Managing currency composition under an ALM framework

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Outline

- Notes from the country experiences
  - Turkey
  - South Africa
- Final remarks

Notes from
Country Experiences

Country Experiences: Turkey

- A practical SALM approach is adopted by Turkish Treasury
- Financial assets and liabilities in the mandate of Turkish Treasury are considered in designing borrowing strategies
  - Treasury cash reserve
  - Treasury receivables
  - central government debt stock
  - contingent liabilities (Treasury guarantees)

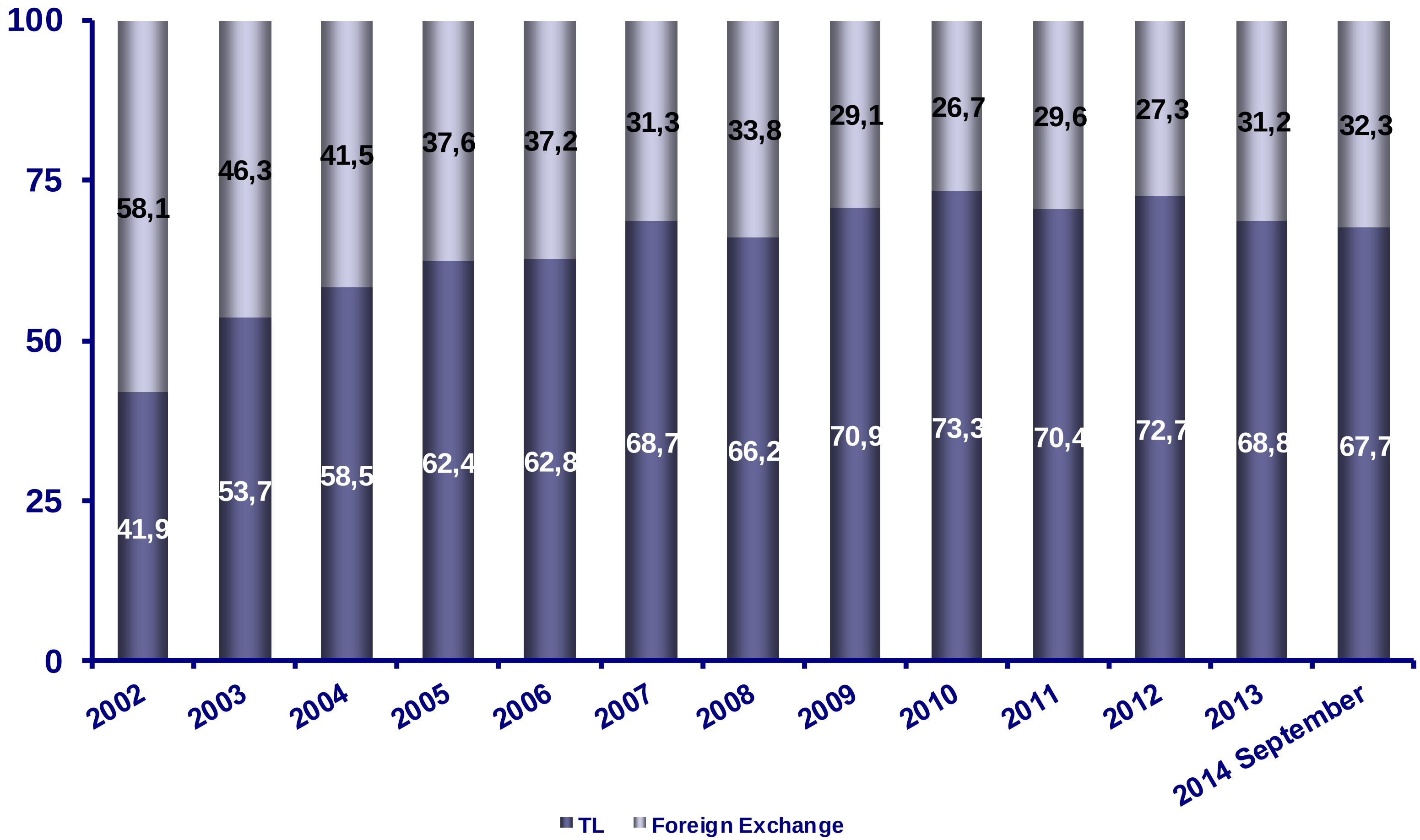
Country Experiences: Turkey

Implications of SALM for currency choice

- Reducing the share of FX denominated debt has been the main priority to minimize exchange rate risk
  - No longer issuing FX denominated security in local markets since 2010
  - The share of FX borrowing in total has been reduced to 10 per cent in 2014 from 33 per cent in 2002
- Treasury does not make use of derivatives to change it's portfolio composition
- Debt sensitivity analyses are regularly conducted and reported to the high level Debt Management Comittee
- FX composition is guided considering the correlation between local currency and major foreign currencies

