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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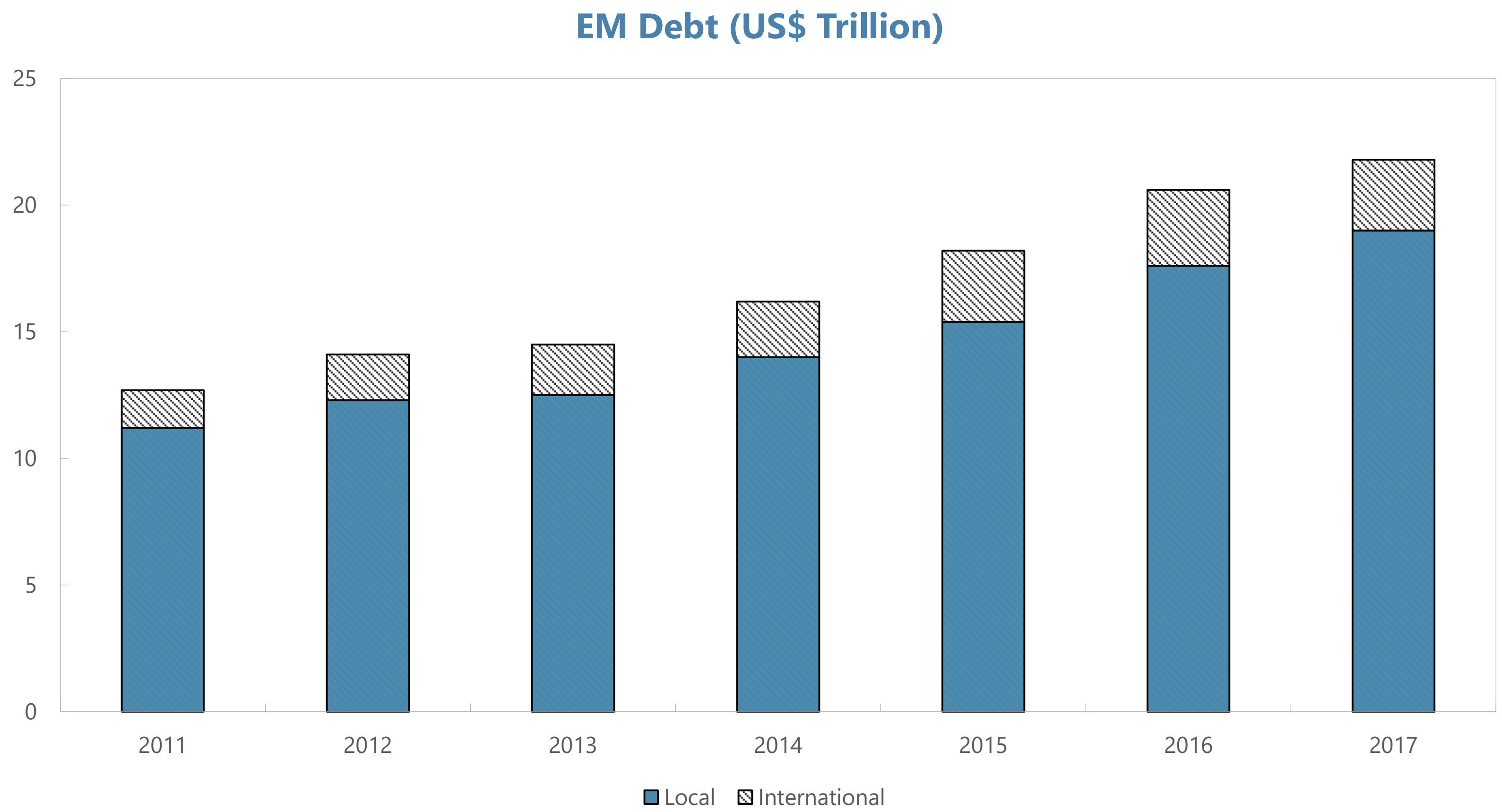
FX Risk and Debt Management

