Reducing Exposure to FX Risk by Non-Resident Investment in LCDM

World Bank Webinar

Turkish Treasury

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Outline

- Why we have aimed to reduce FX exposure of debt stock
- Which strategies we have employed to reduce FX risk
- How we assess increasing share of non-resident investors
- Final remarks

Why we have aimed to reduce FX exposure of debt stock

The share of FX denominated debt in central government debt stock was around 47% in 2000.

A sharp currency depreciation has significantly affected the portfolio during the 2000/01 Financial Crisis. In 2002, the share of FX denominated debt in central government debt stock was around 58%.

A 5 percent real exchange rate depreciation would have affect general government debt stock/GDP ratio 2.2 percentage points.

NEED TO REDUCE FX EXPOSURE OF DEBT STOCK

Which strategies we have employed to reduce FX risk:

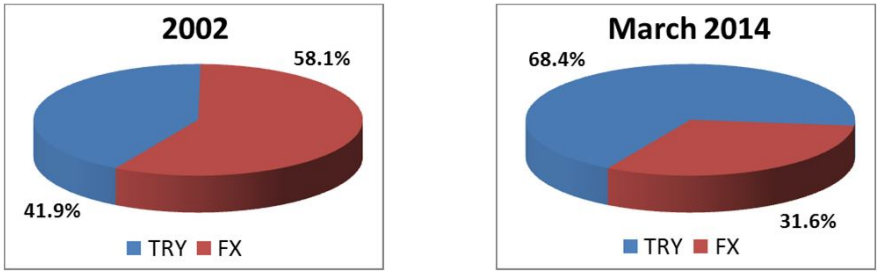
Strategic Benchmarks for Risk Management

- Keeping a certain level of cash reserve : **to reduce liquidity risk**
- Borrowing mainly in TRY in domestic markets: **to reduce FX risk**
- Using fixed rate TRY instruments as the major source of domestic borrowing and decreasing the share of debt which has interest rate refixing period less than 12 months: **to reduce interest rate risk**
- Increasing the average maturity of domestic borrowing taking market conditions into consideration and decreasing the share of debt maturing within 12 months: **to reduce refinancing risk**

Which strategies we have employed to reduce FX risk:

