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Addressing Debt Vulnerabilities: Role of Debt Strategies and Debt Managers
A Policy Perspective

by

Mr. Udaibir S. Das

Monetary and Capital Markets Department

International Monetary Fund

Sovereign Asset and Liability Division

Monetary and Capital Markets Department

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A Policy Perspective

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A Debt Crisis? Debt Default?

- Focus on global economic recovery and sustainable growth
- Emphasis on re-establishing economic and financial stability
- All round adjustment underway both within and across countries
- For some, adjustment is harder
- Some have reached a point where imbalances are acute and policy options are limited

A Debt Crisis? Debt Default?

- All efforts to account for the impact on the poor and most vulnerable
- Helping find necessary budgetary savings
- Ring-fencing social spending on the most vulnerable

Global economic crisis has hit the low-income countries very hard

- IMF responding with **unprecedented actions** to help support the efforts of its LIMCs
- Increased resources for LICs
  - Resources expected to boost concessional lending ($17 billion through 2014)
  - Interest payments zero on outstanding concessional loans (through 2011)
  - New set of lending instruments tailored to the diverse needs of LICs

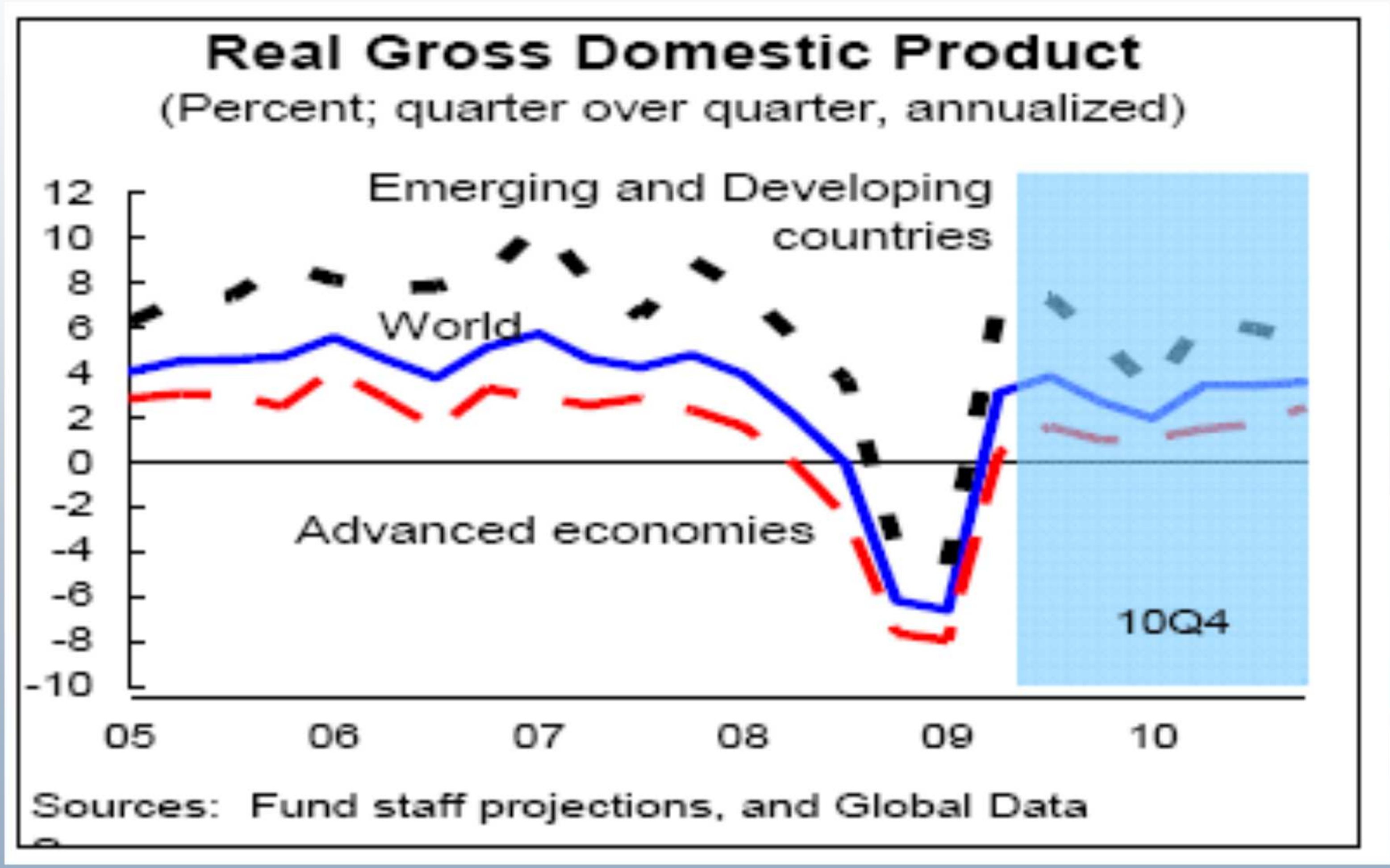
Key Take Always

1. **Rising** debt and fiscal vulnerabilities
2. Positive but **uncertain outlook** of debt capital markets conditions
3. **Renewed focus** on debt and risk management arrangements
4. **Importance** of new IMF/World Bank MTDS Framework
5. Significant **challenges** lie ahead for debt managers
6. **Macroeconomic** and policy oriented focus **key** for sustainable strategies

