Debt Management and Financial Markets

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Outline of presentation

• Why?
• Recent trends
• How?
• Impact of crisis?
What is “domestic debt”?

- Jurisdiction/market of issuance
  - easiest to get data
- Currency
  - very relevant to risks
- Residency of holder
  - “official” definition, e.g. for IMF
  - relevant to international resource transfer
  - hard to get information on debt securities
- Relation between jurisdiction and residency increasingly tenuous; though possibly strengthening between jurisdiction and currency
- No “right” definition, depends on purpose of analysis
Why?
Debt Manager’s Perspective?

- Reduces risk
  - Allows government to move to more robust debt profile
    - Improves the choice set
  - Provides resilience in face of sudden stops in international markets
    - Provides additional flexibility to respond to budgetary shocks
- Reduces issuer’s costs – reduces liquidity premia
- Link between DM and DMkt development key element of Bank-Fund MTDS framework
Other Benefits

- Increase the efficiency and completeness of the domestic capital markets
- Facilitates the use of market securities for monetary policy operations
  - Allows more independent monetary policy
  - Strengthens the transmission mechanism
  - Contributing to broader macro-economic stability
- Spurs institutional and regulatory development necessary for wider private sector markets
  - Creates yield curve (for pricing) and provides benchmark
  - Generates investor appetite
Other Benefits

• Facilitates a more efficient allocation of financial resources across the whole economy
  – True opportunity cost of financing reflected in market interest rates
  – Enhances macro-economic growth

• Enhances financial stability
  – Offers agents tool for hedging the asset-liability mismatch on their own balance sheets, reducing risk of creating unexpected contingent liabilities (banking sector)

• Overall, enhances economy’s ability to weather external shocks
  – Rationale for G8 initiative to develop local bond markets in Africa
Impact on risk

- Many EMs have been following an explicit strategy to reduce exchange rate risk in the debt portfolio
  - Increasing the proportion of domestic securities
- DM often working in cooperation with other agencies
  - Both public and private
  - Complementary reforms
domestic debt shares
percent of total, by jurisdiction

Source: Panizza (2008)
• Greater diversity of instruments
  – Longer, fixed-rate tenors
  – Inflation-indexed debt
  – Floating rate notes
  – Retail debt

• Reflecting expansion of investor base …
Change in Debt Composition (Brazil)
Change in Debt Composition (Turkey)

- **2003 Oct**
  - YTL Fixed: 23%
  - YTL Variable: 27%
  - FX Fixed: 26%
  - FX Variable: 10%

- **2008 Oct**
  - YTL Fixed: 34%
  - YTL Variable: 33%
  - FX Fixed: 23%
  - FX Variable: 10%
Impact on risk

• While this has generally increased the interest rate exposure of the portfolio, overall vulnerabilities have been reduced.
  – Brazil, between 2002 and 2008, the sensitivity of the net public sector debt /GDP ratio to a combined 3 standard deviation shock to both interest and exchange rates has declined significantly from +16.5% in 2002 to -4% in 2008
  – Turkey, in 2001 impact of a 5% depreciation would add 2.2% to debt / GDP; by 2007 this had declined to 0.6%. But interest rate risk still high – 5% increase in rates would add 1.6% to debt / GDP in 2001; reduced to 1.3% in 2007
How?
General Pre-conditions

• Macroeconomic stability
  – High and volatile inflation
  – Unsustainable debt levels
  – Balance of payments vulnerability
  – Over-valued exchange rate

all lead to high risk premia and low investor appetite
Appropriate Market Infrastructure

- Sound (and independent) regulatory framework
- Robust payment and settlement systems
- Appropriate legal framework
  - Adequate and well-enforced contracts
  - Insolvency procedures
- Supportive tax regime
  - Aim for tax neutrality
  - Consider operational costs
- These conditions build confidence in the integrity of the market
Debt Management Specific

• Commitment to accept market-based outcomes
• Sound, transparent debt management strategy
  – Enhances investor understanding
  – If introducing new instruments - need to commit to continued minimum supply
  – Helps reduce risk premia
• Regular and predictable issuance plan
  – Standard, benchmark instruments
• Investor relations
  – Effective dialogue leads to synchronization of needs
Links to effective cash management?