Country Experiences: Turkey

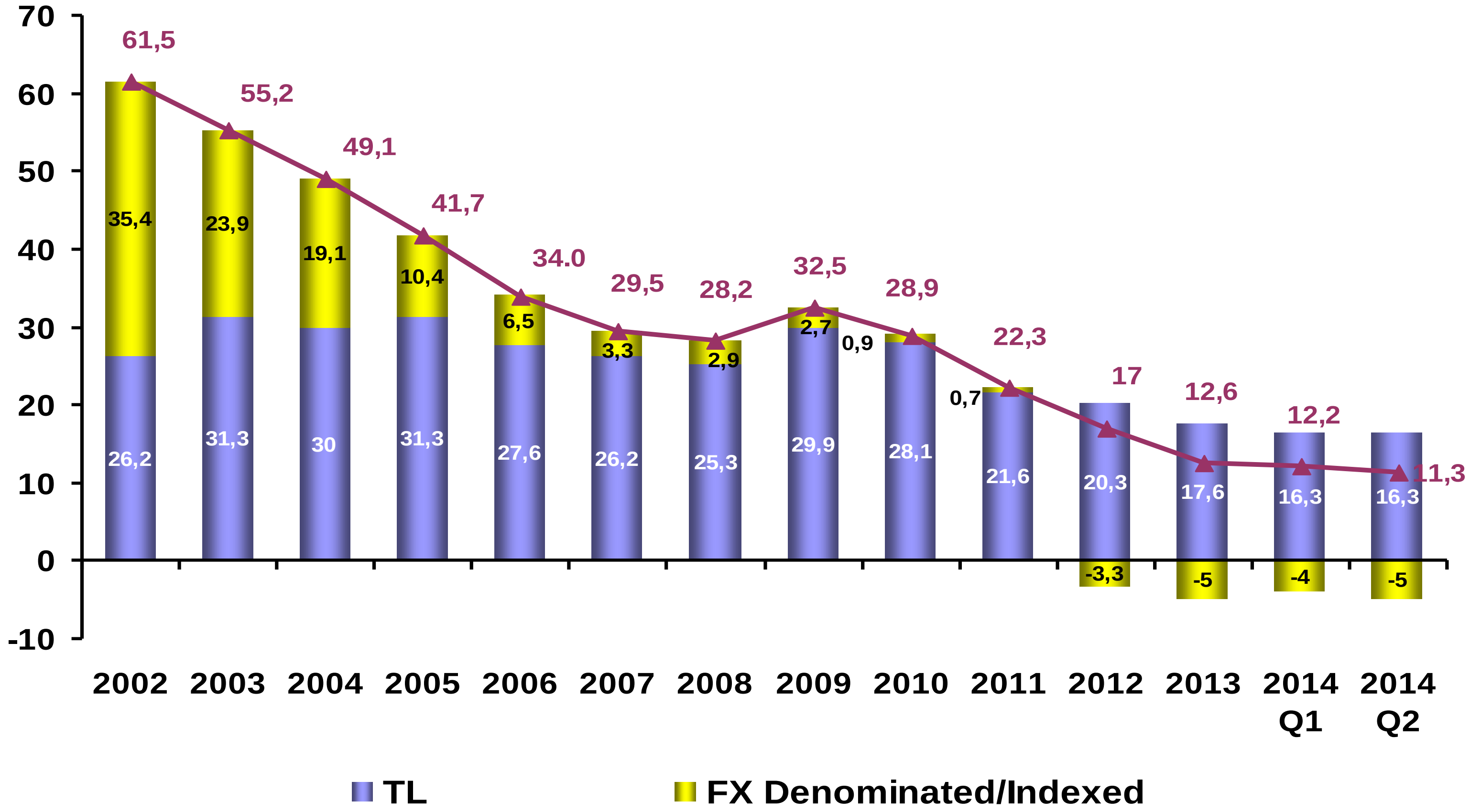
Currency Composition of Central Government Gross Debt (%)



Source: Undersecretariat of Treasury

Country Experiences: Turkey

Public Net Debt Stock (% of GDP)



Country Experiences: South Africa

- The Asset and Liability Management Division is a unit within the National Treasury responsible for managing government's annual funding programme in a manner that ensures
  - prudent cash management
  - an optimal portfolio of debt
- It also promotes and enforces prudent financial management of state-owned entities through financial analysis and oversight

