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Government Securities Market in Kosovo: Overview and Recent Developments

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Abstract: This paper provides an overview of recent developments in government securities market in Kosovo. In contradistinction to similar studies of developed financial markets an analysis of developments in the Kosovo's government securities market, meets certain difficulties and takes into account a number of assumptions, which are to be specifically noted. The Government of the Republic Kosovo has successfully begun issuance of Treasury bills since January 2012, but market development is still at an early stage. The Central Bank of the Republic of Kosovo maintains, records, trades and settles all government securities transactions through the BES trading platform, which term includes the initial electronic auction sales at the primary auction, electronic trading and the central securities depository. Most T-bills have been kept by the commercial banks for their own account, and six-month bills have been bought by institutional investors. As a result, no secondary market has yet developed. Capital markets are nonexistent.

Keywords: financial market; financial system; government securities; treasury bills

JEL classification: E42; E44; E58

1. Introduction

Developing a government securities market is a complex undertaking that depends on the financial and market system development of each country. For many governments, this involves immense challenges, as the problems that inhibit securities market development run deep in the economy. The government issues bonds and Treasury bills in the domestic capital market to fund budget deficits and manage its short-term liquidity needs. It usually does this in a non-opportunistic way, whether rates are low or high, with the aim of minimizing cost over the long run (World Bank Report, 2001, p. 6).

Budget financing is the traditional reason why governments issue securities. During the fiscal year there is invariably a lack of synchronization between the pattern of revenue collections and that of expenditure. Governments seek to finance this temporary imbalance through the issue of treasury bills.

More generally however, there is very often an imbalance between the level of government revenues and actual government expenditure for the fiscal year as a whole. While the importance of attracting individual investors to the government securities market is generally recognized, particularly in developing countries the buyers of government securities tend to be mostly institutional investors, notably banks, insurance companies and pension and mutual funds (the wholesale market).

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The Kosovo's Financial Sector is one of the newest financial sectors in Eastern Europe whose developments began in early 2000. Legal infrastructure on debt market in Kosovo will create a legal possibility that the central and local government have the opportunity to borrow in order to implement their development policies.

The government securities market comprises the issue, distribution, trading and redemption of treasury bills, notes and bonds. The arrangements and activities related to the issue and initial distribution of these securities constitute the primary market while the subsequent trading of securities is done in the secondary market. It is generally recognized that an active and efficient government securities market is a catalyst for development of the broader capital market. The development of capital markets has long been recognized as an important requirement for promoting long term economic growth (World Bank Report, 2001, p. 18).

Among the specific functions of a government securities market are:

- To provide a source of funding, for budget deficits (by allowing governments to raise financing through the sale of treasury securities) thereby reducing recourse by the government to monetary financing (from the banking system) which can have greater inflationary consequences;
- To provide an alternative means of saving for the public;
- Government securities are an important monetary policy instrument for implementation and for the transmission of interest rate signals to the rest of the economy; and
- Because of the above benefits, the government securities market is the centerpiece for the development of the broader capital market, by creating a benchmark for the pricing of other financial assets.

Borrowing through the issue of securities is considered more acceptable because it provides the opportunity for spreading government indebtedness more widely throughout the economy and over longer repayment periods. In addition to general budget financing, issues of government securities might be tied to the financing of specific infrastructural projects (World Bank Report, 2001, p. 19).

An efficient government bond market is deemed to be central in the development of the capital market because it provides a benchmark for the pricing of securities offered by other issuers (Lucio, 2006). Basically, government securities are deemed to carry little risk. Thus rates of interest on these securities are considered the "risk free" return for an investment. This "risk free" return is the basic and most important element that goes into the pricing of other assets. An additional return over this base is added for the specific risks of other issuers (Gray, 1996, p. 5). The total return on a non-governmental security therefore comprises the "risk free" return plus a premium to reflect the additional risk over the treasury bills or government bonds.

2. Fundamental Prerequisites for a Well-functioning Government Securities Market

Having in mind that the development of government securities market in Kosovo is in initial phase, the effort at the beginning will be more concentrated on the development of a primary market. Therefore, at the beginning more frequent presence of the government on the primary market will be necessary in order to stimulate the demand for government securities.

Development of the primary government securities market is based on acceptance of the market principles in management of the budget deficit through issuance of securities. Therefore, the policy of public debt management has to avoid generation of possible distortional effects on the primary government securities market (Calvo, 2000, p. 8). If the issuance of government securities has been understood as a possibility for increment of the expenditures and creation of higher budget deficit, would cause unavoidable increment of the inflationary expectations and increment of the interest rates, which would finally cause increment of the borrowing cost to the government (African Development Bank, 2000).

