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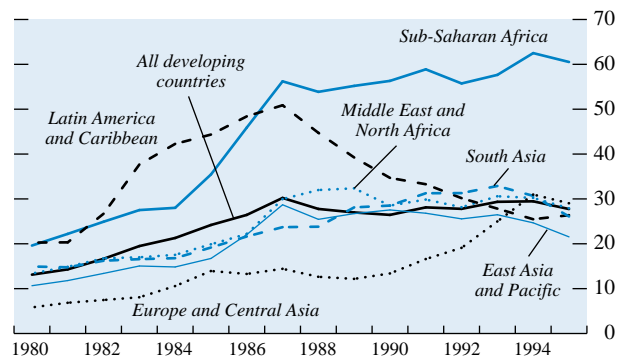
External Liability Management

Although greater access to international markets has been highly beneficial for emerging market countries, it has also exposed them to the vicissitudes and volatility of global financial markets. In addition to the macroeconomic challenges posed by relatively large and potentially volatile flows, the large external foreign currency debt of developing countries also makes them vulnerable to swings in international exchange rates and interest rates. The vulnerability of countries to speculative attacks is also often exacerbated by a weak external debt position. Indeed, the benefits of prudent macroeconomic policies have been compromised at times by the fiscal consequences of losses associated with these exposures.

In emerging market countries, sovereign exposures to currency risk can be broadly gauged by the amount of external public debt (Figure 16). In 1996, the outstanding stock of sovereign debt issued or guaranteed amounted to 25 percent of their combined GNP (\$1.5 trillion) and three times their foreign currency reserves. Roughly half of the external debt of emerging markets was exposed to foreign interest rate risk: a fifth of that was short-term (less than one-year maturity), and two-fifths of the remaining long-term debt was at variable rates.

During the past two decades, a number of emerging markets have experienced the damaging consequences of adverse movements in international currencies and interest rates. In the early 1980s, the debt-servicing burdens of some Southeast Asian, Latin American, and African countries were severely affected by the appreciation of the dollar, the worldwide increase in interest rates, and the decline in commodity prices. In the first half of this decade, the debt burden of several Asian countries increased significantly owing to their large and unhedged exposure to the Japanese yen. A third of the increase in the dollar value of Indonesian external debt between 1993 and 1995, for example, was attributable to cross-currency movements, particularly the steep appreciation of the yen. The exposure of Indonesia to the yen has been especially costly as about 90 percent of its export revenues are denominated in dollars, while at the time 37 percent of its external debt was denominated in yen. In the Philippines, which has a third of its external debt denominated in yen, the appreciation of the yen accounted for about half of the increase in the dollar value of its ex-

Figure 16. External Long-Term Public and Publicly Guaranteed Debt Outstanding
(In percent of GNP)



Source: World Bank, Global Development Finance database.
Note: The groupings are as shown in the source.

ternal debt in 1995. In China, the appreciation of the yen is estimated to have increased the servicing costs of the public debt by about \$5 billion. The subsequent depreciation of the yen in 1996 offset some of the losses incurred by these countries.

The large foreign currency exposure of emerging market countries can be explained by a number of historical and structural factors, including the lack of domestic borrowing instruments, the large capital requirements of development and infrastructure projects, and a large share of official financing (multilateral and bilateral), which tends to be denominated in donor countries' currencies. More recently, as emerging market countries have gained greater access to international debt markets, the currency composition and the maturity structure of their external borrowing have tended to be driven to a large extent by a desire to reap the immediate fiscal benefits of borrowing in foreign markets with the lowest unhedged nominal interest rates. Several emerging markets (e.g., Argentina, Colombia, Mexico, Hungary, and Turkey) have issued foreign currency debt denominated in yen and deutsche mark in the last few years. Such borrowings often have been driven by the low coupon rates offered on these currencies, rather than by a debt strat-

egy based on minimizing the exposure of the revenue of the sovereign or country to these currencies. Following the negative impact of the appreciation of the yen in 1994–95 on their debt burden, a few of these emerging markets (Hungary and Mexico) have reduced or hedged their exposure to the yen.

Furthermore, the lower cost of foreign currency debt vis-à-vis domestic currency debt does not just reflect the creditworthiness of sovereign borrowers, but also the presumption on the part of external creditors that their claims would have implicit seniority over domestic claims. Such implicit seniority arises from a covenant structure (e.g., cross-default and *pari passu* clauses) that allows for extensive legal recourse on the part of the external creditor. For example, cross-default clauses covering a wide array of lenders and instruments may deny the sovereign borrower the possibility of restructuring only a narrow, but particularly pressing, instrument, such as short-term note obligations falling due, without precipitating an advancing of the due dates of most other short- and long-term issues. Similarly, *pari passu* clauses make it difficult for sovereign borrowers to negotiate a bond restructuring unless the great majority of, if not all, bondholders are included. Furthermore, in the absence of an agreement, creditors have extensive rights under existing statutes to seek legal recourse in the relevant jurisdictions. Such recourse could result in a significant impairment of trade and financial flows involving the debtor countries, as well as impairment of its external debt. In addition, there is also a growing perception among external creditors that effective international and regional financial arrangements—such as the IMF’s New Arrangements to Borrow and the new foreign exchange swap arrangements among some Asian countries—are evolving to reduce the risks of a systemic liquidity crisis. Indeed, the successful resolution of the Mexican crisis during the first half of 1995 is taken as tangible evidence that the risk of such a liquidity crisis has receded. It is unlikely that the cost of the macroeconomic adjustments needed to prevent an interruption in servicing external debt in the event of adverse economic developments is fully taken into consideration by a country when deciding on the size of external exposure.