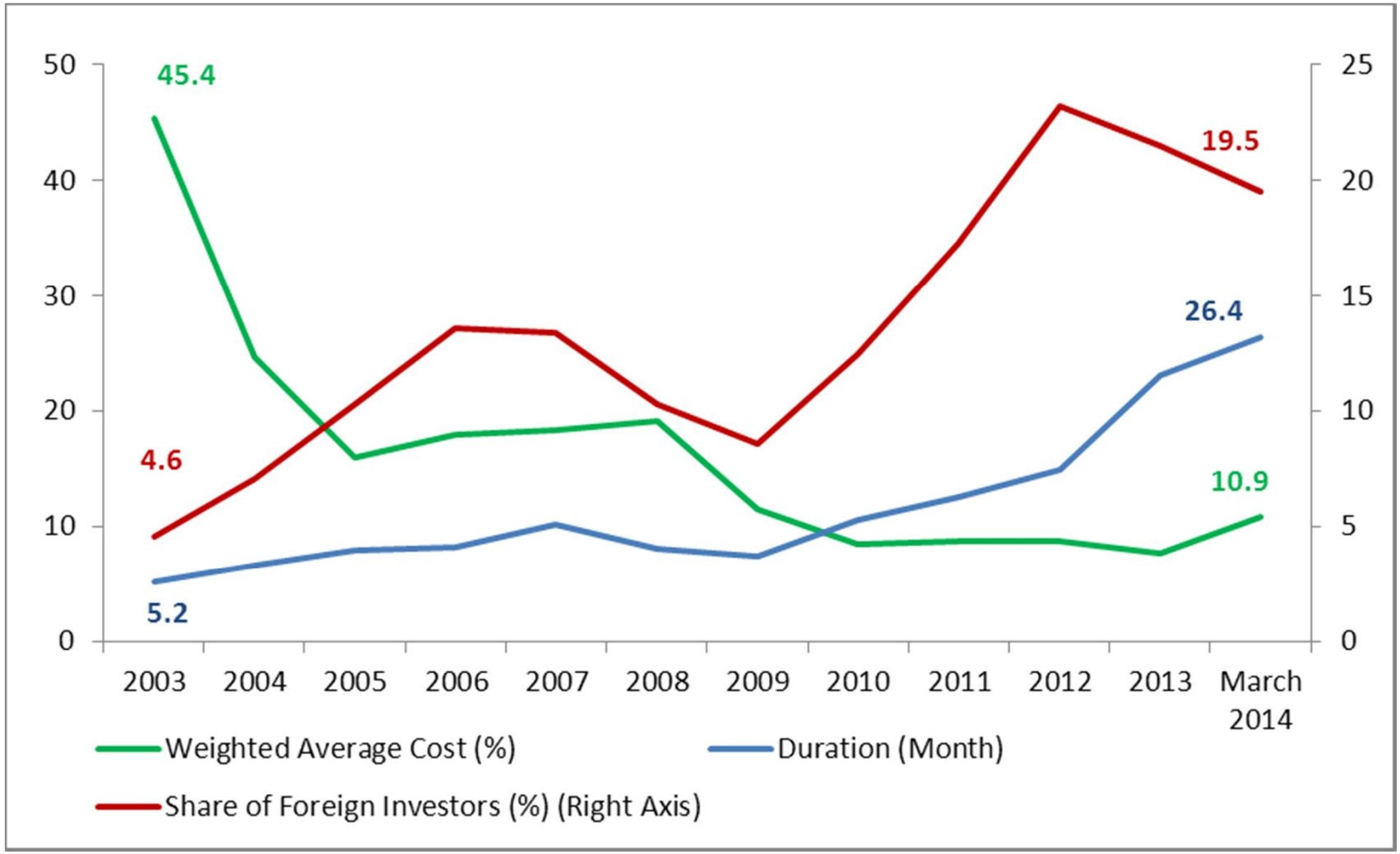
- Turkish economy has a good track record in the last decade thanks to the sound macroeconomic policies
- With the help of strategic benchmarks, the FX exposure of the central government debt stock has been significantly reduced
  - Domestic borrowing strategy: regular issuances of fixed coupon TRY bonds with 2, 5 and 10 year maturities and CPI-indexed TRY bonds with 5 or 10 year maturities
  - No FX indexed/denominated instrument issuance in domestic market since January 2010