Government securities market development must be viewed as a dynamic process in which continued macroeconomic and financial sector stability are essential to building an efficient market and establishing the credibility of the government as an issuer of debt securities (Ma *et al.*, 2010). Prerequisites for establishing an efficient government securities market include a credible and stable government; sound fiscal and monetary policies; effective legal, tax, and regulatory infrastructure; smooth and secure settlement arrangements; and a liberalized financial system with competing intermediaries. Where these basics are lacking or very weak, priority should be given to adopting and implementing a stable and credible macroeconomic policy framework, reforming and liberalizing the financial sector, and ensuring the proper pace of liberalization in different areas (World Bank Report, 2001, p. 12).

From the perspective of government securities market development, management of fiscal policies must aim at increasing the incentives of both domestic and foreign investors to invest in government securities.

The structure of the financial system and its links to macroeconomic policies must be given careful consideration early rather than late in the reform process (Stiglitz, 1993). The soundness of the banking system also has important implications for development of the government securities market. Domestic and foreign investor concerns about the soundness of the banking system will adversely affect the ability of the government to roll over or issue new debt (Fry, 1997, p. 4).

The central bank in its role as regulator of the market and the primary issuer will also influence market structure, as the government is a central player in the government securities market.

3. Legal and Regulatory Framework for Government Securities Market in Kosovo

One major prerequisite for sound government securities market development is the legal, regulatory, and supervisory framework. The fundamental parts of the legal framework supporting an efficient domestic government securities market usually include an explicit empowerment of the government to borrow, budgetary rules for the issuance of government securities, rules for the organization of the primary market, role of central bank as agent for the government, the debt management framework, rules governing issuance of government securities, and rules pertaining to the secondary market (BIS, 1996, p. 10).

The legal framework defines incentives for all market participants: the issuing government, the central bank, regulatory agencies, market intermediaries, investors, etc.. Some of the more important areas where the legal framework will affect the development of government securities markets include defining the exact parameters under which fiscal budgeting processes will be linked to government securities issuance. The legal framework must define the rights and obligations of parties to debt contracts in the primary and secondary markets for issuers, investors, and intermediaries (Calvo, 2000, p. 9).

The regulatory framework for securities markets, including government securities markets, is usually seen as having three distinct objectives: assurance of fair, efficient, and transparent markets; minimization of systemic risk; and protection for investors and consumers of financial services (Bossone & Promisel, 1998).

Short and medium term government securities (treasury bills and notes) are very attractive to commercial banks because they help in liquidity management. The preference of commercial banks for treasury bills makes the instrument ideal for use by the central bank in influencing bank liquidity and the level of interest rates, both of which are the primary focus of monetary policy (Shiu & Yan-Leung, 2000). In some countries monetary policy is conducted using securities issued by the central bank. More often, however, government securities are used in these monetary policy operations, referred to as open market operations (World Bank Report, 2001, p. 13).

In Kosovo, Pursuant to the Law on Public Debts No. 03/L-175, (Article 2, paragraph 1.1. and 1.2.), and Regulation on Primary and Secondary Market of Government Securities adopted by the Ministry of Finance and the Central Bank of the Republic of Kosovo, CBK acts as an agent of the Ministry of Finance to issue Securities. On 17 January 2012, the first auction was held to issue Securities of Government of the Republic of Kosovo and Treasury bills with maturity of 3 months on behalf of Government of the Republic of Kosovo. This auction recorded the beginning of functioning of primary market for issuing Securities of Government of the Republic of Kosovo. CBK hold during 2012 all auctions pursuant to the Schedule on Issue of Securities of Government of the Republic of Kosovo through electronic platform for Securities Trading. Pursuant to Regulation on Primary and Secondary Market of Government Securities, Section 1, paragraph 1.26 and Section 7, all auctions have to be realized through Commercial Banks operating as Primary Dealers (CBK Annual Report, 2012, p. 134). In addition to Primary Dealers, participants in the market of Securities of Government of the Republic of Kosovo were also the other non-banking institutions and natural persons, who submitted their bids in auctions through Primary Dealers, Pursuant to Regulation on Primary and Secondary Market of Government Securities; bids from participants were competitive and non-competitive. For competitive bids, participants bided the amount and annual return rate, whilst for non-competitive bids participants bided only the amount and accepted the annual return rate as determined by successful competing bids.

4. Overview on Auctions for Issuance of Government Securities (period 2012-2014)

In accordance with the calendar for the issuance of the government securities of the Republic of Kosovo in 2012 were held 14 auctions. In 12 of these auctions were issued securities with maturity of 91 days in the amount of €10 million issued in each auction, and in two other auctions were issued securities with maturity of 182 days in the amount of €20 million in July 2012, and €24 million in September 2012.