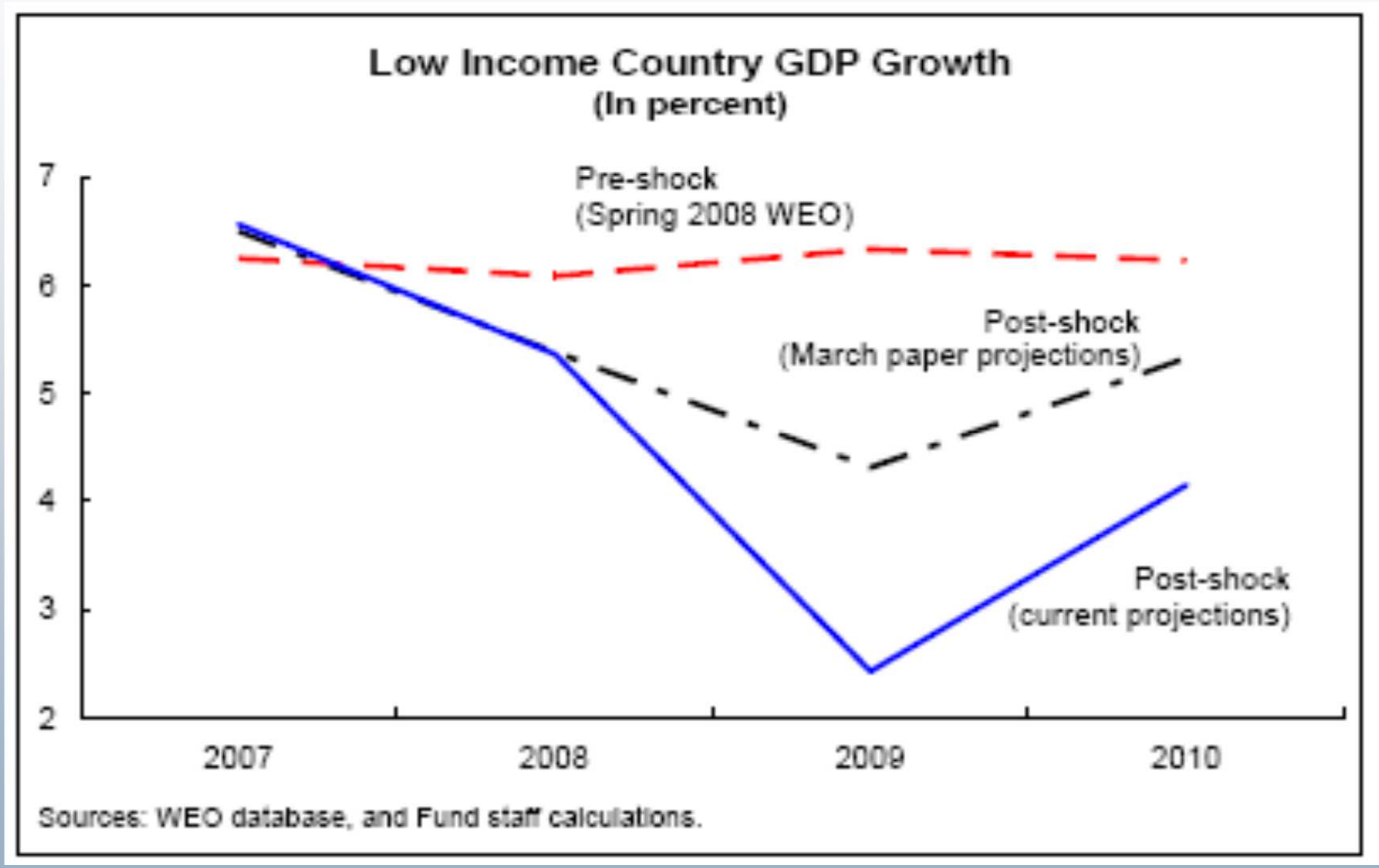
The Big Picture

Increased Deficit, Debt and Fiscal vulnerabilities as a result of the Global Economic Crisis

Global growth is projected to contract by 1.1 percent in 2009…

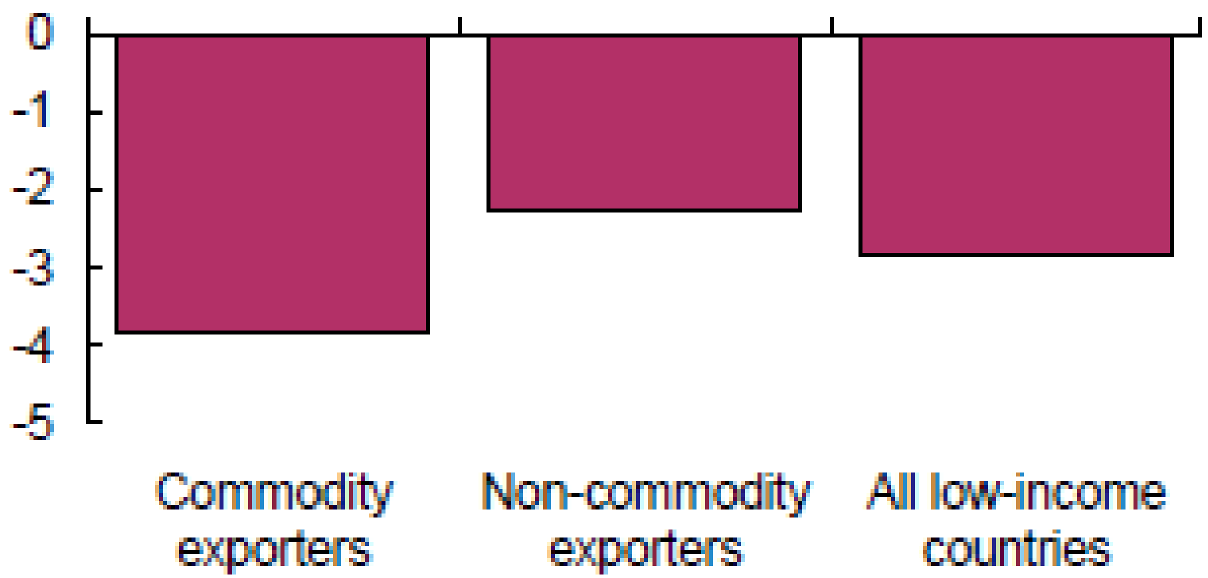


For LICs, growth projections have been revised down significantly since March



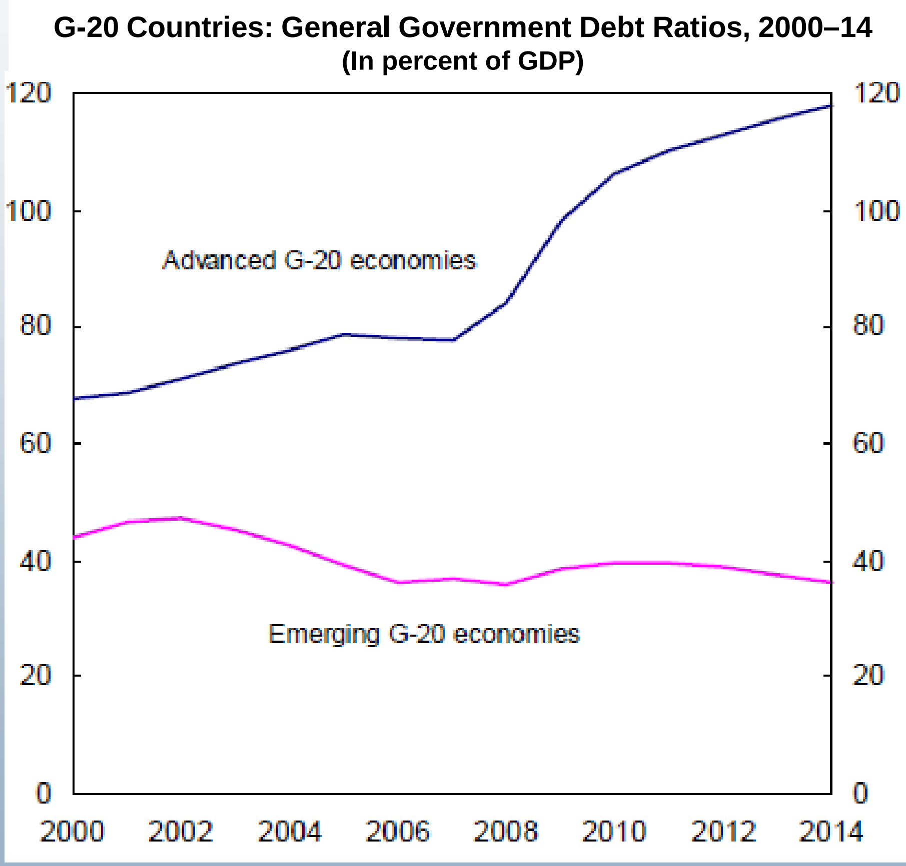
LICs' fiscal balances are projected to deteriorate by 2.8 percent of GDP in 2009

