Sovereign Debt Management Forum 2014

Background Note for Breakout Session 3

Coordination between fiscal and debt management policies – Emerging Issues

Introduction

Debt management cannot be carried out in vacuum; it should be anchored in sound macroeconomic and financial sector policies to ensure that the level and rate of growth in public debt are sustainable, and that the composition of the debt does not put undue risk on these policies. There are policy trade-offs, interdependencies and inter-linkages between debt management and fiscal policy, that must be understood and coordinated. Information on the government's liquidity needs (future and current), the medium- to long-term fiscal strategy, and the exposure of the debt to changes in market rates and potential budget impact, debt sustainability, etc., should be shared among debt managers, fiscal policy advisers and central bankers.

Weak debt management practices may force the fiscal authority to change course of policy as risky or unsustainable debt structures can increase the costs of debt servicing and push the government to cut planned expenditures to meet its debt obligations. Conversely, weakness in fiscal policy can impact the effectiveness of debt management as tax and expenditure policies determine the levels of primary surplus/deficit and the amount of debt that needs to be issued to meet the governments' financing needs. If the financing needs are high, investors will demand higher risk premium and may limit debt managers from issuing the preferred debt instruments at reasonable costs and forsake the targeted debt composition.

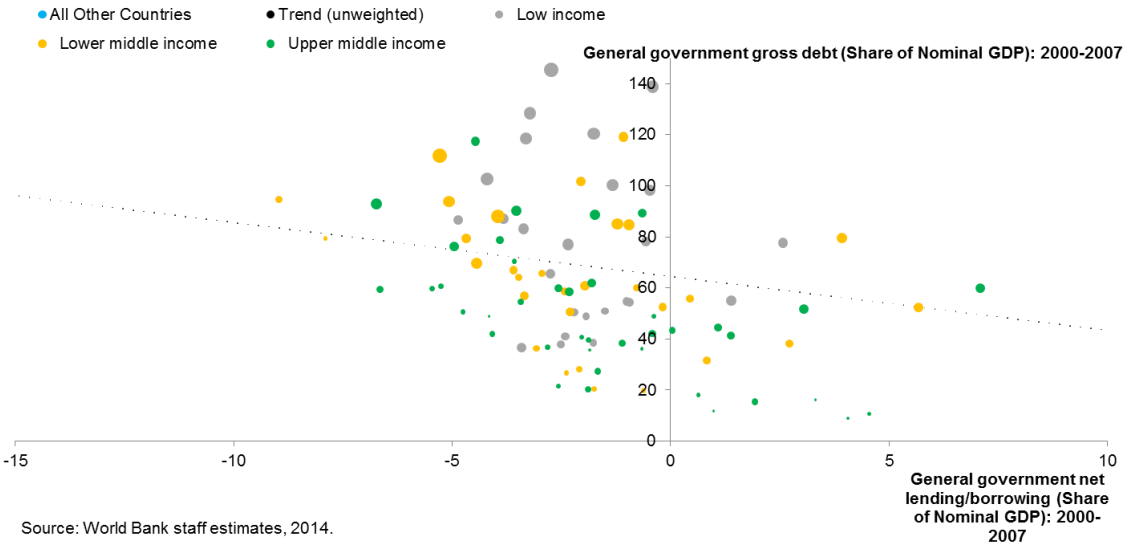
Fiscal policy as a macroeconomic stabilization tool is frequently judged in terms of its macroeconomic impact over the economic cycle, dampening boosts and stimulating busts. However, proper stabilization requires fiscal sustainability. An unsustainable fiscal path will eventually bring painful fiscal adjustment or else call for debt restructuring, usually preceded by costly financing terms. Fiscal stabilization policies break down when they are not inserted in a sound fiscal sustainability framework. It is key to coordinate fiscal and debt management policies and look at the available "fiscal space" at any point in time in order for the authorities to take into account the long-term debt implications of the country's fiscal policy stance. Coordination is also needed to ensure that debt management is conducted in a way that protects access to needed financing to back fiscal policy stabilization from short-term disruptions in financial systems.

Policy coordination under the current global environment

In the current global environment, it was amply demonstrated that public debt management problems often find their origins in the lack of attention paid by policymakers to the costs of weak macroeconomic management. The recent crisis presented a time when fiscal positions had rapidly deteriorated and the competition for funding dramatically increased. In addition, expansionary fiscal policies/loose monetary policies have reduced interest rates to extremely low levels in parallel with the increase in debt levels in increased funding needs. The challenge is how to deal with a situation where rates increase (substantially) and funding needs (due to rollover) remains high At a time when the funding needs of governments and corporations increased, many sovereigns found themselves borrowing at high costs, or only able to access the market for restricted amounts and currencies and for short maturities at much higher spreads than before the crisis

Figure 1.