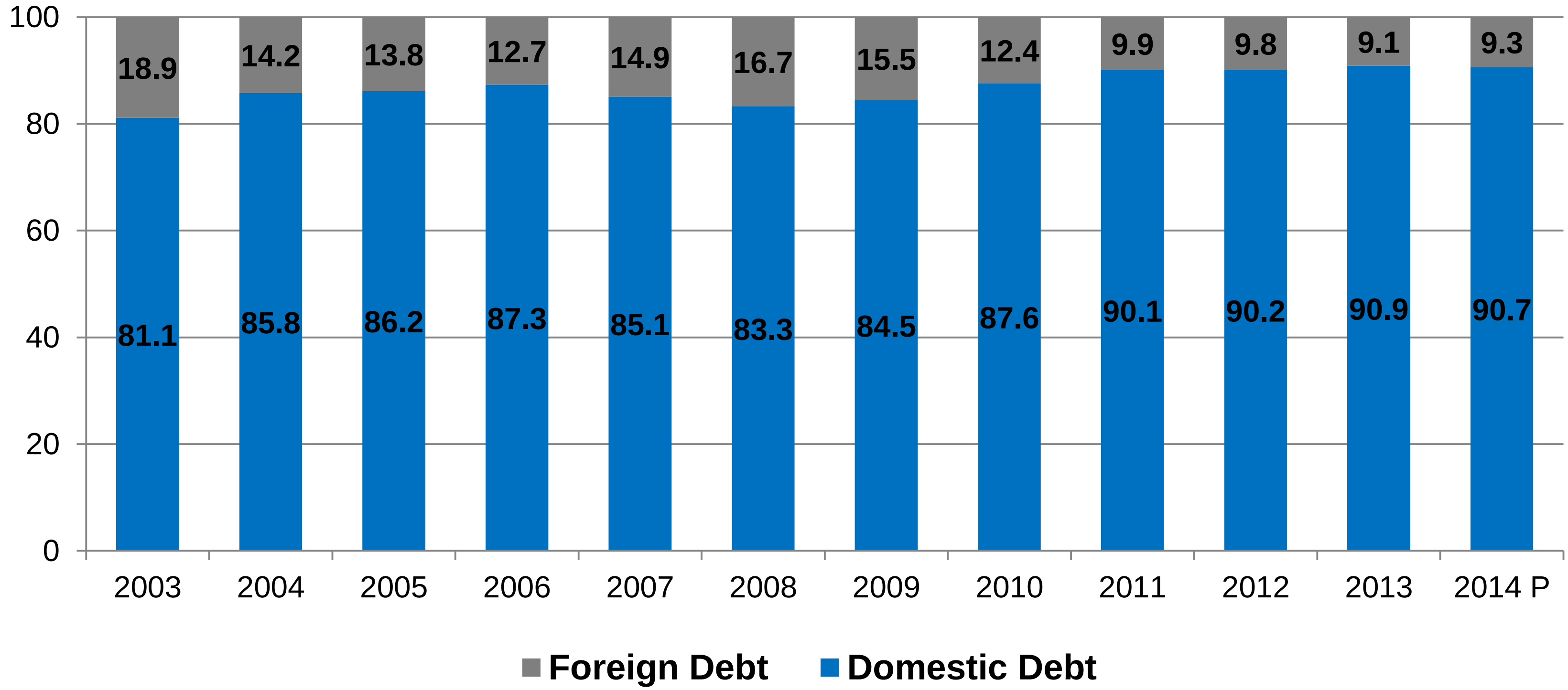
Country Experiences: South Africa

Implications of SALM for currency choice

- Minimizing foreign currency debt to manage external vulnerabilities is one of the important goals
- Debt management has contributed to broader policy objectives, including reversing the country's foreign exchange reserves from a negative net position to current levels of about US$50 billion
- Medium term FX risk benchmark -previously between 20 and 25 per cent of the total debt portfolio- set at 15 per cent in 2014