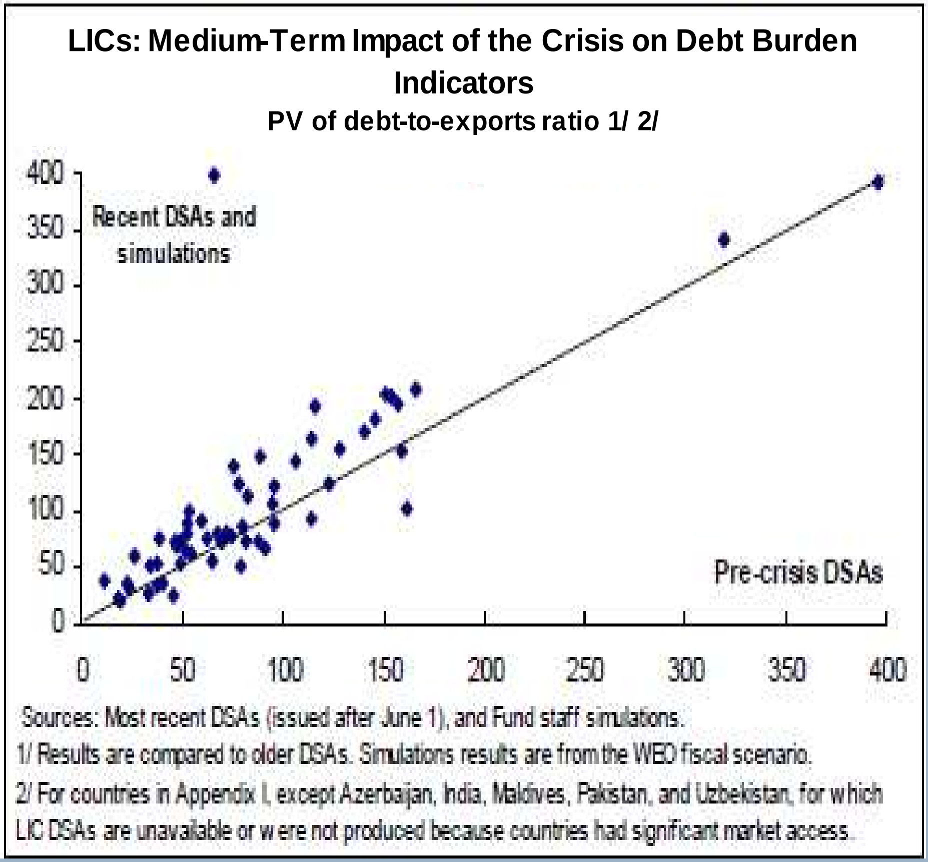
Change in Average Overall Fiscal Balance in 2009 relative to 2008, by Country Groups 1/
(in percent of GDP)



Source: Fund staff estimates and projections.
1/ Including grants.

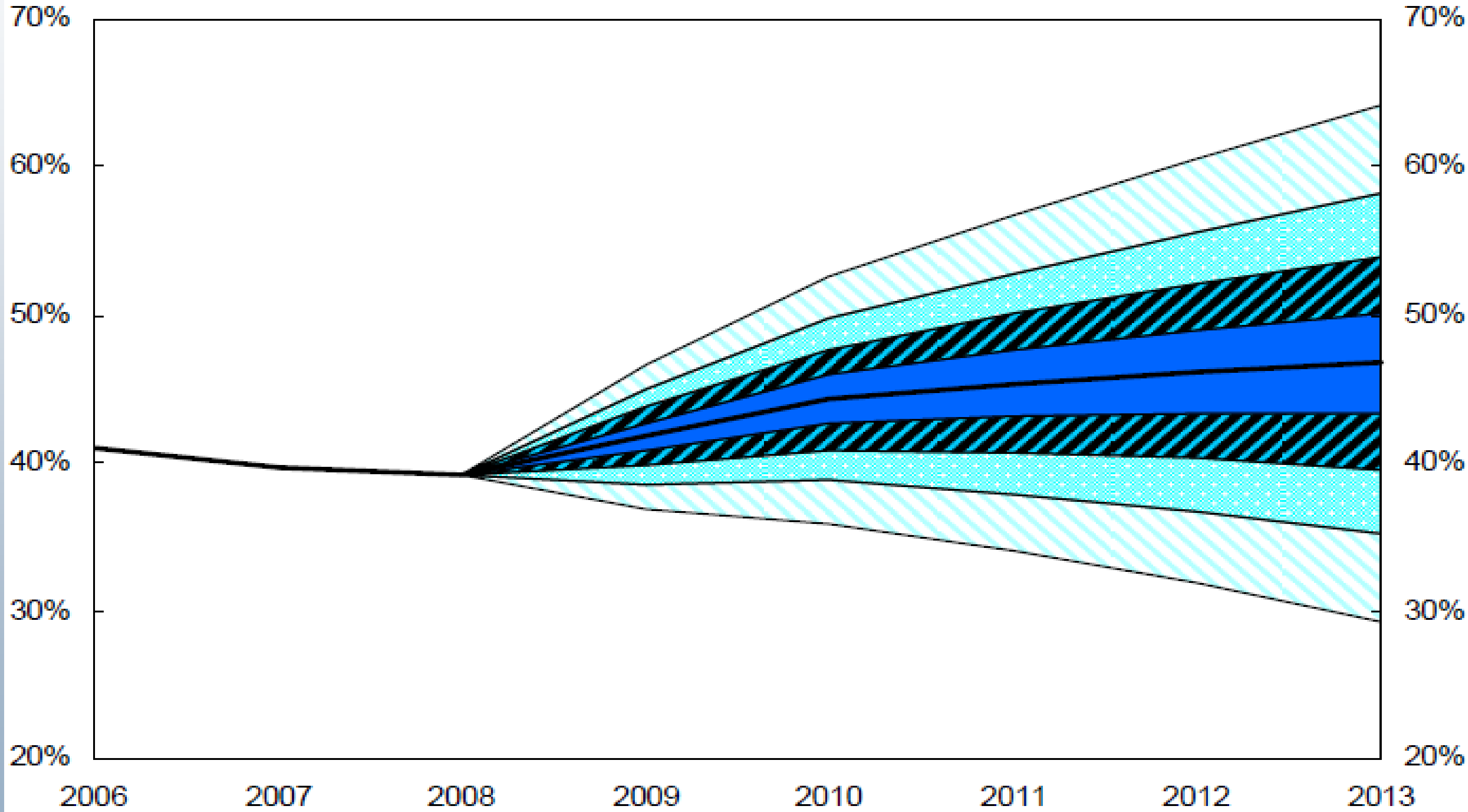
While fiscal policies in LICs are directed toward supporting growth, the risks to debt sustainability continue to rise