General government gross debt (% of Nominal GDP): 2000-2007 vs Fiscal Position (% of Nominal GDP): 2000-2007 in All Developing Countries

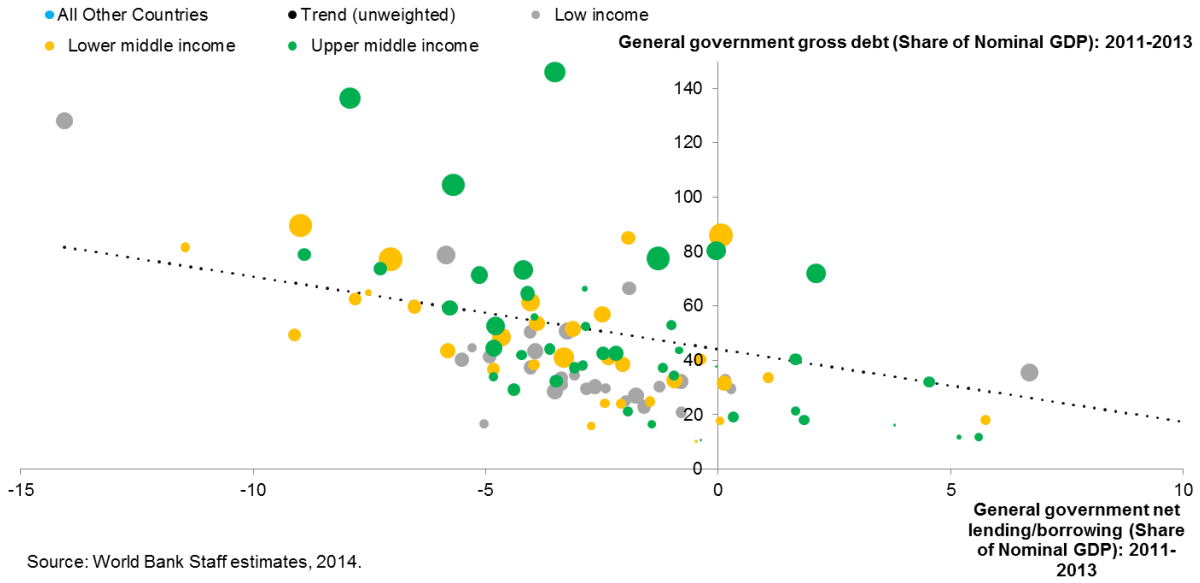


Source: World Bank staff estimates, 2014.

In good times, prudent debt management, fiscal, and monetary policies can reinforce one another in helping to lower the risk premia in the structure of long-term interest rates. In crisis times, especially if the public debt portfolio has a composition which is highly exposed to risks, this may prove somewhat difficult. Debt managers and fiscal and monetary authorities should share information on the government's current and future cash flow needs. Borrowing limits and sound risk management practices can help to protect the government's balance sheet from debt servicing shocks. It is important that policies in all areas are conducted in the context of a sound macroeconomic framework.

Figure 2.

General government gross debt (% of Nominal GDP): 2011-2013 vs Fiscal Position (% of Nominal GDP): 2011-2013 in All Countries



Source: World Bank Staff estimates, 2014.

Policy coordination needs arising from fiscal stimulus or fiscal consolidation

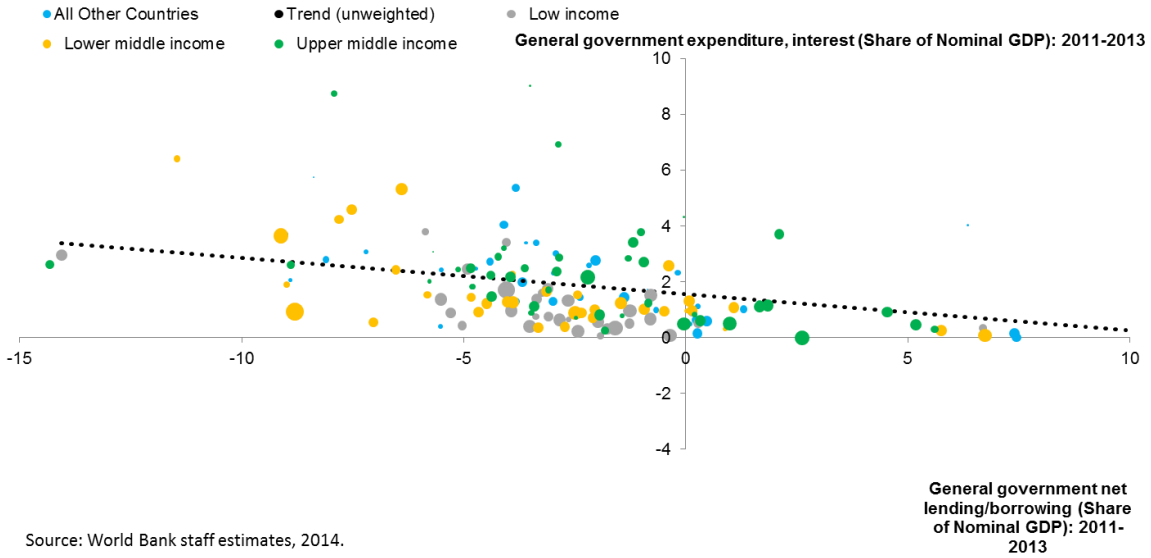
The issue of policy coordination assumes even greater importance in time of fiscal stimulus or consolidation. *Ex-ante* the level of debt is mainly determined by fiscal policy, although *ex-post* the debt composition can play an important role. Inappropriate fiscal, monetary, exchange rate, or financial policies generate uncertainty in financial markets regarding the future returns available on local currency-denominated investments, thereby inducing investors to demand higher risk premia. Borrowers and lenders alike may refrain from entering into longer-term fixed rate commitments, which can severely hinder debt managers' efforts to protect the government from excessive refinancing, interest rate and foreign exchange risk.

