Managing Emerging Market Public Debt in a Crisis:

Has this time been different?

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Agenda

1. EMs before the crisis:
   - Macroeconomic fundamentals
   - Debt management
2. Impact of the global financial crisis
3. Debt managers’ response to the crisis
4. Lessons learnt
Healthier fiscal balances opened space for countercyclical policies

Source: World Bank LDB Working Database
...and contributed to a downward trend in debt/GDP ratios

Central Government Debt (% of GDP)

Source: Central Government Debt from World Bank LDB Working Database; GDP from World Bank WDI
Credibility of monetary policy increased...

Average CPI Inflation (annual % change)

Source: IMF/IFS
...and allowed a sustained easing of policy rates

Selected Policy Rates (%)

Source: Bloomberg LP, Datastream
Economic growth was stronger this time

- Emerging market economies grew faster than developed countries

Source: World Bank *WDI*

Note: High Income OECD is based on World Bank classification, excluding Czech Republic, Hungary, South Korea and Slovak Republic
Healthier external accounts helped reduce vulnerability to shocks

External Debt (% of Exports of Goods and Services)

Source: World Bank WDI
Stronger fundamentals facilitated the transformation of public debt portfolios

- Increase in the share of the domestic debt

- Extension of the maturity of the domestic debt:
  - Supported by increased credibility of monetary policy
  - Diversification of the investor base:
    - Expansion of the local investor base especially non-bank financial institutions
    - Increased interest by foreign investors

- The aim of the portfolio shifts was to reduce the exposure of EMs to exogenous shocks and changes in market sentiment.
There was a significant reduction in FX risk...

- Currency composition of government debt portfolios moved dramatically in favor of local currency

![Graph showing ratio of external to domestic debt](image)

**Ratio of external to domestic debt**

- Emerging Markets
- ECA
- LAC
- EAP

Note: USD-linked domestic debt reallocated to external.
...and net foreign currency debt was significantly reduced (1)

Gross external debt vs. Int. Reserves (no China)

2001

USD billion

FX Reserves    FX debt    Net FX debt to GDP (right axis)

...and net foreign currency debt was significantly reduced (2)

Exposure to refinancing and interest rate risks was also reduced (1)

- There was a contraction in the ratio of floating rate to fixed rate bonds

**Floating to fixed rate debt (excluding Brazil)**

Exposure to refinancing and interest rate risks was also reduced (2)

- There was an extension in the average life

![Average Life Chart]

The global financial crisis had a dramatic impact on funding conditions...

- Funding conditions in international capital markets deteriorated, with generalized spikes in EM Credit Default Swaps (CDS) and in Emerging Market bond Index (EMBI) spreads.
EMs experienced significant capital outflows

- This increased the challenge to debt managers, especially in countries still dependent on external funding.

### Quarterly Portfolio Flows (% of GDP)

Source: Portfolio flows from IMF IFS; GDP from World Bank WDI
Capital outflows were particularly strong in fixed income markets.

Net Bond Fund Flows (% of GDP)

Source: Emerging Portfolio Funds Research

Note: Flows by country; as a % of GDP
SAR excludes Sri Lanka; MNA excludes Morocco; SSA excludes Kenya
EM external debt issuance stalled for months … then rebounded strongly

- This was the consequence of increased risk aversion and higher borrowing costs.

**Issuance Volume and Number of Deals**

- Total EM Volume (excluding China)
- Total number of deals (right axis)

**Source:** Dealogic System

**Note:** Global Market public issuances, Emerging Market countries, excluding China
The impact of the crisis on local currency bond yields was mixed.
Debt managers responded with a range of actions

1. Delay borrowing or use sources other than regular market instruments
2. Adjusting market borrowing to changed demand
3. Implementation of liability management operations
Most countries reduced or delayed borrowing from regular market sources…

- Using **cash reserves**
- **Government bond purchases** by central banks
- **Stepped up borrowing from multilaterals:**
  - MDB financing increased significantly (w/available headroom)
  - IMF resources
  - WB contingent credit lines
- **Start/expansion of retail debt programs.** Issuance of **new products:**
  - **Indonesia:** Expanded retail market; Introduced a Sharia-compliant market instrument
  - **Hungary:** 3-year CPI linker for retail market
  - **Turkey:** Revenue-indexed bonds and CPI linkers for wholesale market
...and the majority revised market borrowing to reflect composition of demand

- Suspension of international issuance
- **Reductions in LX bond auctions:**
  - Virtual halt in LX market for medium- and long-term paper
  - Dramatic reduction in issuance of fixed rate paper
  - Mixed impact and response across countries
- Issuance concentrated in the **shortest tenors and floaters:**
  - Increased volume of T-Bill issuance, some dramatically
  - Two of the worst hit relied on short-term and floaters for 8 months
...and buybacks and switches were used as liability management tools

- **Buybacks** alleviated sell-off pressure, enhanced liquidity and improved pricing of liquid instruments:
  - **Hungary**: $2.5 bn buyback program permitted resumption of bond auctions
  - **Mexico**: Buyback of medium-/long-term securities enhanced instrument liquidity
  - **Indonesia**: Buybacks/switches of short-term debt provided price references

- **Switches** stabilized market, consolidated debt into large benchmarks and reduced refinancing risk (e.g. Brazil, Indonesia and South Africa)

- **Revision of formal targets**:
  - Some included a higher share for FX debt
  - Brazil reviewed its quarterly targets for the portfolio composition
  - Those with broader directional targets operated within existing mandates
The response of debt managers in some advanced countries was similar

- Extreme and sudden expansion of the borrowing requirement meant large-scale issuance of short-term paper at the peak of the crisis
- Pain exacerbated by compound effect of economic crisis and financial instability affecting primary dealers
- Dislocation of primary market and reduced liquidity in secondary markets
- Some DMOs bypassed primary dealers to deal directly with investors
- Greater use of syndication to issue bonds
Some mostly positive lessons learned…

- Sound macroeconomic policy was elemental for insulation and recovery.
- Prudent debt management pre-crisis played a role in enhancing EMs resilience (sometimes requiring difficult cost-risk tradeoffs).
- Debt managers had room to maneuver, adapt, and absorb risk.
- Multilateral funding was critical where international capital markets were closed and domestic investors flew to safer markets.
- Countries with larger, more developed bond markets fared better.
- Crisis highlighted EMs improved capacity in public debt management.
...but no room for complacency

- Uncertain outlook:
  - Global imbalances persist
  - Volume of government borrowing globally
  - Divergent views on strength of recovery

- Need to maintain preparedness for market dislocations and seek opportunities to contain risk in public debt portfolios
  - Take advantage of ample liquidity to reduce currency and interest rate risks
  - Stress test scenarios and cost-risk modeling need to include potential capital outflows
  - Ensure timely and accurate communications with investors and other stakeholders – even more critical when market participants are risk averse

The paper was also published in the book “Sovereign Debt and the Financial Crisis: will this time be different?” edited by Carlos Braga and Gallina Vincellete, Chapter 16.