Stochastic simulations of medium-term debt paths confirm the risks of sustained increases in debt ratios…

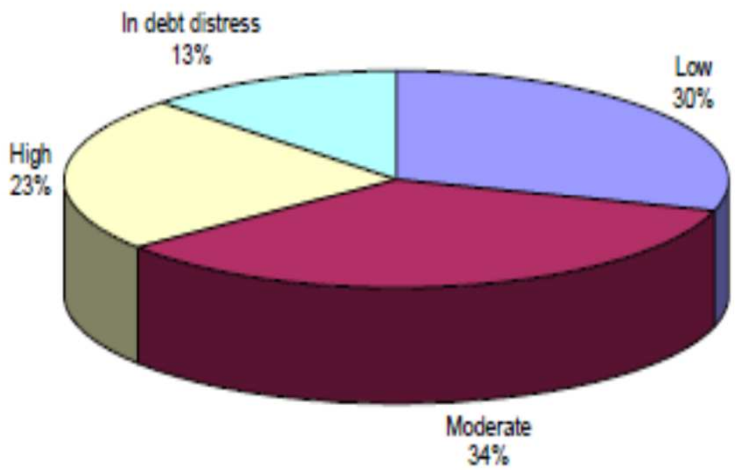
Representative Emerging G-20 Country: Evolution of Public Debt
(Gross debt in percent of GDP)



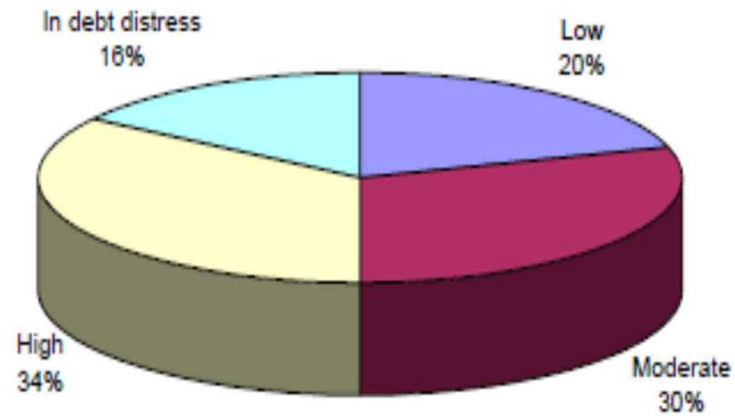
Note: Lines represent the distribution (in deciles) of the simulated debt-to-GDP ratios. Staff estimates based on the October 2009 WEO.

...and a greater probability that more LICs could move into debt distress scenarios

Current Risk of Debt Distress (Pre Crisis) 1/ 2/



Post Crisis DSAs 2/ 3/



Source: Fund staff estimates.

1/ Based on debt sustainability analyses available as of end-July 2009, except for Gerorgia (low risk), which experienced a deterioration in its risk of debt distres

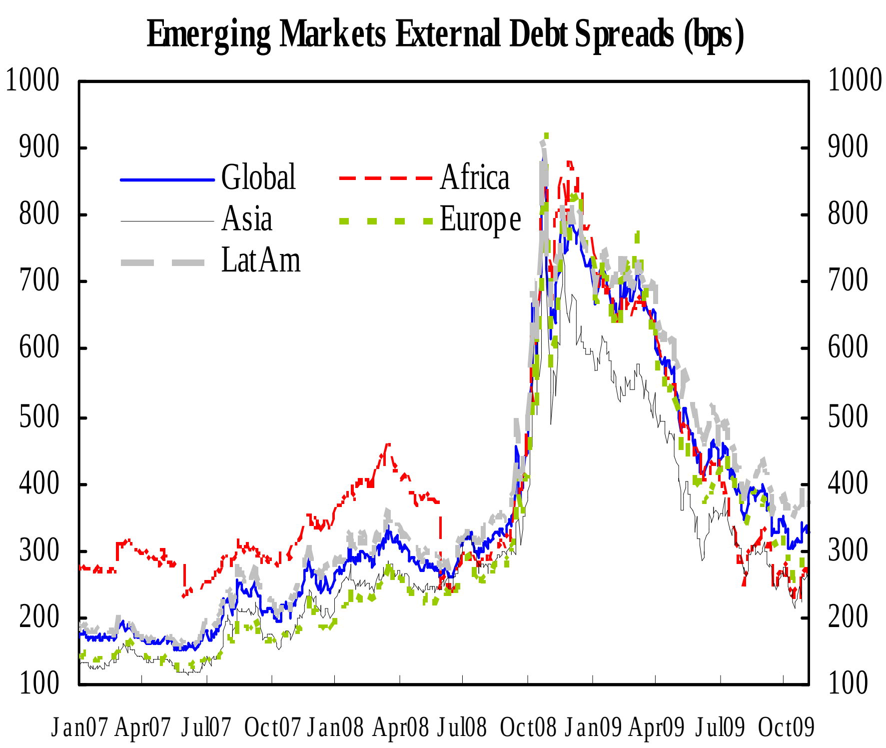
2/ For all countries included in Appendix I, except Azerbaijan, India, Maldives, Pakistan and Uzbekistan, for which LIC DSAs are unavailable or were not produced because countries had significant market access.

3/ Based on recent DSAs and Staff simulations. The post-crisis risk ratings resulting from staff simulations are based on the worst-case scenario that all identified debt vulnerabilities automatically translate into a deterioration of the country's pre-crisis risk of debt distress rating.

