Sovereign Debt Management Forum 2014

Summary Note for Breakout Session 1

Coordination between debt management and monetary policy: the cases of large capital inflows and central banks that issue their own securities

I. Summary of session

The moderator stated the session objective as exploring the situations where coordination between debt management and monetary policy could be difficult to achieve and the manner in which potential conflicts could be mitigated or resolved. The session included three presentations: Mr. Peter Stella, international consultant, made the case for harmonizing the roles of Central Banks (CBs) and treasuries in the domestic debt market; Mr. Carlos Linares Head of the Peruvian Treasury presented the case study of Peru; and Ms. Sharon Almanza, Deputy Treasurer from the Bureau of Treasury and Mr. Zeno Abenoja, Director from the Bangkpo Sentral, presented the case study of The Philippines. While Mr. Stella focused on the problems created when CBs act as managers of their own debt and the potential solutions to address them, the cases of Peru and The Philippines explained the tensions that emerged between the debt management and monetary policy over the last 10 years and the response given by the policy makers.

II. Key insights from presentations and discussion

International sound practice indicates that institutional arrangements should allow for a clear separation of debt management policy and monetary policy objectives and accountabilities. To the extent that each policy counts on its own instruments and objectives, this separation facilitates both public policies achieving their objectives and evaluating the performance of policy makers. Unfortunately in many countries CBs issue their own debt to implement monetary policy and this complicates the separation mentioned above.

As Mr. Stella explained, a CB could end up issuing its own debt for multiple reasons: finance the bail out of financial institutions (banking crisis), legal restrictions to acquire government securities, or, unavailability of a volume of government securities large enough to withdraw the excess liquidity in the banking system. The growth of the CB debt stock beyond certain level is bound to pose important challenges both to the CB itself and to debt managers.

CBs in Peru and The Philippines experienced a rapid increase in their liabilities after the middle of the last decade as they funded a significant accumulation of foreign currency (FX) reserves. As the return on

their FX reserves was significantly lower than the interest paid on the liabilities, the P&L quickly deteriorated showing up as quasi-fiscal losses. As the net capital inflows were also appreciating the currencies of the recipient countries, FX assets were losing value vis a vis local currency (LX) liabilities compounding the CB losses. In Peru the CB had 3 years of straight losses: 2011-2013 and the Ministry of Economy and Finance (MEF) was holding high balances with the CB to mitigate the cost of sterilization. The CB in the Philippines also experienced important losses in 2012 and 2013.

Treasuries on the other hand face the challenge of sharing the domestic market with another issuer from the public sector. To avoid competing with CBs, Treasuries often accept leaving the short segment of the curve to the CB, keeping the medium and long-term tenors for themselves. The cost of this solution is the fragmentation of the domestic debt market as the debt instruments placed by both issuers are not perfect substitutes. As showed in the presentations by Peru and The Philippines, when monetary policy is under pressure, interest rates on short-term instruments could diverge significantly by issuer.

The fragmentation of the domestic debt market is a problem because it hinders the development of a full yield curve that is the basis for the pricing of the financial products. As it is the case in the two country cases, access to CB debt instruments is usually restricted which inhibits the arbitrage between long and short tenors limiting the price discovery process and the representativeness of the curve. Market fragmentation also reduces liquidity and therefore may increase the funding costs to the government.

This problem of fragmentation reflects something more fundamental: the issuance of debt by the CB is driven mainly by monetary policy objectives which not always coincide with the debt management objectives.

Debt managers of Peru and the Philippines insisted in the importance of having a deep and active market for government securities a found that this is a more difficult undertaking when CBs issue their own debt for monetary purposes. Also for CBs market segmentation limit the transmission of monetary policy, however this angle was not discussed in the session.

To solve with the problems created by the fragmentation of the domestic debt market, countries from diverse regions as Mexico, Israel, Brazil, and Singapore have replaced central bank domestic debt instruments with treasury instruments. As presented by Mr. Stella, although the problem is the same in different countries the approach needs to be tailored to the particular circumstances: legal and institutional framework, effects on the debt figures, among others.

Replacing CB debt may not always be feasible. Peru is willing to explore ways. If not feasible, the coordination between debt managers and central bankers is of paramount importance to reduce the tensions and facilitate each entity achieve its own objectives.

III. Conclusion and issues for further discussion

1. Moving towards a single debt instrument allows monetary policy to operate without the distraction of having a "dual" operational role while it gives the debt manager the possibility of taking a comprehensive approach toward managing sovereign domestic and foreign debt.
2. Replacing central bank domestic debt instruments with treasury instruments could also facilitate the development of the domestic debt market, enhance the liquidity of the remaining instruments and improve the transmission mechanisms of monetary policy.
3. If consolidation of instruments is not an option coordination between debt management and monetary policy is a second best. For example, The Philippines case illustrated that by reducing foreign currency borrowing when the CB sterilization needs increase helps reducing the overall fiscal cost of debt operations.
4. Issues for further discussion. What factors make it difficult to replace CB debt for Treasury instruments? How can these barriers be confronted? What other problems can illustrate tensions between debt management and monetary policy?