Outline

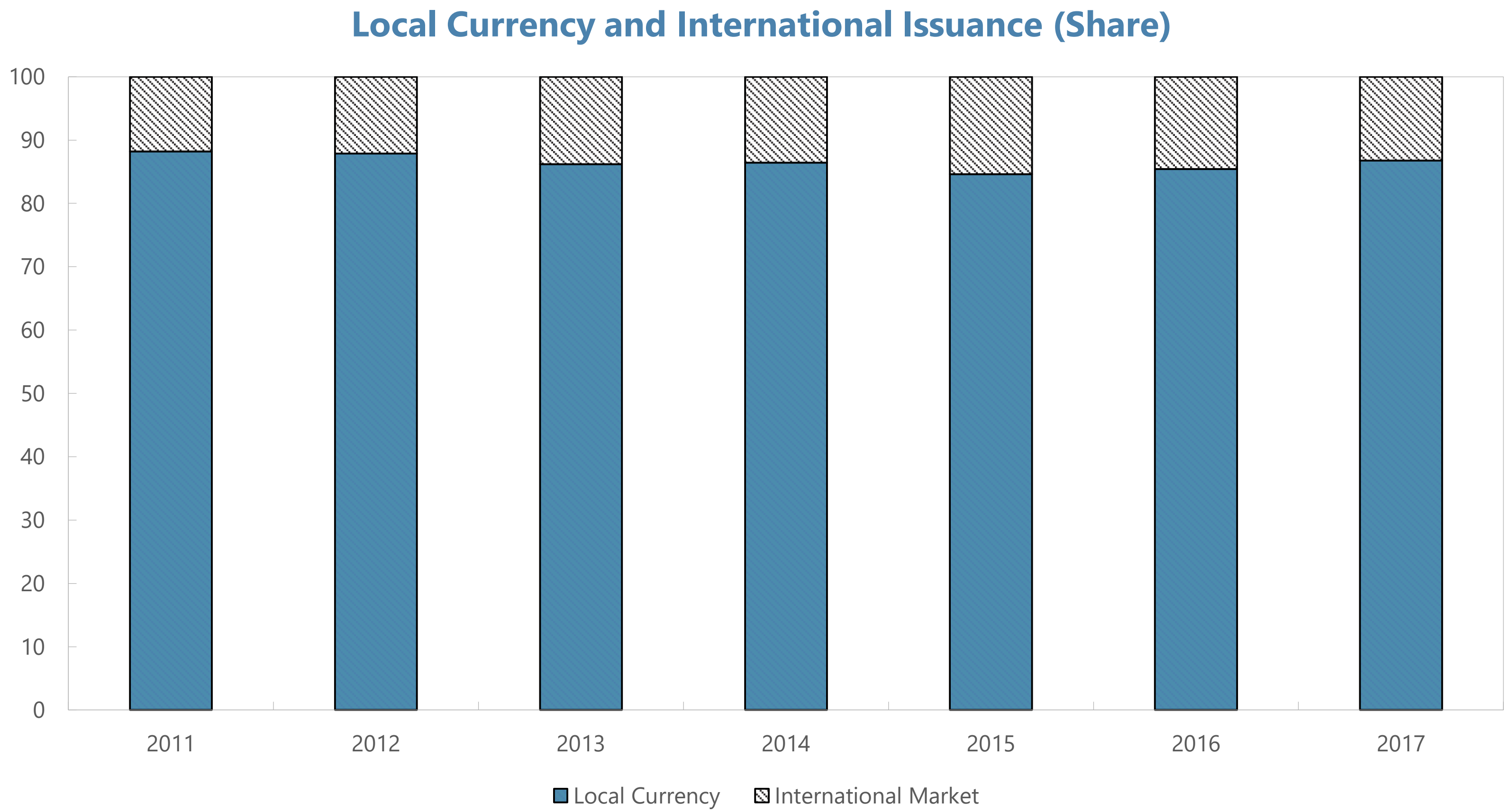
- **Recent sovereign FX issuance**
- Managing FX risk in a debt management context