• Required to plan issuance calendar effectively
  – Avoid cancelling (or adding) auction at short notice

• Regularity of issuance
  – May result in running short-term cash balances on TSA

• Use of benchmark bonds
  – Challenge on rollover
  – Retain flexibility in legal provisions for buybacks or other debt restructuring operations
Issuance mechanism

• Key policy choice
• Auctions, syndication or tap / fixed price tender
  – Execution risk
  – Price discovery
• Auctions - Uniform or Multiple
  – Revenue consequences
  – “winner’s curse”
  – Implications for participation
• Restrictions on participation
  – Credit risk
  – “cornering” the market
Primary dealers?

• Advantages
  – Distribution
  – Promote market
  – Reduce execution risk
  – Provide market information and advice

• Pre-requisites
  – Competition (and number)

• Link to secondary market design
  – Decisions on primary market access should be tied to market-making obligations

• Design incentives to meet issuer’s objectives
  – Non-competitive facilities
  – Fees
Price transparency

- Often linked to choice of secondary market trading mechanism
  - Need for coordination with securities market regulator
- Required if market to provide sound reference point
  - Needed for repo and other valuation
- Role for official prices
  - Link to PD obligations
  - Natural disincentive for dealers to be transparent
- Even more critical when conditions are volatile
Diverse investor base

• Need to reduce concentration of investor base / increase diversity
  – Minimize loss of access
  – Enhance liquidity

• Banks
  – Captive market?
  – Buy-to-hold?
  – Contingent risk?
Foreign investors?

• Broadens investor base and improve market liquidity
  – Often catalyst for change, facilitating the introduction of longer-term fixed rate bonds
    • Turkey: 5 year fixed rate bond in 2006; 5 year inflation-linked bond in 2007
    • Brazil: 10 year fixed rate bond in 2006

• But bring challenges …
  – May encourage speculative inflows and complicate monetary policy
  – May aggravate market volatility if significant capital outflows
Other investors?

• Institutional investors
  – Regulatory reform required?
  – Contractual savings market have played a catalyst role in developing liquidity (E.g. Chile and Poland – pension reform trigger)
  – Mutual funds can also be important

• Retail
  – Direct or indirect?
  – Can be important sector (e.g. South Africa, Hungary, Brazil)
  – Cost-efficient distribution mechanism
  – Regulatory requirements (e.g. avoid mis-selling)
  – Specialized instruments

• Investor education critical as savings options increase
Impact of crisis
Early 2008 …

• Initially, primary markets looked to be fairly robust
• DMs did revise financing plans
  – Switched into short-term or floating rate note auctions
• September conditions deteriorated significantly
• Some regional contagion
  – Poland affected by negative developments in Hungary
<table>
<thead>
<tr>
<th>Country</th>
<th>Jan 31</th>
<th>Oct 31</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>254</td>
<td>451</td>
<td>+197</td>
</tr>
<tr>
<td>Mexico</td>
<td>198</td>
<td>390</td>
<td>+192</td>
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<tr>
<td>Hungary</td>
<td>106</td>
<td>438</td>
<td>+332</td>
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<tr>
<td>Poland</td>
<td>102</td>
<td>368</td>
<td>+266</td>
</tr>
</tbody>
</table>
Post September …

- Exit of foreign investors added significant volatility to exchange rates
- Dealers have weaker balance sheets
  - Aggravated by increased volatility in markets
  - Limiting ability to meet PD obligations
  - Secondary market liquidity drying up – absence of prices …
- Primary issuance declining (EMs drawing on cash cushions)
Foreign investors … exiting

Non-resident holdings of government bonds (Jan 2008 = 1)
Impacting spreads ...
Leading to some price distortions ...
Lessons?

- Need to develop strategic, not just relative value, investor base
- Maintain strong cash reserves
- Maintain appropriate scope for flexibility – in both issuance and other aspects of market microstructure
- Develop strong dialogue with market participants
Concluding remarks

• DM and domestic debt market development intrinsically linked

• Access to deep and liquid domestic market enables DM to reduce risk while containing cost
  – More robust debt profile
  – Increased capacity to absorb shocks

• Brings wider benefits for the economy
  – More independent (and effective monetary policy)
  – Spurs broader financial sector development
    • An efficient yield curve
    • Reference for valuing and hedging other securities
Concluding Remarks

• Need to be committed to
  – Willingness to accept market outcomes
  – Transparency
  – Effective cash management

• Supported by development of domestic investor base