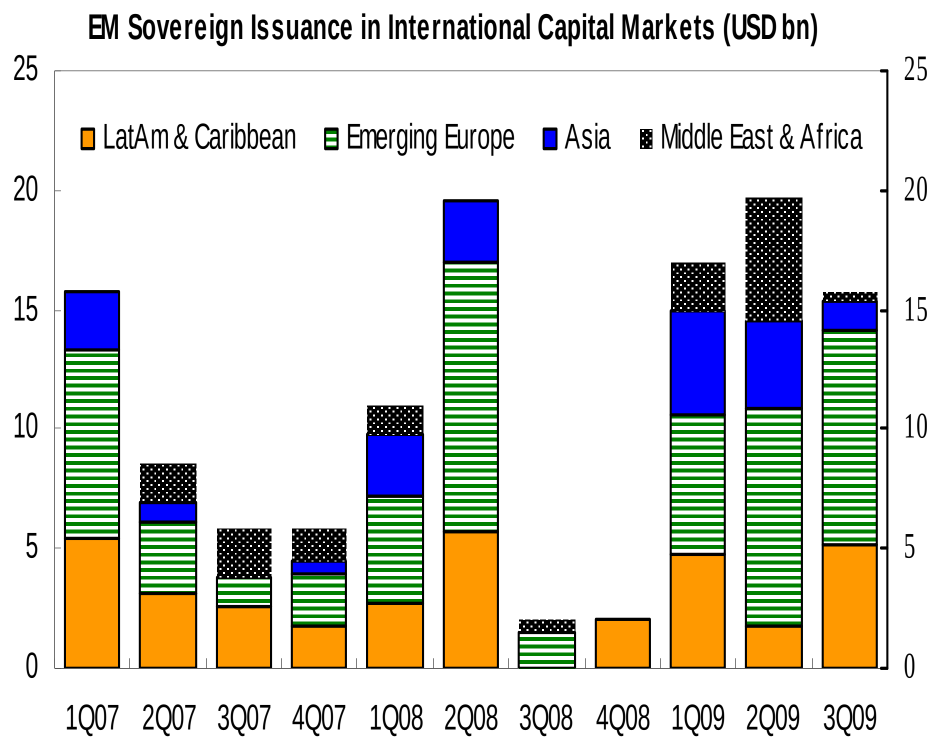
Another Big Picture

Evolution of Debt Capital Markets Conditions

After the shutdown in international debt markets in 4Q08, financing conditions facing EM issuers have improved considerably

