Easy Money: Implications Of Armenia's Recent Sovereign Bond Issuance

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On Thursday, September 19, 2013, Armenia issued its first sovereign US$-denominated bond and joined Bolivia, Namibia, Nigeria, Rwanda, Mongolia, and a handful of other (mostly low-income) countries that within the past year or so entered the international market for the first time.

Armenia's bond issue had the following characteristics: it had a size of US$700 million; a repayment period of 7 years; carried a coupon of 6 percent annually; and was sold below the asking price, yielding a total of 6.25 percent per year for investors, if they hold the bond to maturity.

The issue is rumored to be nicknamed "Kardashian", after the famous US TV personalities, the Kardashian family. In should be noted that Armenia's credit rating is in "junk" (i.e., non-investment/speculative) territory, as per both Moody's (Ba2) and Fitch (BB-) rating agencies. Finally, Deutsche Bank, HSBC, and J.P.

Morgan Chase-the banks, which helped close the deal-were paid an estimated US$5 million for this transaction.

What is behind this move by the government of Armenia and what would be the relevant criteria for evaluating such a step?

The use of the proceeds raised by selling the bond is perhaps the most important criteria for judging the effectiveness in all such cases. As we indicated in "Armenia: Avoiding an Economic Catastrophe", Armenia has to repay US$1 billion until the end of 2014, most of which to the International Monetary Fund (IMF). However, according to a recent IMF statement, Armenia may get a new loan from that financial institution, which will enable its government to roll over the debt payments falling due.

The second portion of government's debt coming due is owed to Russia.

Although it is unclear whether Armenia's (disastrous) commitment to join the Russia-led Customs Union will have any implications on the debt servicing, it is entirely conceivable that the portion of Armenia's debt owed to Russia too will get rolled over because of that commitment. Should this be the case, the Armenian government will have the entire US$700 million to spend as it pleases!

There are several reasons why issuing this bond now was a very bad idea from the country's and its average citizen's perspective:

First, much like in 2009, the government of Armenia has no developmental plan to speak of, and is likely to spend the proceeds of the bond on boosting current expenditures, such as, increasing pensions and salaries and providing a subsidy for imported Russian gas. Both of these expenditure categories will help ease the social tension in the country and thus help the Sargsyan regime delay the unavoidable. These expenditures will not, however, result in job creation or investment and could therefore be viewed as wasteful.

Second, given the extent of budgetary leaks in Armenia (see PFA's estimates contained in our Diaspora Report, on page 34), this will be a lucrative opportunity for top-level officials to become even wealthier. Once the US$700 million are deposited at the Central Bank (CBA) and in return the dram-denominated equivalent of that money is deposited at the government's account at the CBA, this becomes like any other government revenue, subject to the same corrupt "ways and means". An estimated 20-30 percent of these funds will eventually be embezzled through various procurement malpractices and other loopholes employed by the Armenian government.

Third, unless used to repay existing debt coming due, this bond issuance adds an additional 8 percent of GDP to Armenia's public debt and requires payments of US$42 million in interest cost per year, for 7 years in a row. Since the interest paid on this bond is much higher than that presently accrued on Armenia's debt (much of which is still on concessional terms due to Armenia's low per capita income), the bond deal increases the country's debt burden disproportionately and brings Armenia one large step closer to debt distress. It is partially for these reasons that following the announcement of the Armenian bond issue Moody's lowered its foreign-currency bond ceiling on Armenia.

Fourth, in practice most of these large sovereign bonds are never repaid-once issued (and the money is spent!) they are rolled over, perpetuating the country's debt overhang. When the time comes to roll over this particular bond in 7 years, chances are the global economy will be at its peak (or thereabouts) with interest rates being much higher than now, potentially costing the country a lot more than 6.25 percent to issue a new bond. In the meantime, once the international rates start going up (expected to happen beginning early-2014), the Armenian bond will trade down (this is a feature of bonds with a fixed-rate coupon to lose value when interest rates go up), selling below the initial face value.

Fifth, while the timing is indeed opportune (given that the global conditions have softened following the US Federal Reserve's announcement to leave its unconventional monetary policy unchanged), this deal will not have the benefits that most first-time sovereign bond issues carry. One of the mains reasons behind these sovereign bond issues is to act as benchmarks against which the local (in this case, Armenian) companies could issue bonds in capital markets (both international and domestic). Clearly, with the outlook for the Armenian economy looking increasingly gloomy, there is likely to be very little, if any, appetite from the private sector companies to issue bonds any time soon. Therefore, what could have been a useful guide for the private sector in better times will get mostly ignored and its potential benefits wasted.

But perhaps the most important reason why it is a bad idea for this government to have all this money is because it will undoubtedly reduce their incentive to reform and take the economy out of the dire situation it is in. As any other easy money (or what the famous Harvard economist of the 1980s, Janos Kornai, would call soft budget constraint), this bond will buy them time and reduce their incentives to search for solutions to problems facing the economy (Not that they had those incentives to begin with, but still).

We wonder if the Kardashian family would still be pleased to have their name associated with this bond, if they knew about all of this.

We will keep our views on this one to ourselves!

Is there a silver lining in all of this, you may ask? Unfortunately, none, especially if our conjecture regarding the use of the bond money (as outlined above) becomes true.

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