in the aftermath of the 2008-09 global financial turmoil. Thus, even though Macedonia was one of the few countries in the region with some fiscal space to respond to the turmoil, securing financing for its modest fiscal deficit at acceptable terms was nonetheless very difficult.

Global investors became increasingly risk-averse, reflecting widespread uncertainty about the direction of the financial market. The 2009 Eurobond was issued at very unfavorable terms (3.5 years and 9.875 percent interest), and the attempt to tap the bond market again in 2010 was cancelled after the investor road show, as emerging market spreads spiked due to the Greek crisis and subsequent market turbulence. Risk perceptions in the Eurozone impaired market access in general, and the impact for smaller and less well-known borrowers such as FYR Macedonia was even more pronounced. This reflected some conditions inherent to the country – such as small and infrequent issuances, its vulnerability to external factors, and its proximity to the troubled Eurozone countries – that were further constraining market access. For FYR Macedonia, the spread likely achievable at the market conditions prevailing in late 2011 was in the range of 650-700 basis points (bp) over the high-grade swap rate (about 8-9 percent in aggregate), with a number of financial institutions indicating skepticism that an unenhanced transaction in euros could even be closed.

Box 1. Main Features of Policy-Based Guarantees (PBG): a Renewed Focus on an Existing Financing Instrument

The PBG is a World Bank financing instrument that has been available to client countries for a number of years. Despite this, there were only a few PBGs processed prior to the recent global financial turmoil. During the last few years, there has been renewed interest in this instrument and three countries — Serbia, FYR Macedonia, and Montenegro — have used it to enhance their access to capital markets. Eligible borrowers of PBGs are sovereign governments that have shown a strong macroeconomic management of their development agenda, as well as adequate progress toward those development goals. More specifically, PBGs are offered to countries with: i) a strong track record of performance with a satisfactory structural, social, and macroeconomic package; ii) a sustainable external financing plan; and iii) a coherent borrowing strategy that enables the client to establish itself as a borrower in its own name without a guarantee over the medium term.

A PBG can cover part of debt service payments (principal and/or interest) and its structure and coverage can be determined flexibly on a case-by-case basis, to the extent that commercial lenders share the borrower's credit risk in a meaningful manner and allow the extension of debt maturity and/or lower interest rate costs. The Bank charges a front-end fee (a one-time fee of 0.25 percent of the amount of the guarantee) and a guarantee fee (0.5 percent per annum of the guarantee exposure). Both fees are collected up front in the amount of the present value of the fee for the life of the guarantee.

Source: Policy Based Guarantees for IBRD countries, Summary Briefing.

At the same time, the FYR Macedonia domestic capital market was very shallow. Following a period of intensive development between 2004 and 2009, the government issued securities (Treasury bills and bonds) portfolio became largely consolidated into three and six-month Treasury bills by 2011, reflecting increased market uncertainty and a desire to reduce interest expenditures as pressures on the budget emerged.

PBG: Ensuring Access to Capital Markets

FYR Macedonia turned to the World Bank looking for an instrument that would support the country's response to the turmoil and its development agenda, and also provide sufficient resources to compensate for the severely restricted access to market sources of financing. The PBG extended by the World Bank in late 2011 managed to accomplish exactly that. The World Bank responded rapidly by converting the FYR Macedonia Second Development Policy Loan (DPL2), which was in preparation at the time of the request, into a stand-alone PBG. Within six months of receiving the request, FYR Macedonia received €130 million from private lenders at highly competitive terms and partially guaranteed by the International Bank for Reconstruction and Development (IBRD).

Similar to Development Policy Loans (DPLs), the World Bank's PBGs are offered for general budget support and to boost government programs designed to

bolster growth and poverty reduction. At the same time, the distinguishing feature of these guarantees is that they are used to catalyze private financial flows by mitigating critical risk factors. In this way, by using PBGs, the countries benefit not only from the development program supported by the project, but also from improved market access terms as well as the establishment of relations with private investors.

Processing a PBG requires closer cooperation between a larger number of stakeholders than is the case with a DPL. In addition to the regular policy-level discussion with the client, it is important to closely involve the client's public debt management authority in the design of the PBG instrument.

Given the relatively limited experience of small and developing countries such as FYR Macedonia in dealing with international money markets, the strong cooperation between the World Bank team and the Ministry of Finance was a very important factor to the success of the transaction. On the World Bank's side, the processing of the PBG required the close involvement of the FYR Macedonian Treasury and the Financial Service Unit in facilitating the dialogue with capital markets and designing the product.

In the end, the operation returned the following major benefits to the client government:

- Improved market access, by enabling it to tap funding from the international bank loan market,

Box 2. PBG to FYR Macedonia Resulted in Substantially Improved Commercial Borrowing Terms

Following FYR Macedonia's recent difficulties in accessing the market, the PBG allowed the country to borrow with a five-year maturity, or about 50 percent longer tenor than was achieved through the previous market borrowing (3.5 years). In addition, the terms of the borrowing were significantly below the rates FYR Macedonia received in 2009, as well as the rates available in the prevailing volatile market. Including the arrangement and IBRD guarantee fees, the loan was extended at about 4.3 percent, well below the 8-9 percent rate that FYR Macedonia would have been expected to pay in the absence of a guarantee and assuming that access was restored. The budgetary savings from this are estimated to be roughly €25 million, or about 0.3 percent of GDP.

which it had not done before.

- Expanded the investor base, by catalyzing new interest among large foreign banks and financial institutions that previously had little or no exposure to the country.
- Diversified the country's sources of financing.
- Leveraged the World Bank's capital and helped FYR Macedonia increase the amount borrowed from the IBRD. The PBG guaranteed only a partial amount of the principal (around 65 percent of all debt service), allowing FYR Macedonia to issue a relatively sizable commercial loan of €130 million (out of which €100 million is guaranteed by the IBRD). Structured in this way, the PBG-supported borrowing covered almost half of the financing needs of the budget in 2012.
- Improved borrowing terms, including longer tenor and lower rates.

Conclusions

In the case of FYR Macedonia, the PBG was successful in both supporting a robust reform program as well as mitigating the substantial external risks facing the country due to the Eurozone turmoil. In the market environment prevailing in late 2011, the savings in borrowing terms were estimated at around 300-400bp. More broadly, the PBG allowed the country to borrow on favorable terms at a time when commercial funding was virtually closed.

Compared to a traditional DPL, the PBG proved to be a more efficient instrument in the specific circumstances of FYR Macedonia. With the country's exposure to (the amount lent by) the World Bank close to the maximum amount, the World Bank was unable to provide the amount of financing the country needed, and other sources of external funding essentially dried up. Benefiting from the 4:1 exposure treatment temporarily granted for guarantees, the World Bank was able to convert a €25 million DPL ultimately into a €130 million loan from private lenders for the country. Additionally, with a five-year maturity of the loan and guarantee, the IBRD capital is being recycled more quickly than would be the case with the longer maturity of the DPL, making resources available sooner for other development initiatives.

The World Bank's operational policy of a favorable treatment of guarantees against a country's exposure had a critical role in ensuring the success of the PBG in FYR Macedonia. In the absence of the 4:1 treatment and with the prevailing market rates at the time, it would have been almost impossible for the country to have obtained the same financial efficiency and leverage that this operation provided.

About the Author

Evgenij Najdov is a Senior Economist in the Poverty Reduction and Economic Management Sector Unit of the Europe and Central Asia Region of the World Bank.