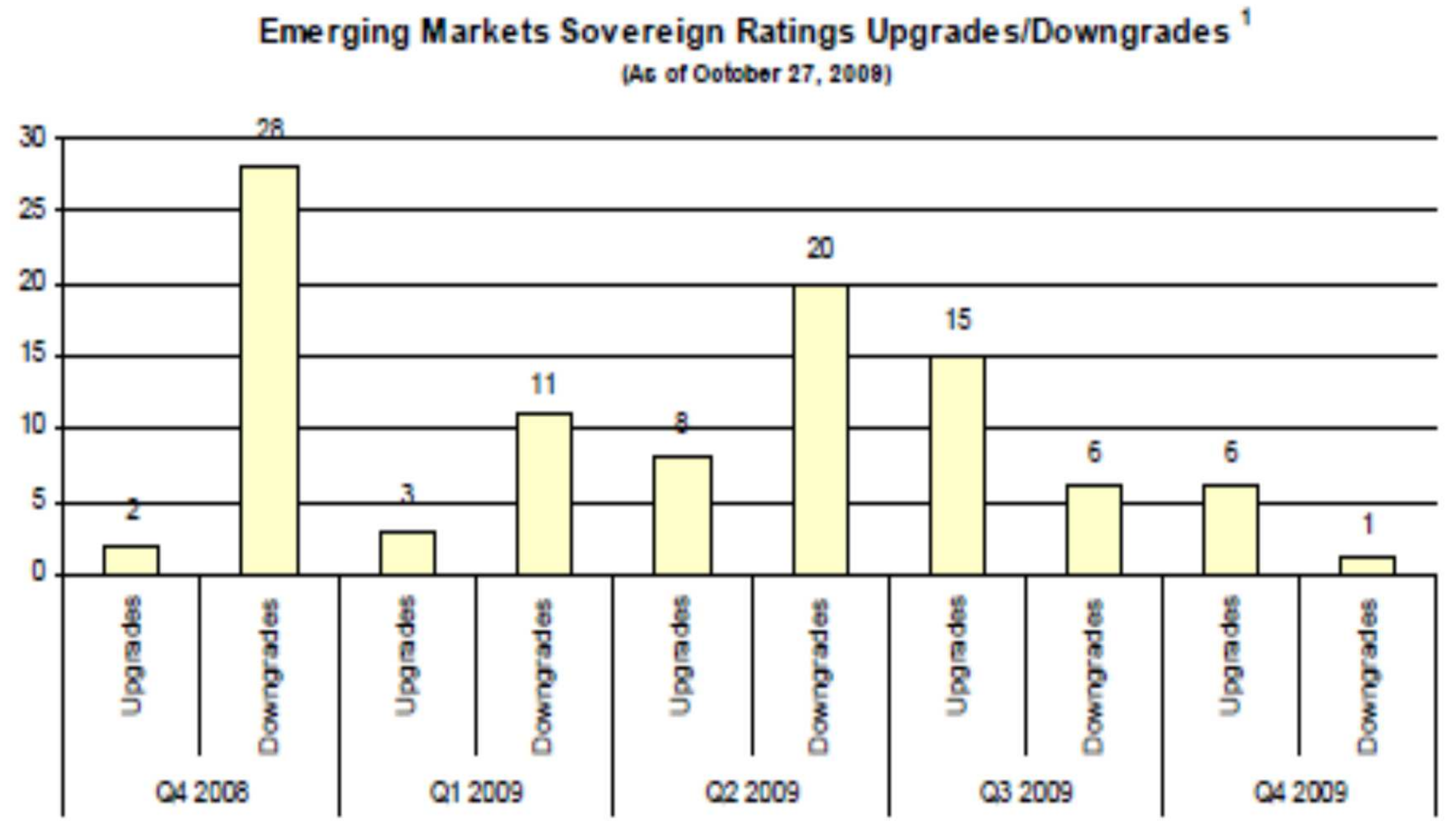


Source: JP Morgan Chase, Bloomberg



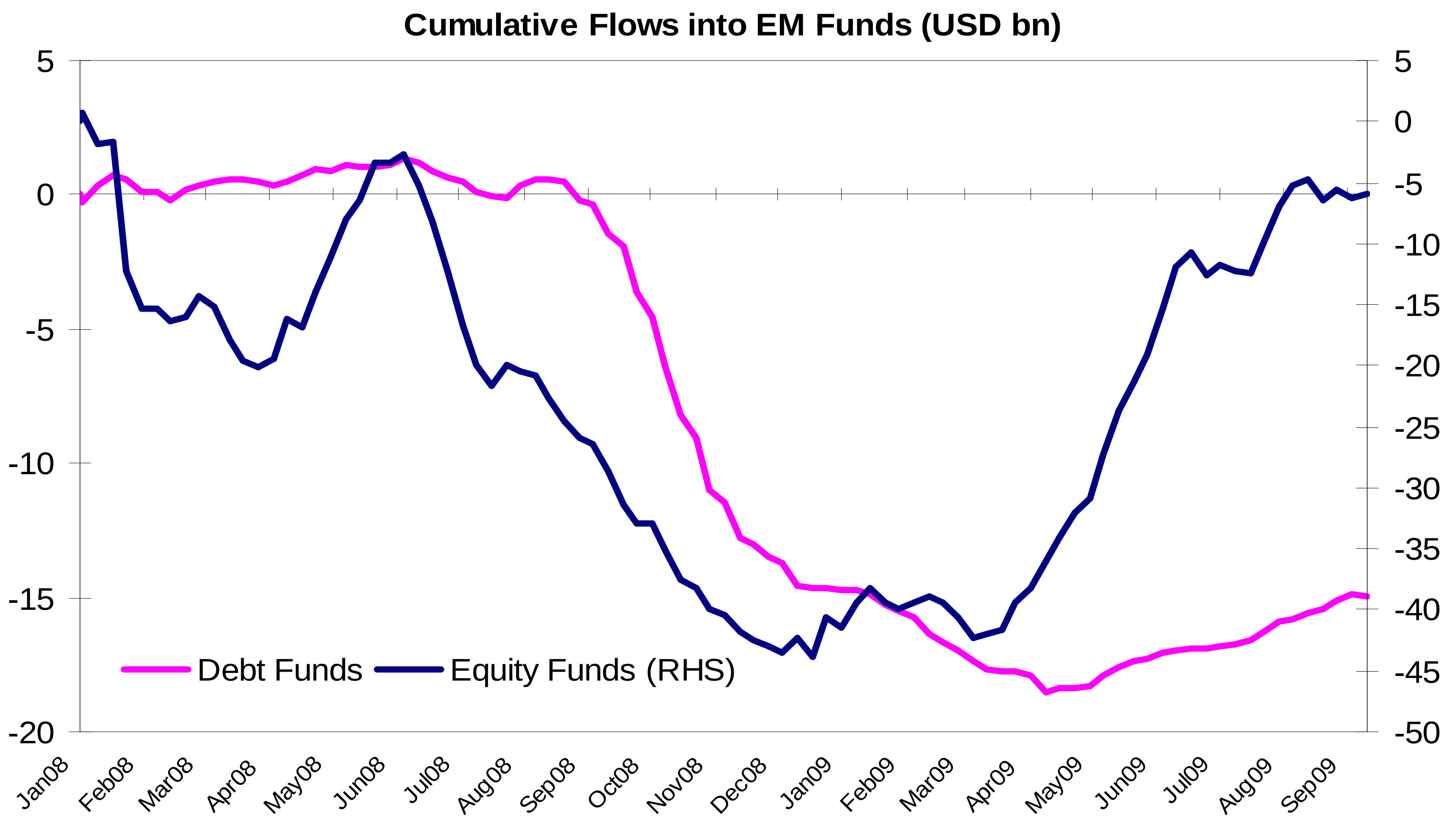
Source: Dealogic

In 3Q09, sovereign upgrades outnumbered negative rating actions for the first time since the beginning of the crisis



1 All rating agencies combined. Does not include ratings affirmations. Includes outlook changes from May 2009 onwards.

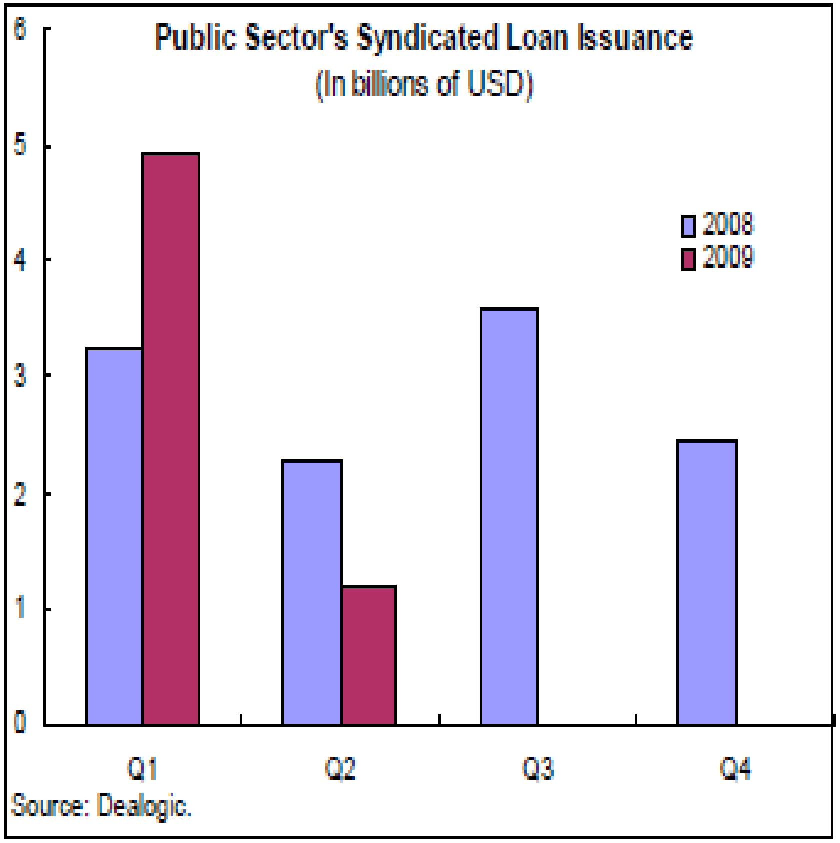
Strong flows into EM debt bode well for the sovereign issuance pipeline building up moving into 2010