All auctions on securities of Government of the Republic of Kosovo have been successfully conducted since the auctions have attended all the primary dealers and the amount bided for purchase of securities has consistently exceeded MoF issuing amount. As a result, the amount bided for 2012 was €407.8 million being by 2.49 times higher than the amount required by Ministry of Finance (Treasury) for auctions of securities with maturities from 91 to 182 days. The highest demand for auctions on securities with maturity of 91 days was in June 2012, where for the issued amount of €10 million the participants' bid was €35.8 million. The lowest demand for auctions on securities with maturity of 91 days was in October 2012, where for the issued amount of €10 million, the participants' bid was €14.7 million (CBK Annual Report, 2012, p. 138).

The demand for government securities with maturity of 182 days was €55.4 million in July 2012 for the issued amount of €20 million, and €39.4 million in September 2012. Participants to auctions, through the primary dealers, were also the non-banking institutions, such as Kosovo Pension Savings Trust (KPST) and Slovenian-Kosovo Pension Fund (SKPF). Figure 1 shows all auctions held in 2012:

Figure 1. Government securities auctions for 2012

The annual return rate on government securities with maturity of 91 days in 2012 marked a declining trend, starting with an annual return rate of 3.5% in January 2012, and reached 1.08% in December 2012, which is a result for participation in the market of securities of Government of the Republic of Kosovo. The average annual return rate in all securities auctions with maturity of 91 days was 2.52%. Regarding the issue of securities with maturity of 91 days, the highest annual return rate was in March 2012 auction (4.0%), while the lowest annual return rate was in December 2012 auction (1.08%). Regarding the issue of securities with maturity of 182 days, the annual return rate was 3.05% in July 2012 auction, and 2.36% in September 2012 auction. The average annual return rate on all auctions for securities with maturity of 182 days was 2.71%. Figure 2 shows the annual return rate movement for government securities.

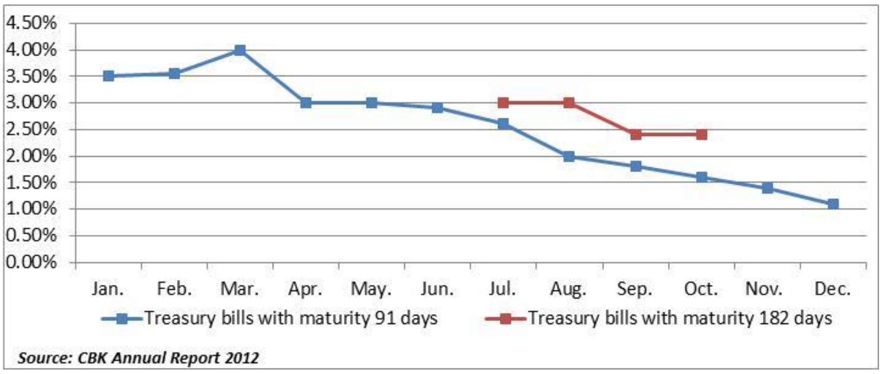

Figure 2. Movement of government securities annual rate of return in 2012

Commencement of issuing Government Securities through auctions showed an added interest by Primary Dealers to purchase them, where in all auctions held in 2012 bids submitted to purchase Government Securities were higher than the amount issued.

During 2013 were held 21 auctions, in 11 of them were issued treasury bills with maturity 91 days, in 7 of them were issued treasury bills with maturity of 182 days, and in other 3 were issued treasury bills with maturity 364 days. Year 2013 was characterized by issuing for the first time of treasury bills with maturity of 364 days with an average return rate of 1.99%. Figure 3 shows all auctions held in 2013 (CBK Annual Report, 2013, p. 91):

Figure 3. Government securities auctions for 2013

Annual return rate during 2013 marked a declining trend as a result of a decreased demand for participation on these auctions. The average annual return rate on treasury bills with maturity of 91 days in 2013 was declined from 2.52% that was in 2012 to 0.57%, and for treasury bills with maturity of 182 days from 2.71% that was in 2012 to 1.27%. The average annual return for all treasury bills in 2013 was 1.01% compared to 2.55% that was in 2012. Figure 4 shows the average annual return rate as of 31 December of the respective years:

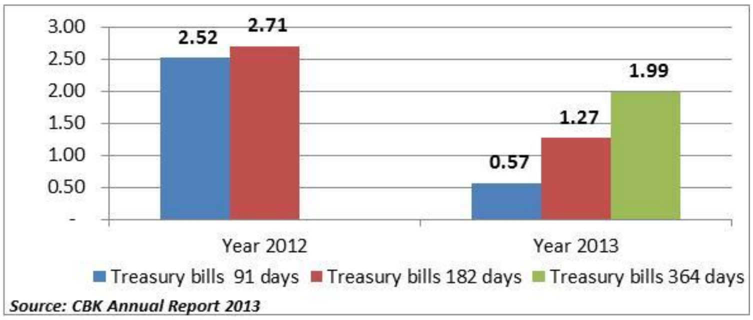

Figure 4. Annual average return rate for 2012 and 2013, in percentage (%)

All of the 2013 auctions were successfully conducted and the amount bided for purchase of securities has consistently exceeded and was almost two times higher than the amounts issued by the Ministry of Finance.

