MCM
Debt and Capital Market Instruments Division

Sovereign Debt Management Forum
Is There Life After Debt?
Foreign Currency Selection:
Three Ways to Solve the Puzzle

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FX Risk and Debt Management

Outline

- Recent sovereign FX issuance
- Managing FX risk in a debt management context
Global EM Debt Continues to Grow…

EM Debt (US$ Trillion)

Sources: BofA Merrill Lynch Global Research, BIS, Bloomberg
...with Local Currency Debt Stable

Local Currency and International Issuance (Share)

Sources: BofA Merrill Lynch Global Research, BIS, Bloomberg

Debt and Capital Market Instruments Division
Developments are Uneven with EMDEs Issuing More Internationally

**Recent USD Eurobond Issuance (USD bn)**

- Upper middle income
- Low and Lower-middle income

Sources: BofA Merrill Lynch Global Research, BIS, Bloomberg
EM Currencies
(Weighted by Sovereign Issuance)

Outline

▪ Recent sovereign FX issuance
▪ Managing FX risk in a debt management context
FX Risk in a Debt Management Context

- **Exchange rates** are typically among the most volatile financial variables and their movements can significantly increase the value of outstanding debt and the debt-servicing costs.

- **Volatile debt-servicing costs** increase the volatility of the budget outcome, which can create economic uncertainty.
1. **Share of FX exposure needs to take into account cost and risk**, as well as the:
   - Capacity of domestic debt market to absorb issuance
   - Possibility to develop the domestic debt market and widen the investor base

2. **Composition of FX debt** – minimizing variance with the local currency
Additional factors to consider

- **Exchange rate regime** will determine the impact of FX risk in debt management. Effects under fixed exchange rate regime different to those under a floating exchange rate.

- **Contingent liabilities** – possible that other public sector entities (e.g. SOEs) may have issued FX debt. These liabilities may crystallize during a currency crisis.
Simple Government Balance Sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Future stream of government revenue (LX)</td>
<td>Future stream of government expenditure (LX)</td>
</tr>
<tr>
<td>Future stream of government revenue (FX)</td>
<td>Outstanding domestic debt (LX)</td>
</tr>
<tr>
<td>FX reserves (FX)</td>
<td>Outstanding external debt (FX)</td>
</tr>
</tbody>
</table>
Managing FX Risk

Broad approaches to Asset Liability Management

‘Stock’ concept – looks at assets that the debt is funding, e.g. FX reserves, financial assets, infrastructure. Fund financial assets from debt of similar interest rate and currency composition.

‘Flow’ concept – how cashflows from assets and liabilities co-vary – choose composition so that debt servicing dampens primary deficit/surplus volatility.
Managing FX Risk

Other options

- **Hedging FX debt with derivatives**, a need to consider a range of factors, including: hedging costs; depth/liquidity of derivatives in domestic currency; counterparty risk, collateral requirements/margining; debt management capacity (staff/systems) to undertake hedging.