The currency composition and maturity profile of the public debt contribute as much to the vulnerability to external shocks as the total volume of debt does, a fact demonstrated during the 1994 Mexican crisis.³¹ Indeed, financial markets’ concerns about Mexican risk were attributable primarily to the currency composition and maturity structure of the public debt rather than its size, which was relatively low by OECD standards—51 percent compared with an OECD average of 71 percent. The Mexican crisis underscored the dif-

ficulty and cost of refinancing a substantial volume of foreign currency debt maturing in turbulent foreign exchange markets.³²

When foreign currency or interest rate exposures can be hedged in swap markets, emerging market countries can issue external debt into receptive international markets without being concerned about movements in exchange rates among other countries or in interest rates. The increasing sophistication of international derivative markets has greatly expanded the possibilities of hedging the risks associated with borrowing in foreign currencies. Thus, borrowers can respond to opportunities to exploit market niches and expand their investor base, say, to include Japanese retail investors, without bearing the cross yen-dollar exchange rate risk. Similarly, they can use the interest rate swap market to manage the maturity structure of their external debt. However, the sovereign credit exposure incurred by the external swap counterparty is usually counted against the counterparty’s limit on exposures to a particular country.

The risks associated with a large net currency exposure, and the existence of deep and liquid domestic capital markets, are the main reasons why most industrial countries have negligible foreign currency debt. In recent years, several small advanced economies have significantly reduced their net foreign currency exposure. The New Zealand government decided in 1994 to eliminate its net foreign currency debt within three years, after concluding that foreign currency debt was adding significant variability to its net worth. Belgium and Denmark issue foreign currency government securities for replenishing foreign exchange reserves. Ireland restricts its gross foreign currency borrowing to the level of its maturing foreign currency debt. Others, like Spain and Sweden, issue foreign currency debt but use swaps or swap options to reduce or eliminate their foreign currency risk. Germany, Japan, and the United States do not issue foreign currency debt, while France and the United Kingdom issue most of their debt in domestic currencies and a small proportion in ECUs. In Italy, foreign currency debt represents about 6 percent of government debt. Canada’s budget deficit is funded entirely in domestic currency, and its foreign currency debt—issued to finance foreign exchange reserves—represents about 3 percent of its total public debt.

Foreign currency debt may also be issued to signal the commitment of the sovereign authorities to a policy of stable exchange rates or prices. In a game theory framework, policymakers signal the credibility and time consistency of their policies to the public and

³¹See International Monetary Fund (1995).

³²The vulnerability of the Mexican government to a financial crisis was exacerbated by the \$29 billion of tesobonos maturing in 1995, in light of the low level of foreign reserves (\$6.3 billion) as of end-1994.

financial markets by raising the cost of renegeing on their commitment. Alternatively, policymakers could signal their commitment to stable prices by issuing inflation-indexed bonds.

The management of the risk associated with external exposures requires significant technical expertise, sophisticated information technology, and strictly controlled internal management procedures, with disciplined enforcement of internal trading and exposure limits. Such risk management requirements are difficult to meet in the best of circumstances, and they are particularly difficult to implement fully in many of the emerging market countries. For example, it has proven difficult for some emerging markets to attract qualified and experienced staff, to build adequate information and control systems, and to develop the administrative controls necessary to manage overall exposures.

In the past few years, the governments of several industrial countries, as well as some emerging market countries, have responded to the new realities of mobile and volatile capital flows and integrated capital markets by significantly revamping their debt management practices. Three principles emerge from their experiences. First, debt management should be shielded from political interference to ensure transparency and accountability in its conduct. Second, debt management should be entrusted to portfolio managers with sophisticated knowledge and experience in risk management techniques, and their performance should be measured against a set of criteria defined by the ministry of finance. Finally, sufficient resources should be allocated to hiring high-quality staff and to acquiring sophisticated systems to support the staff.

To achieve such objectives, a number of countries (e.g., Austria, Belgium, Ireland, New Zealand, Portugal, and Sweden) have concluded that debt agencies with some degree of autonomy from the political sphere should be set up, and that benchmarks for the public debt—specifying its currency composition and maturity structure, and the limits within which it may be exposed to market risks—should be established. Granting debt agencies a separate structure and an autonomous status enables the government to charge the agency with a clearly defined objective and to organize it to achieve such an objective without being hampered by either the management structure or pay scale of the public sector. Typically, debt agencies have been mandated to use modern risk management techniques, hire experienced portfolio managers, and provide incentives for their staff to lower borrowing costs.