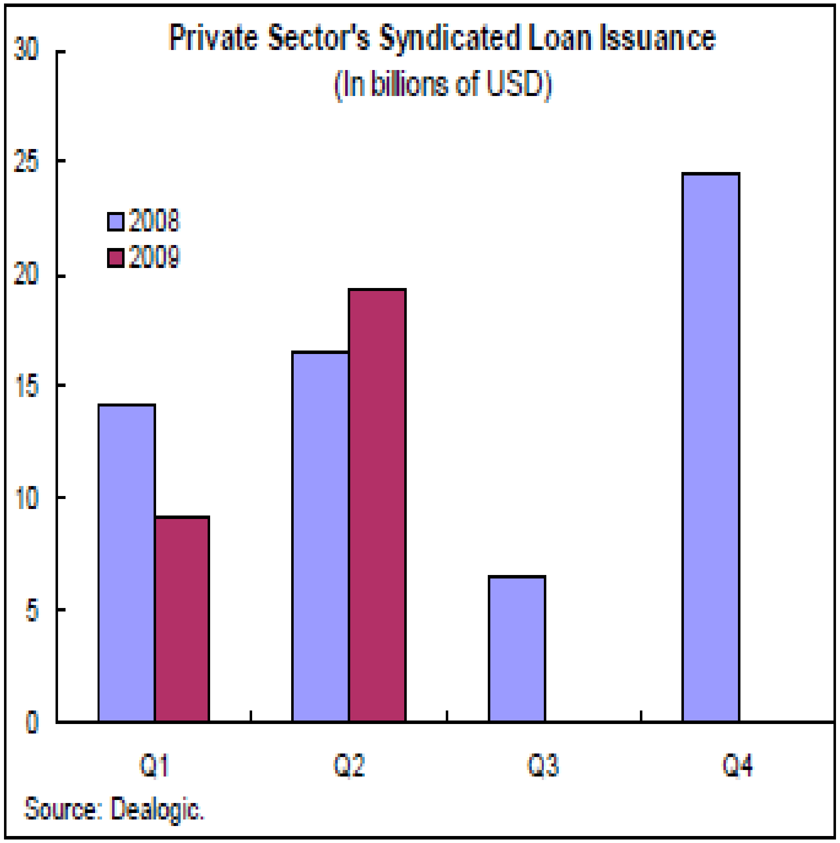


* As of September 11, 2009

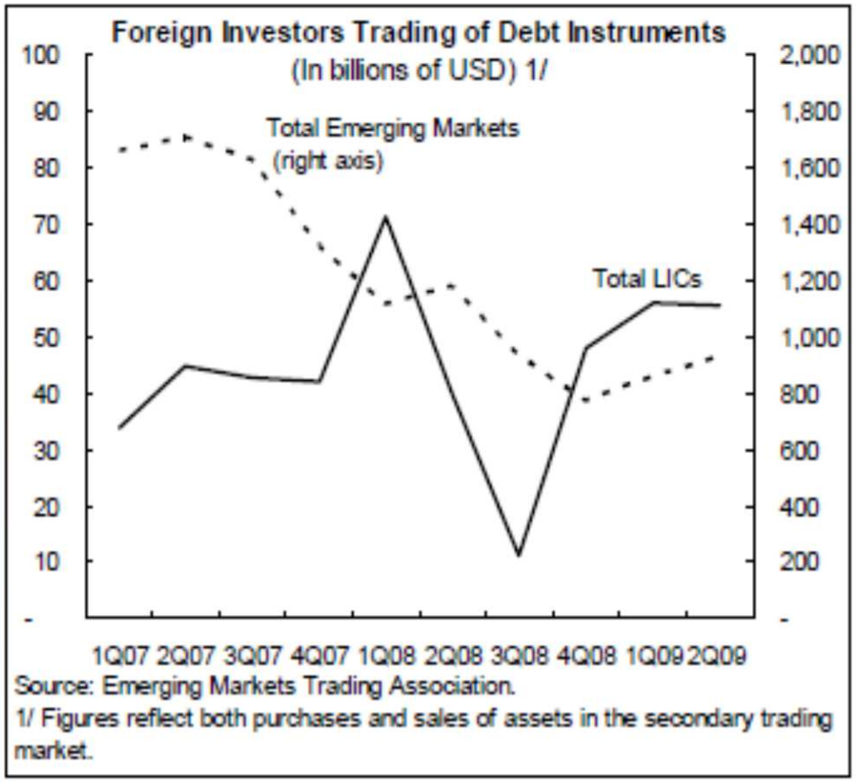
Source: EPFR Global

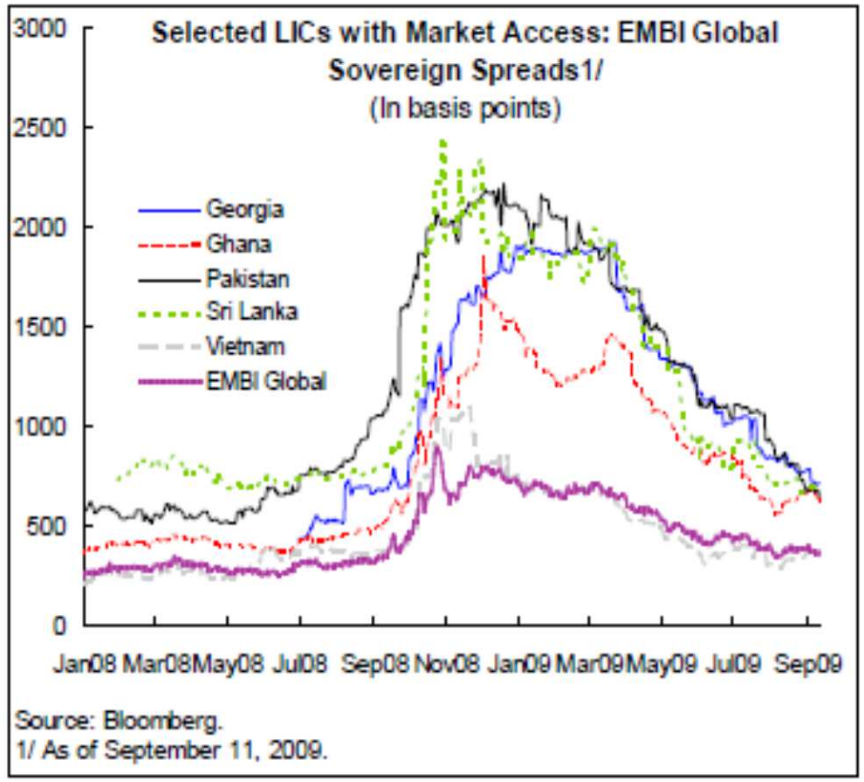
Similarly, LIC sovereigns access to financing has improved, particularly in the external syndicated loan market





Conditions in international primary and secondary bond markets for LICs have also started to eased…





…with Sri Lanka becoming the first to tap international markets after the onset of the crisis (bid-to-cover of 13.6 times)

But the improvements in sentiment and debt supply conditions are not irreversible

- **Heightened volatility.** Significant downside risk remains for EM sovereign bonds

- **Increased borrowing costs.** Surge in bond supply could lead to higher interest rates

- **Portfolio deterioration.** Could trigger weakening of debt structures/composition

Role of Debt and Risk Management

Why is debt management important for LICs in the context of increased financing needs and improving debt market conditions?

