



# Sovereign Debt: A Guide for Economists and Practitioners



## Session 3: Role of Debt Managers in Reducing Risks to Debt Sustainability

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# Outline

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1. Debt management objectives
2. Allocation of risk between the public and private sector
3. Composition of sovereign debt
4. Identifying risks
5. Mitigating risks through financial market development

# Debt Management Objectives: Debt Crises Have Highlighted the Importance of Sound Debt Management Practices

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- Debt management anchored in sound macroeconomic and financial sector policies can ensure that: *the level and rate of growth in public debt are sustainable*
- Government debt management policies may contribute to the emergence of debt crises as: *poorly structured debt portfolios, in terms of maturity, currency, or interest rate composition and large contingent liabilities, have been important factors in inducing crises*
- The benefits of clear objectives for debt management include: *weighing risks against cost considerations*

# Debt Management Objectives: What Debt and What Risk?

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- Well-described Institutional mandates: *accountability*
- Defining risk broad based, including: *funding risk, variability in interest cost*
- Additional risk measures are possible but can be difficult to define and manage: *potential exits for asset and liability management (within public sector and transfer of risk to private sector)*
- Debt management objectives should be shared by fiscal and monetary authorities, as well as financial sector regulators

# Debt Management Strategy: Guiding Borrowing Decisions and Reducing Risk

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- Risk management framework: *composition of the public debt portfolio, capturing government preferences with regard to a cost-risk trade-off*
- Monitoring and management of risk, including:
  - Maturity structure
  - Unhedged exposures
  - Embedded optionality and derivatives
  - Cancellation and acceleration clauses
  - Contingent liabilities
- Analysis and forward looking developments over the medium-term
- Governance and quality of execution of the risk management mandate

# Managing Risk:

## Use of Risk Management Tools

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- Risk management framework with defined levels of exposure: *work better for advanced economies with access to risk management products*
- Emerging markets and developing economies face a different set of tradeoffs: *translating into lower risk and lower debt given the larger degree of uncertainty regarding economic development and market access*
- Sudden stops and original sin considerations: *investor jurisdiction and FX risk – applies to EMDEs and AEs*

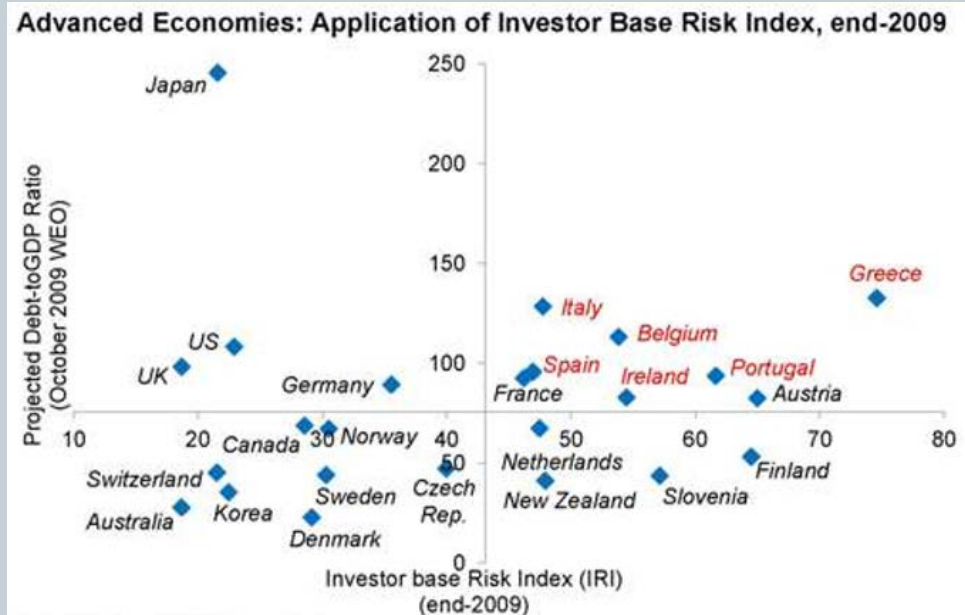
# Managing Risk:

## Investor Base Index – Who is Holding the Bonds?

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- Risk considerations relating to the investor base may impact borrowing costs

		Demand-side Risk Indicator	
		Low	High
Supply-side Risk Indicator	High	<b>Quadrant I</b> High Debt but Resilient to a Run	<b>Quadrant II</b> High Debt and Prone to a Run
	Low	<b>Quadrant III</b> Low Debt and Resilient to A Run	<b>Quadrant IV</b> Low Debt but Prone to a Run



Source: Serkan Arslanalp

# Improving the Quality of the Investor Base: Financial Market Development

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- Tapping the domestic market has a number of advantages, including: *minimizing refinancing risk in the government debt portfolio and, by lengthening the average time to interest rate resetting, its exposure to the interest rate risk*
- Addresses imperfections in the international financial system:
  - Better absorption of capital inflows
  - EMs intermediate their savings and reduce ‘uphill’ flows back to AMs financial markets
- From EM perspective:
  - Diversify funding sources for sovereign and corporate sector
  - Reduce balance sheet risk, currency mismatch, and impact of financial crisis on the real economy