Currency Composition of Central Government Debt

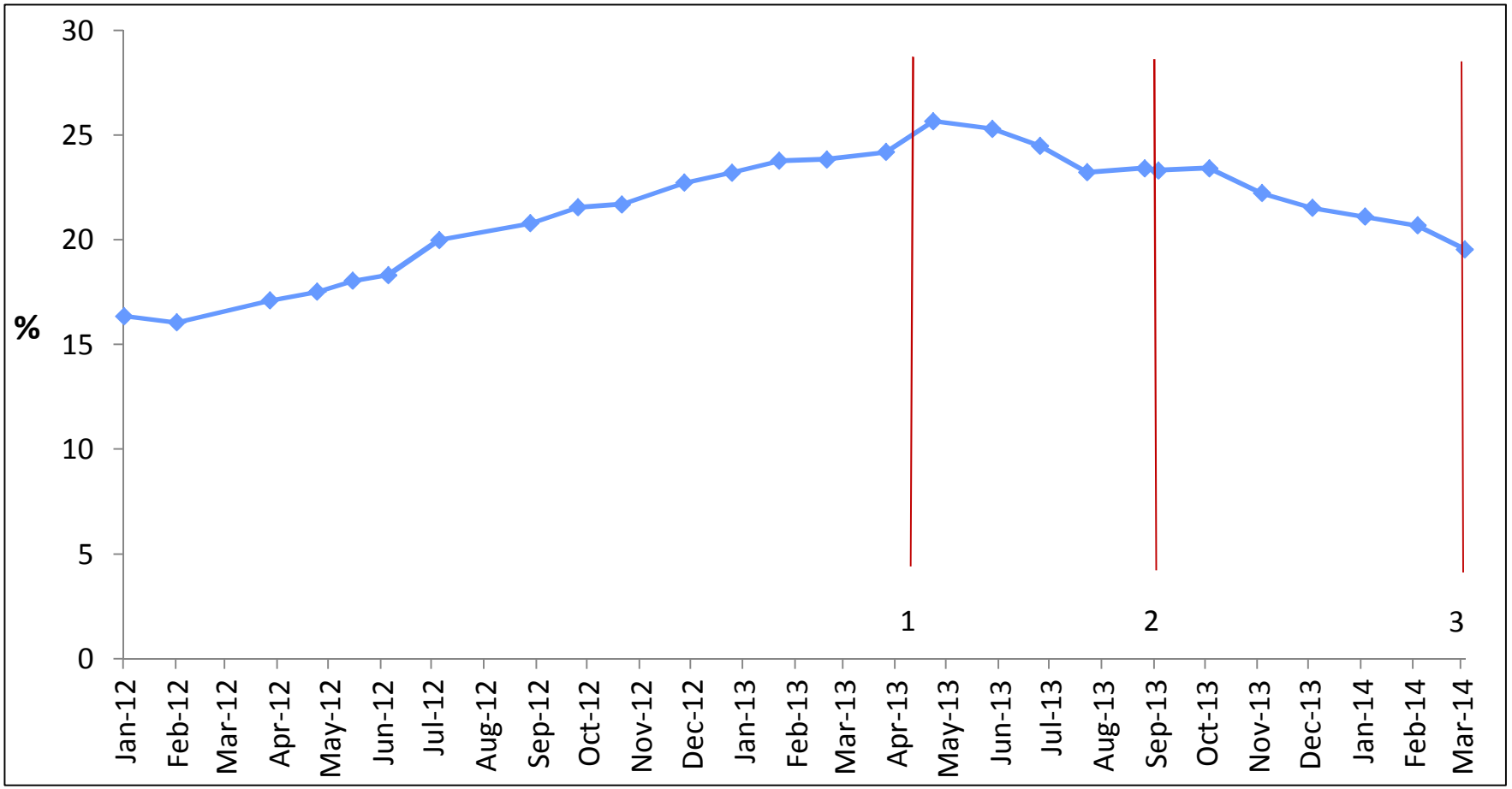


- Non-resident investment in TRY debt instruments started to increase
- Favorable tax system, enhanced investor relations and entrance of Turkish gov't bonds to the international bond indices also contributed to this trend

Foreign investors helped Turkey to lower its borrowing costs and extend duration of its debt



Share of Foreign Investors in Domestic Debt Stock (Monthly, 2012-2014 March)



1. May 2013: FED Tapering Decision (25.7 %)

2. September 13: First FED Tapering (23.3 %)

3. March 2014: Local Elections (19.5 %)

How we assess increasing share of non-resident investors:

- The share of foreign investors in domestic debt stock by itself is far from explanatory
- The breakdown of foreign investors is an important issue in analyzing their impacts on the local market (e.g. institutional vs individual, bank vs non-bank)
- Public debt dynamics and relevant financial indicators must be taken into account, as well as the factors determining the foreign investors' behaviors

How we assess increasing share of foreign investors:

Foreign Investors Stress Index (FISI)

FISI basically estimates the current level of risk that might emerge as a result of foreign investor outflows by incorporating

- share of foreign investors
- duration of foreign investors' gov't bond holdings
- risk profile of the debt stock
- market roll-over ratios
- the ratio of securities held by the domestic banking sector to the GDP

Final Remarks

- The general view is that foreign investors induce a set of positive impacts such as decreasing yields, extending the yield curve, deepening LCDM and reducing exposure to FX risk
- On the other hand, there are possible risks arising from a high foreign investor share (e.g. a sudden and strong reverse flow scenario could lead to significant volatility)
- The potential impact of foreign investors' inflow/outflow on borrowing costs, market liquidity and volatility requires closer attention
- With the construction of FISI, we aim to create an assessment tool that helps to analyze impacts of foreign participation in LCDM through a more integrated framework by considering duration of foreign investors' holdings, risk profile of public debt, market roll-over ratios and absorption capacity of local investors