- **Improved access to funding. Better** position to benefit from the movements in sovereign spreads

- **Increased use of non-concessional borrowing from multilaterals.** More likely to qualify for non-concessional IMF lending

- **Renewed interest from foreign direct investors.** Establish that long-term financing projects are creditworthy and proper end use of borrowed funds

Role of a Debt Strategy

A Medium-Term Debt Management Strategy Framework (MTDS)

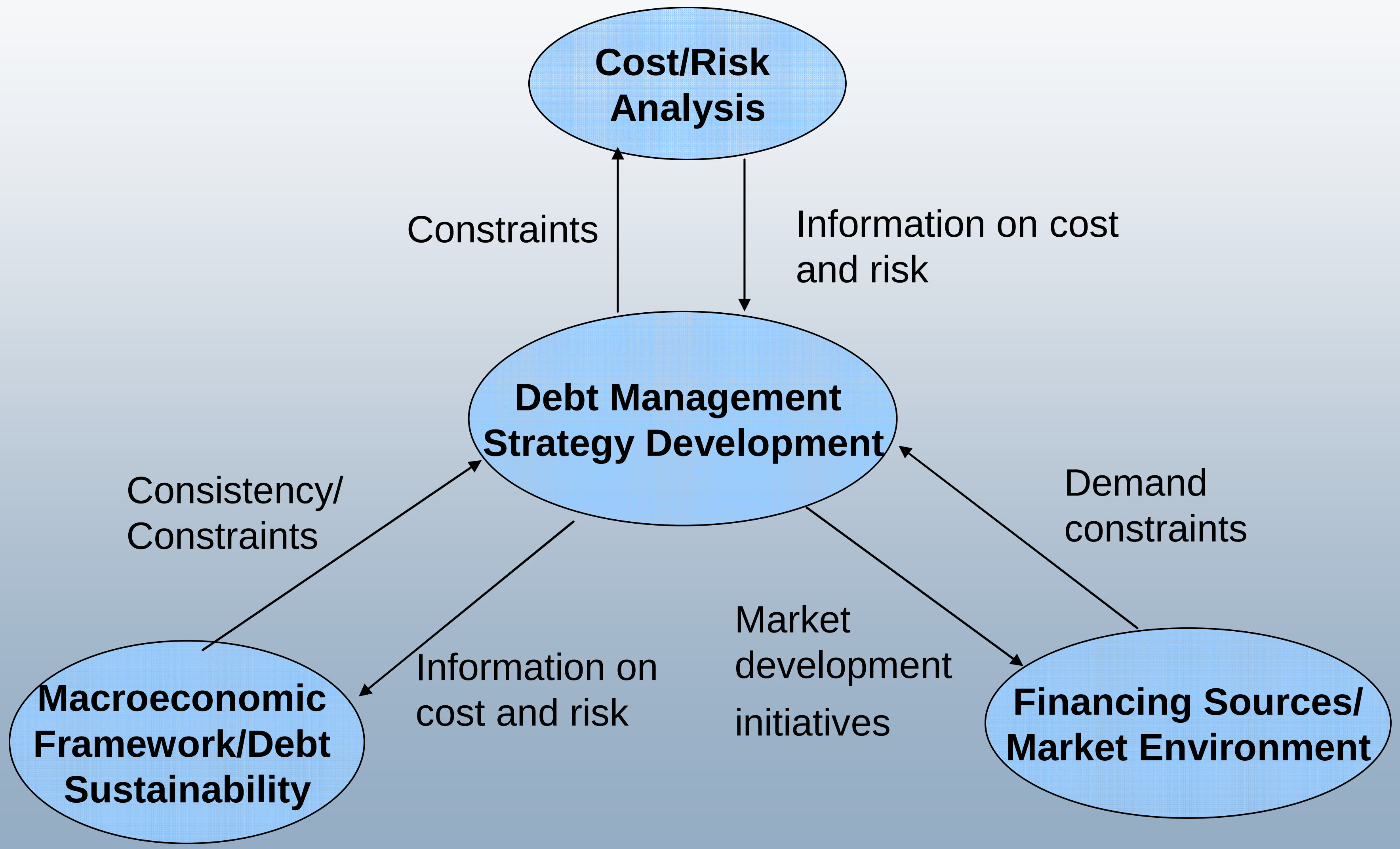
What is a debt strategy?

- A medium term plan to achieve a desired composition of the government debt portfolio
- Operationalizes key debt management objectives that helps meet financing needs and payments obligations
- Makes funding decisions consistent with a prudent degree of risk while maintaining debt sustainability
- Facilitates reform of local debt capital market

Debt management strategy formulation

- Objectives set by policy makers but strategies proposed by the debt manager
- Account for policy and market constraints
- Debt managers must therefore be an integral part of the full process
- Ensure consistency with macroeconomic and financial policies

Debt strategy can help anchor policy consistency



Clearly the debt manager cannot do it alone!

- **Need a comprehensive approach**
  - Raise awareness with policy makers
  - The new IMF/World Bank MTDS Framework provides that comprehensive approach
- **Through the MTDS the debt manager can help**
  - Ensure two-way link
  - Identify complementary reforms
  - Enable countries to design debt strategies

MTDS formulation suggested steps

1. Objectives and scope of the MTDS
2. Current strategy and costs and risks of existing debt
3. Potential sources of finance
4. Medium-term macro and market environment
5. Vulnerabilities, risks, and structural factors
6. Analysis of alternative debt management strategies
7. Review with fiscal and monetary authorities and market participants
8. Propose and approve MTDS

Policy Inter-linkages Are Key

- Sustainable fiscal and exchange rate policies
- Credible monetary policies
- Efficient coordination of debt and monetary management
- Capital account policies and the exchange rate regime

Policy Inter-linkages are Key (continued)

- Nature of macro-shocks should guide debt strategy choices
- Account for balance of payments financing constraints
- Portfolio restrictions on financial institutions

Key prerequisites for effective debt strategies

- Capacity to elaborate medium-term fiscal and macro plans that determine financing needs
- Capacity to design and implement sound debt policies
- Access to deep and diversified financial markets
- Effective monetary and liquidity management capacity

Capacity building should take a project approach

- Diagnostic studies (initial MTDS mission) identifies reform areas
- Assistance in debt management capacity
- Capacity building in complementary reform areas for effective MTDS formulation and implementation
- Follow-up MTDS missions to evaluate progress

Enhance the visibility of the debt management function

- Debt management should be viewed as a key policy area
- May need a separate debt management institution
- May need to raise the debt manager's function in the ministry of finance and central bank hierarchy

Debt strategies and the crisis

- Debt managers face considerable challenges in meeting increasing funding
- Countries with sound overall macro and debt policies have fared better than others
- Debt managers have shown more flexibility in instrument choices and currency mix
- But have generally maintained pre-crisis medium-term debt strategies and targets
- Taken measures to shore up domestic primary and secondary markets

Some lessons from the crisis

- Strategies must be anchored in sound macro fundamentals to be credible
- Closer monitoring of foreign investor participation in domestic markets
- Approach from an asset and liability management framework
- Realistically and continually assess debt and portfolio related risk exposures
- Study the links between deficits, debt and interest rates
- Need to announce credible exit strategies now to avoid risk of public debt snowballing in the absence of corrective action.

Forthcoming from the IMF….

- "Crisis and Policy Lessons for Debt Managers"
- "Interlinkages between Effective Risk Management of Debt and Financial stability"
- Extension of IMF's *Risk Measures Dynamic Toolkit* for a Sovereign Debt Portfolio
- "Deficits, Debt and Interest Rates"
- "Determination of EM Sovereign External Bond Spreads"
- "Measurement and Management of Sovereign Contingent Liabilities: New Approaches"
- "ALM and Debt Management"