FINANCIAL ADVISORY & BANKING

Sovereign Debt Management Forum 2014

Background Note for Breakout Session 1

Coordination between debt management and monetary policy: the case of large capital inflows

Introduction

International sound practice indicates that institutional arrangements should allow for a clear separation of debt management policy and monetary policy objectives and accountabilities[1]. 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.

Most advanced economies follow this principle making the central bank (CB) solely responsible for monetary policy while the ministry of finance (MoF) is in charge of setting policy for government debt management[2]. CBs can use a variety of tools to affect the liquidity in the banking system and attain its main objective of keeping inflation under control. MoFs on the other hand manage the composition of the government borrowing as the tool to achieve debt management objectives usually expressed in terms of lowering the funding costs in the medium term at prudent risk levels and contribute to domestic debt market development.

Separation of policy objectives and policy implementation may not always be straightforward as there are important policy interdependencies. A widening deficit in the balance of payments (BoP) for example may force the debt manager to support the CB exchange rate regime by borrowing in foreign currency in spite of cost-risk or market development considerations. To manage these potential conflicts debt managers and monetary authorities need to share an understanding of the objectives of debt management, monetary and financial sector policies given the interconnections and interdependencies between their respective policy instruments[3]. A formal debt management strategy that takes into account such interdependencies goes a long way in facilitating policy coordination.

This session presents cases in which tensions between debt management and monetary policy arise and illustrates how they are addressed in different countries.

Policy coordination under large capital inflows

Tensions between debt management and monetary policy are common in emerging market economies under significant foreign currency (FX) inflows stemming from a sustained increase in the external demand for its goods and services and/or in capital inflows. The resulting windfall of foreign exchange creates a challenge for CBs that are obliged to sterilize the surge in FX reserves to keep inflation under control[4].

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[1] WB IMF (2014), "Revised guidelines for public debt management". See 1.3 Coordination with monetary, fiscal and financial sector policies.

[2] Yet it is common in emerging market economies for CBs to act as MoF agents in domestic debt operations with mandates that vary from country to country and that may include running the auctions of domestic government securities, serving as depository and acting as paying agent .

[3] WB IMF (2014), See 1.3 Coordination with monetary, fiscal and financial sector policies.

[4] Building up the foreign reserves and sterilizing its impact on the money supply is not the only policy option; CBs could refuse to buy the foreign exchange inflows and let the local currency appreciate.

Monetary policy authorities often rely on several tools to manage the impact of large capital flows including adjusting reserve requirements imposed on the banking system, expanding the repos with Government Securities (GoS), or, increasing the issuance of CB securities. The firmer the CBs stance against the appreciation of the local currency (LX) the larger the sterilization requirements and the corresponding cost. Since CBs usually bear the cost of monetary policy, these operations tend to deteriorate their P&L and could potentially impair their policy independence.

This environment that makes CB's life more complicated is usually welcomed by debt managers since FX windfalls are typically accompanied by abundant supply of cheap funding. Incentives to borrow in FX intensify as lower FX interest rates combine with pressures for the revaluation of the LX. The revaluation pressures also attract foreign investors to the government securities in LX that become a vehicle for *carry trades* with investors willing to accept unusually low interest rates as they bet on the rising value of the LX. These inflows tend to depress interest rates in the front end of the yield curve providing an incentive for the debt manager to shorten the tenors in the borrowing program.

In general, policy tensions increase when the MoF opts for FX funding as it compounds capital inflows and sterilization pressures to the CB. When the CB's response is to sterilize with its own securities new tensions arise as this affects the MoF's plans to develop a domestic market for government securities as presented below.

Policy coordination needs arising from issuance of CB securities

Another source of tension between debt management and monetary policy emerges when CBs issue their own instruments in the domestic market[5]. While MoF debt is born from the need to finance budget deficits, CB debt tends to be associated with the need to absorb liquidity related to a banking crisis, or, with the inability to use or insufficient supply of GoS needed to conduct sterilization operations in the secondary market.

The objectives of each issuer are different: while MoF aims to finance the government budget at the lowest risk-adjusted cost and contribute to market development, CBs manage debt instruments primarily to ensure that liquidity conditions are consistent with their operational targets—usually a short term interest rate[6]. In consequence, the existence of two sovereign domestic debt issuers with their own particular objectives leads to a bifurcated domestic debt market which implies smaller individual issue sizes, less liquidity and in the end higher financing costs for both issuers.

The drawbacks of fragmented markets have led various countries to seek ways to bring about debt market unification by providing CBs with a stock of government securities that can be used for monetary

[5] This may or may not be associated with the windfall of foreign exchange inflows

[6] See Peter Stella (2014). Refining the Coordination of Monetary Operations and Government Debt Management. Working Note, page 14

policy implementation thereby eliminating CB securities[7]. Several mechanisms for the unification have been used by different countries including the capitalization of the CB with GoS, the CB gradually buying GoS in the secondary market, the MoF depositing a pool GoS in a special account in the CB, etc. Mechanisms that have been successful in achieving this aim have taken into account and been molded by the particular country-specific institutional arrangements for cooperation; MoF-central bank financial relations; the legal and economic environments facing the country as well as the degree of financial market sophistication at the start of the unification[8].

Conclusion

Some economic environments make coordination between debt management and monetary policy difficult. A case in point is that of emerging market economies experiencing sustained windfall of foreign exchange from export of commodities, remittances, or, capital inflows. Under these circumstances debt managers need to consider the composition of their borrowings to assist CBs face the challenges these FX inflows pose to monetary policy. Lack of coordination may lead to the intensification of revaluation pressures, increase the needs for sterilization and worsen of the CB's balance sheet. Another potential source of tension between debt management and monetary policy arises from CBs issuing their own securities for monetary policy implementation. Since CBs and MoFs have different objectives, their respective strategic approach to debt issuance is also likely to be different and therefore mutually inconsistent with negative ramifications for market development. To avoid the negative effects of fragmentation on the development of the domestic debt market many countries have adopted mechanisms that allow CBs conducting monetary policy operations with GoS rather than with their own.

Issues for Discussion

- Under heightened pressure of foreign exchange inflows what actions were taken by debt managers and monetary authorities to improve coordination?
- What was the vehicle for policy coordination? Was it formal? How did it work?
- Was there a formal debt management strategy in place? Did it properly take into account the environment of FX inflows?
- Looking backwards what else could have been done and what stopped the policy makers from taking those actions?
- Looking forward, what can be done to improve policy coordination?
- Is the issuance of CB instruments a problem to debt management? Why?
- Has the CB considered transitioning from conducting monetary policy with C-Bills to T-Bills? What are the pros and cons?
- When is it possible to unify the debt market and when do countries need to settle for a second best?
- Does the debt manager take into account the cost of monetary policy implementation when designing strategy and borrowing plans?
- Are there policy coordination mechanisms that can help discuss market fragmentation?

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[7] Market unification, as described here, may not always be a feasible option. Countries where this is the case, usually try to coordinate the timing and sector of the curve where issuers operate

[8] See Peter Stella (2014), page 15

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