Country Experiences: South Africa

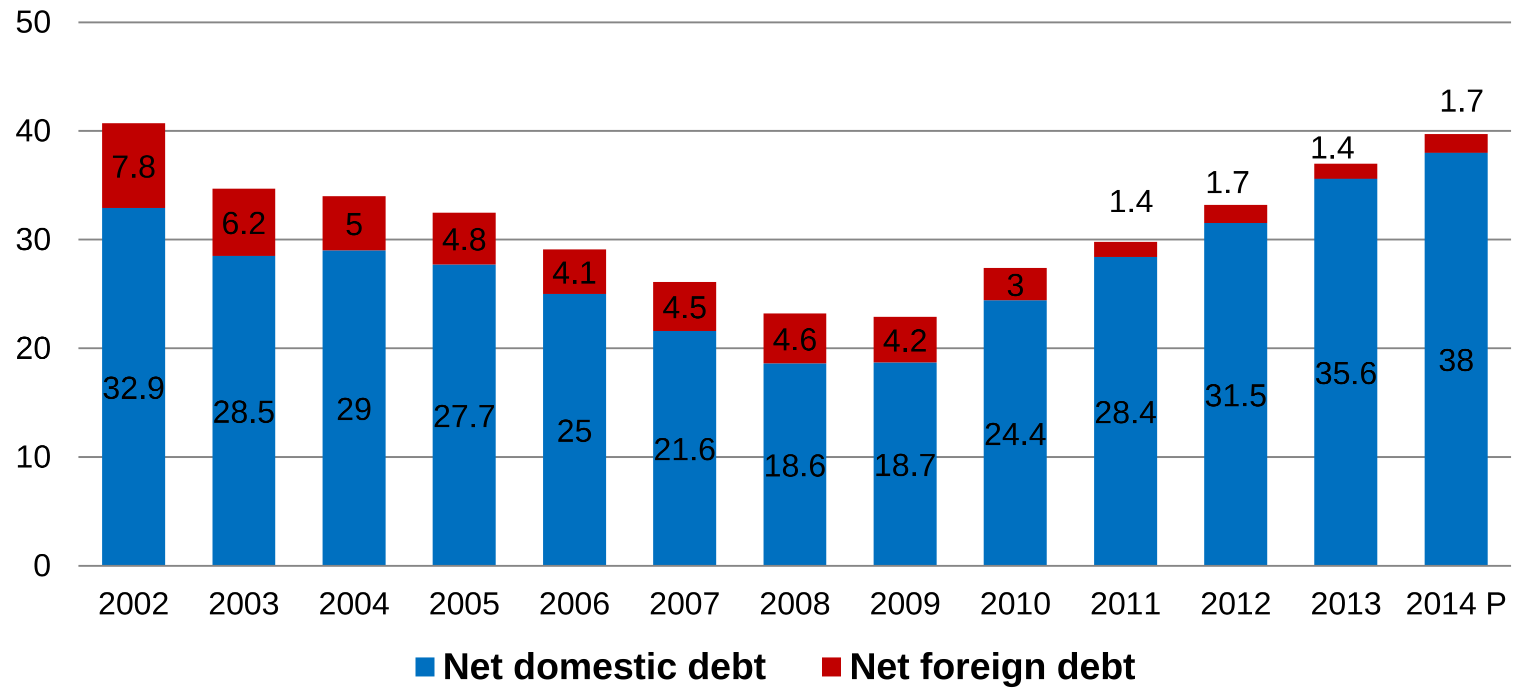
Currency Composition of Government Gross Debt (%)



Source: National Treasury, Budget Review, 2014

Country Experiences: South Africa

Government Net Debt Stock (% of GDP)



Source: National Treasury, Budget Review, 2014

Final Remarks

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- Mismatches in financial characteristics of sovereign assets and liabilities imply in principle more vulnerability to financial risks as well as less efficient performance in terms of net worth of the balance sheet

- Given the governments' limited ability to generate foreign currency revenues, an unexpected depreciation of the exchange rate deteriorates the government's fiscal position due to amplified debt service

- In terms of currency risk, SALM approach adopted by DMOs can contribute to
  - management of the macroeconomic risks of uncoordinated monetary and debt management policies and
  - building a more resilient sovereign balance sheet to currency fluctuations

Final Remarks

Key challenges of adopting SALM approach in currency risk management:

- Coordination and communication with the central bank
  - Foreign reserve management is usually done by the central bank that operates independently from fiscal policy. This situation can make successful cooperation on risk management more difficult since the objectives are quite different
- Institutional capacity
  - The risk analysis of the balance sheet calls for specialist staff and an advanced technical capacity
  - Also, operating active hedging instruments such as currency swaps entails specific legal and IT system arrangement

Final Remarks

- New institutional arrangements may be founded in order to address communication and governance challenges
  - i.e. certain departments, coordinating committees
- Exchange rate risk on government debt and foreign reserves can be managed jointly without a specific need for modelling
- Reducing the outright exposure with passive hedging or active hedging instruments depends on several factors including risk management unit’s capacity, institutional choices and development of financial markets
- The composition of the FX debt portfolio can be set either by considering the composition of foreign exchange reserves or based on the correlation with the local currency