During 2014, our of the 21 auctions that were held, in 4 of them were issued treasury bills with maturity 91 days, in 7 of them were issued treasury bills with maturity of 182 days, in other 6 were issued treasury bills with maturity of 364 days, and for the first time in 4 auctions were issued government bonds with maturity 2 year. Annual return rates during 2014 have marked and increased trend as a result of a decreased demand for participation in auctions for securities with shorter maturities (CBK Annual Report, 2014).

The average annual return rate on treasury bills with maturity 91 days during 2014 marked a declining trend of 2.90% compared with 2013. The annual return rate on treasury bills with maturity 182 days in 2014 were about 5.3% higher than in 2013, while for treasury bills with maturity of 364 days marked the largest decline of 13.30% compared to 2013. While, for the first time this year were issued 4 government bonds with maturity of 2 years where the average return rate was 2.76% during the year. Figures 5 and Figure 6 show all auctions held in 2014 and the average annual return rates:

Figure 5. Government securities Auctions for 2014

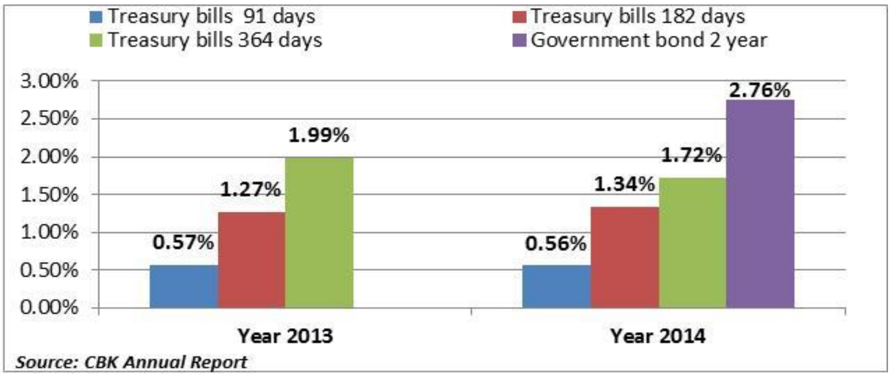

Figure 6. Annual average rates of return, in percentage (%)

All of the 2013 auctions were successfully conducted. Year 2014 was characterized with the beginning of realization of transactions on the secondary market where participants have completed the sale-purchase transactions on the secondary market through the primary dealers. Treasury bills or T-bills, which are money market instruments, are short term debt instruments issued by the Government of Kosovo and are presently issued in three tenors, namely, 91 day, 182 day and 364 day.

5. Concluding Remarks

The government securities markets have gained importance in most countries in the overall financial system in recent years. The need to develop the government securities market emerges from the three roles it seeks to play, for the financial markets, for the Government and for the central bank. The government securities market act as a channel of integration of various segments of the financial market. The government securities market constitutes a key segment of the financial market, offering virtually credit risk-free highly liquid financial instruments, which market participants are more willing to transact and take positions.

The Government of the Republic Kosovo has successfully begun issuance of treasury bills since January 2012, but market development is still at an early stage. Development of the government securities market in Kosovo will be based on market principles when covering budget deficits, which include flexible and competitive determining of interest rates.

Having in mind the confidence level of potential investors (banks, non-banking financial institutions, non-financial sector companies, individual investors), as well as their financial power, at the beginning the Kosovo government issued securities with 91 and 182 days maturity. Then gradually extended the maturity period of government securities depending on how successful the government was in gaining greater confidence of the potential investors and in line with economic development of the country.

The Central Bank of the Republic of Kosovo as an agent of the Ministry of Finance maintains, records, trades and settles all government securities transactions through the BES, which term includes the initial electronic auction sales at the primary auction, electronic trading and the central securities depository. Most T-bills have been kept by the commercial banks as primary dealers for their own account, and six-month bills have been bought by institutional investors.

The Central Bank of the Republic of Kosovo has made all necessary preparations for the development of secondary market of securities. Trading in securities is considered as an important factor to the further development of financial sector. This market promotes the efficiency in financial intermediation process and is considered an important ground for capital market development in Kosovo.

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