In Ireland, the government delegated in 1990 the borrowing and debt management functions of the Irish Department of Finance and the domestic government bond market operations of the central bank to an autonomous debt agency, the National Treasury Man-

agement Agency (NTMA).³³ The decision to establish the NTMA was justified on the grounds that it could be given clearly defined performance objectives and a degree of independence from other government objectives, and that the concentration of resources and expertise would result in better risk management and lower debt-servicing costs. The main objective of the NTMA is cast with reference to a low-risk medium-term benchmark portfolio and aims at funding maturing government debt and annual borrowing requirements at a lower cost than that of the benchmark portfolio while containing the volatility of annual fiscal debt-service costs. The currency composition of the Irish foreign currency debt benchmark is not made public, but deviations of the actual portfolio from the benchmark tend to be small. As of December 1995, the currency composition of the Irish foreign currency debt was as follows: 38 percent in deutsche mark, Dutch guilder, and Swiss francs; 28 percent in pounds sterling and French francs; 20 percent in U.S. dollars; 7 percent in ECUs; and 7 percent in yen and other currencies.

In New Zealand, the country's debt management strategy is implemented through the New Zealand Debt Management Office (NZDMO), which has been responsible for managing the public debt since debt management policy became disentangled from monetary policy objectives in 1988. Although the NZDMO has been placed in a division of the New Zealand Treasury, it maintains some degree of autonomy from the rest of the government, and has its own advisory board. The objective of the NZDMO is "to identify a low risk portfolio of net liabilities consistent with the Government's aversion to risk, having regard for the expected costs of reducing risk, and to transact in an efficient manner to achieve and maintain that portfolio." To minimize its net risk exposure, the NZDMO has gradually set the duration and currency profile of its liabilities to match that of its assets. As most of the government assets are denominated in New Zealand dollars, this strategy has entailed a gradual elimination of the net public foreign currency debt—which was achieved in September 1996—and a lengthening of the duration of the domestic public debt.

In Sweden, the National Debt Office (SNDO), which was founded in the eighteenth century, was moved from under the authority of the Parliament to that of the Ministry of Finance in 1989 to improve debt management practices.³⁴ The primary objectives of the SNDO are to minimize the costs of borrowing within the limits imposed by monetary policy and to finance the day-to-day government budget deficit at the minimum possible long-term cost. The board of the SNDO establishes separate benchmark portfolios

³³See Ireland, National Treasury Management Agency (1996).

³⁴See Sweden, National Debt Office (1996).

for the domestic and foreign currency debt and sets the permitted deviations from the benchmark portfolios. Within these broad guidelines, the SNDO manages the currency allocation, the maturity structure, and the market risk of the overall debt portfolio. As of December 1996, the composition of the Swedish foreign currency debt benchmark was 26 percent deutsche mark, 16 percent French francs, 12 percent U.S. dollars, 6 percent yen, and the rest in ECUs and ECU-basket currencies. The duration of the foreign currency debt portfolio was around 2.2 years, and borrowing was diversified along the yield curve to reduce shocks to specific parts of the yield curve and to bunch risks.

In the past two years, a small number of emerging market countries have also reformed their debt management practices and introduced benchmarks for their external debt. In Colombia, the Ministry of Finance and Public Credit has recently authorized a substantial increase in the staff in charge of managing and hedging its external debt portfolio, modernized its data systems, and consolidated the external borrowing strategies of the central government and the parastatal companies. Particular attention has been paid to attracting staff with the appropriate knowledge and experience in portfolio analysis and to offering competitive remuneration to retain the staff. The main reform introduced by the authorities is to manage the sovereign liability portfolio with respect to a set of low-risk benchmark parameters specifying exchange rate, liquidity, and interest rate risks. The benchmarks are to be based on structural economic factors and the risk

tolerance of the government. The restructured portfolio will include a higher portion of dollar debt (80–85 percent instead of the current 72 percent), in line with the currency exposure of government revenues, and a lengthening of the maturity profile of the external debt.

In Hungary, the Ministry of Finance took over the cost of servicing Hungary's net foreign debt in early 1997. While the National Bank of Hungary (NBH) will remain formally responsible for the interest payments and amortization of the foreign loans issued under its name, it will receive transfers from the Hungarian Ministry of Finance broadly equivalent to the cost of servicing that part of external debt in excess of the foreign exchange reserves of the NBH at end-1996. The authorities also established benchmarks for external debt management and have aligned through hedging operations the currency composition of external debt with that of the currency basket to which the national currency is pegged (70 percent deutsche mark, 30 percent dollar). Particular emphasis is being placed on lengthening the maturity of the debt and evenly spreading debt redemptions to avoid a clustering of debt maturities.

While some other emerging market countries, including Argentina, Mexico, South Africa, and Turkey, are currently reviewing their debt management practices, in other developing countries there is no separate debt management office, debt management objectives are sometimes cast in general terms, and there are often no formal guidelines on the currency composition and the maturity structure of the public debt.