Debt managers should provide the fiscal authority with an assessment and alternative scenarios on the amount of debt that can realistically be absorbed by the market without a substantial increase in interest rates or in risks. This amount also depends on the specific risk features underlying the debt: indeed investors may have regulatory and operational limits in holding this debt because of its risk as measured by the rating level or other risk criteria. If these aspects are not taken into account, an imbalance between supply and demand may arise resulting in an increase in the cost of debt, with negative impact on debt sustainability. Although the responsibility for ensuring prudent debt levels and conducting DSA lies with fiscal authorities, debt managers should monitor any emerging constraints in future borrowings , based on portfolio

risk analyses and market reactions observed when conducting debt management operations, and inform the government on a timely basis. Figures 1 and 2 show how the recent few years (2011-13) have seen the emergence of higher debt levels and larger fiscal deficits that the pre-2008 global crisis period (2000-07). This is translating itself into higher annual interest payments (as a share of GDP) in several developing countries (Figure 3). In addition, the Debt managers should monitor changing investor behavior, anticipate arising constraints in the external and domestic market, and come up with solutions for coping with increasing funding needs.

Figure 3.

General government expenditure, interest (Share of Nominal GDP): 2011-2013 vs General government net lending/borrowing (Share of Nominal GDP): 2011-2013 in All Countries



Source: World Bank staff estimates, 2014.

Debt managers' analysis of the cost and risk of the debt portfolio may contain useful information for fiscal authorities' own debt sustainability analysis (and vice versa), including vulnerabilities arising from exposures to exchange rate risk, interest rate risk and refinancing risk. In addition, debt managers play an important role in setting the composition of the debt through their borrowing activity in financial markets on behalf of the government, which places them in direct contact with market participants. Their observation of investor behavior in both primary and secondary markets, as well as their discussions with market participants, may provide useful insights into the willingness of investors to hold that debt. This window on investors' views can be a useful input into fiscal authorities' assessments of debt sustainability and may help policymakers identify any emerging debt sustainability concerns. There should be appropriate communication channels to share this information with fiscal authorities on a timely basis.

In this context, the session focuses on the IMF's debt limits policy that considers the evaluation of the proposed borrowing plans as one component of the fiscal program of the government, while drawing also on the assessment of vulnerabilities in the DSA. This session also highlights

the relevant experiences of how to coordinate fiscal and debt management policies with an indicator that assesses the "fiscal space". This reports on the findings of the recent IADB study on how countries in Latin America conduct fiscal policy that takes into account the long-term debt implications of the country's fiscal policy stance.

Conclusion

The current financing landscape facing both developed and developing countries has strongly demonstrated the need for debt managers, fiscal and monetary authorities, and financial sector regulators, to share an understanding of the inter-linkages between the policy decisions they make. Given the interconnections and interdependencies between their respective policy instruments, it is important to understand how the policy instruments operate, how they can reinforce one another, and how policy tensions can arise. Although the responsibility for ensuring prudent debt levels and conducting debt sustainability analyses lies with fiscal authorities, debt managers should be aware of any emerging debt sustainability and fiscal risks emanating in the economy when conducting debt management operations, and inform the government on a timely basis. The session highlights the issues encountered in practice while coordinating fiscal policy and debt management operations through the experiences of selected countries.

Issues for Discussion

- Debt and fiscal sustainability in the face of rising infrastructure needs in developing countries.
- Debt ceilings and prudent debt management and new borrowing decisions
- Role played by prudent debt management and fiscal policies in reinforcing one another and helping to lower interest rates.
- Assessment of debt vulnerabilities through debt conditionality, DSA and evaluation of government's public investment and associated borrowing plans.

References

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