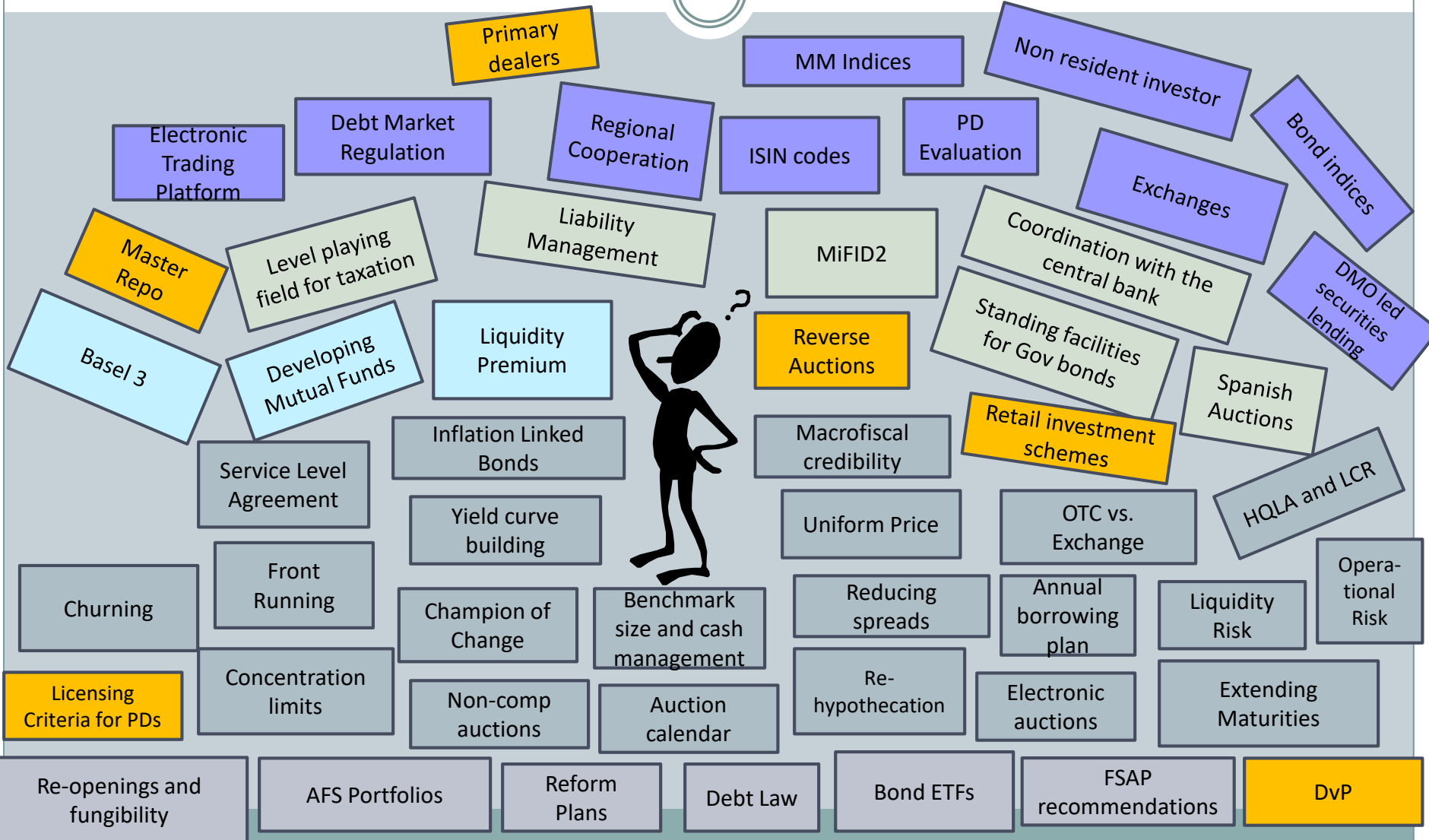
# Financial Market Development: Important Preconditions

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- Credibility of the government as a rational policymaker and an issuer of securities
- Commitment of the government to pay its debt obligations and market interest rates
- Transparency and predictability
- Sound banking system
- Developing secondary market liquidity
- Well-functioning money market
- Appropriate technical and regulatory infrastructure
- Policy coordination

# Developing the Domestic Bond Market: Complex and Involved – Market Microstructure Matters

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# Sequencing of Reforms in Developing the Domestic Bond Market

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- **Stage I – initial stage:** negligible liquidity in the secondary market, focus on establishing the primary market and creating the preconditions for secondary market development
- **Stage II – deepening stage:** basic elements of the primary market and secondary market are established and functioning, focus on improving liquidity on the secondary market
- **Stage III – maturing stage:** well-functioning primary market, liquid secondary market in normal times, focus on the development of sophisticated instruments and segments such as derivatives, and making the market internationally competitive

# Key Points -1

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- To increase the efficacy of economic policy making, debt management should be coordinated with fiscal, monetary and financial regulation policies
- Debt management offices should be well equipped, both in terms of appropriate personnel and technical apparatus, to be able to attain their main objectives of monitoring and managing the sovereign's debt portfolio risks

## Key Points -2

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- In normal times, debt management should aim to cover the funding needs at the minimum borrowing costs on a medium-term basis under the assumption of reasonable risks
- In debt distress times, debt management should be appropriately prepared to face funding difficulties and possibly debt restructuring options, including strategies to maintain or regain market access
- Under both normal and debt distress periods, debt management should also aim to develop the local currency bond market as an additional tool to effectively manage debt portfolio risks

# Further Expansion of Chapter

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- In addition to Michael and Jill's comments, any suggestions would be welcome

## Relevant Publications

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- Jonasson and Papaioannou, A Primer on Managing Sovereign Debt-Portfolio Risks (IMF WP 18/74)
- Revised Guidelines for Public Debt Management (IMF and World Bank 2014)
- The Debt Management Performance Assessment (DeMPA) Tool (World Bank 2007)
- Group of 20 (G20) Action Plan to Support the Development of Local Currency Bond Markets (LCBM)—a Diagnostic (prepared by staff of the IMF, World Bank, EBRD, and OECD 2013)
- Handbook on Developing Government Bond Markets (IMF and World Bank 2001)