Global EM Debt Continues to Grow…



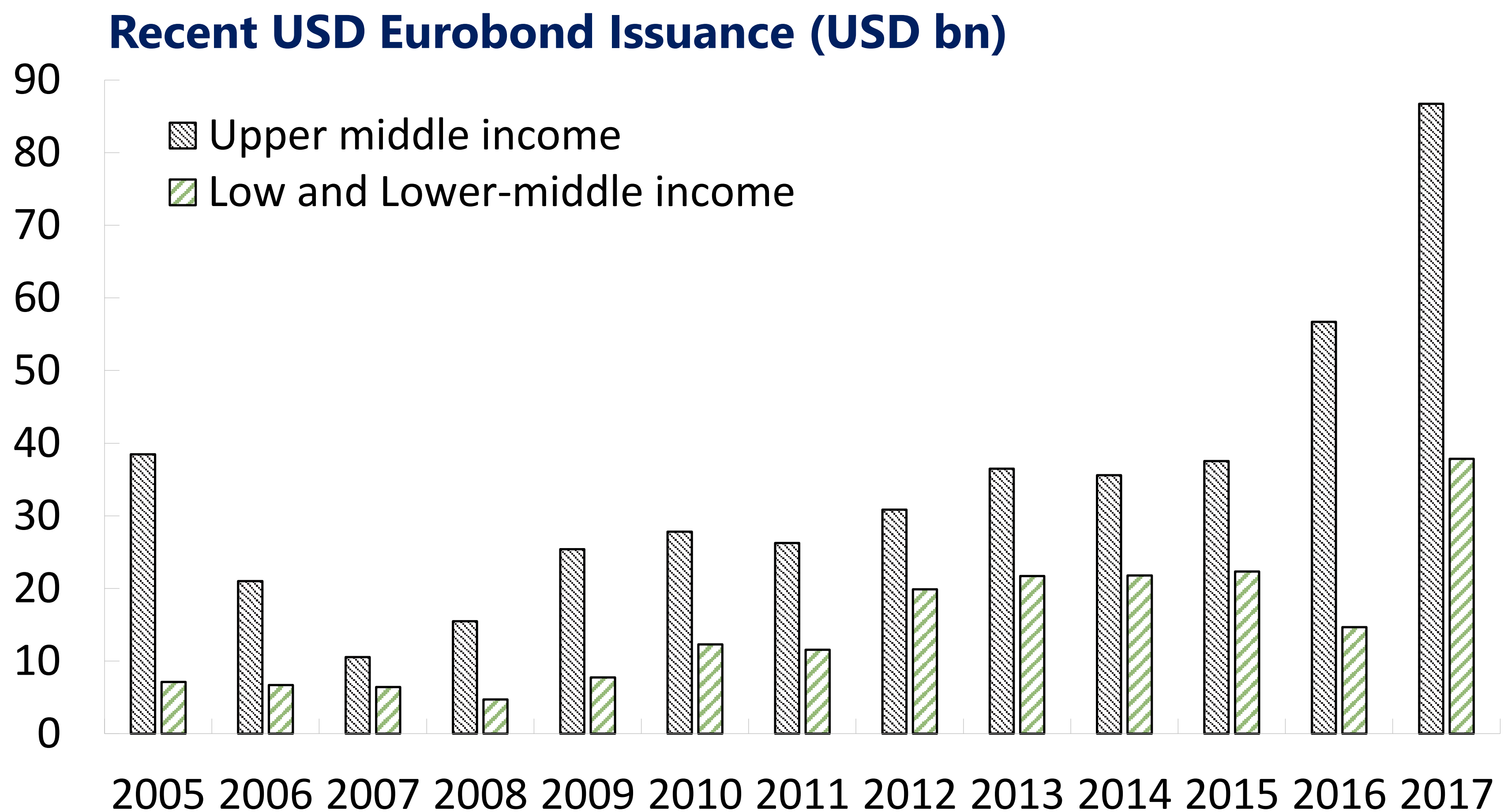
Sources: BofA Merrill Lynch Global Research, BIS, Bloomberg

...with Local Currency Debt Stable



Sources: BofA Merrill Lynch Global Research, BIS, Bloomberg

Developments are Uneven with EMDEs Issuing More Internationally



Sources: BofA Merrill Lynch Global Research, BIS, Bloomberg

EM Currencies
(Weighted by Sovereign Issuance)

Source: IMF/WB. (2018). Staff Note for the G20 IFAWG Recent Developments on Local Currency Bond Markets in Emerging Economies.

FX Risk and Debt Management

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

FX Risk in a Debt Management Context

1. <u>Share</u> 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. <u>Composition</u> of FX debt – minimizing variance with the local currency

FX Risk in a Debt Management Context

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.

Managing FX Risk

Simple Government Balance Sheet

Assets	Liabilities
Future stream of government revenue (LX)	Future stream of government expenditure (LX)
Future stream of government revenue (FX)	Outstanding domestic debt (LX)
FX reserves (FX)	Outstanding external debt (FX)

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