*Recent Global Developments: Implications for Debt Management in Emerging Markets and Developing Countries**

Harun R. Khan

A very good morning to all. A warm welcome to Governor, Central Bank of Afghanistan, Deputy Governors of Bhutan and Nepal, officials from Government of India, executives of SAARC Secretariat and member countries and my colleagues from the Reserve Bank of India to the beautiful city of Jaipur. My special welcome to chairpersons and speakers for having accepted our invitation to share their expertise/knowledge on different areas of debt management with all of us.

2. A little bit about the city of Jaipur. Jaipur is an important city of India with a rich heritage and history. It is the capital of the state of Rajasthan and is fondly termed as the Pink City. Jaipur has a timeless appeal in its colourful bazaars with delightful handlooms and trinkets. Beautifully laid out gardens and parks, attractive monuments and marvellous heritage hotels, once the residence of Maharajas, not to mention the ambling camels and cheerful people in multi-hued costumes make Jaipur a tourist's paradise as part of the *Golden Triangle* tourist circuit alongwith Delhi and Agra. You could explore and experience all these during the social activities and the city tour.

3. Now coming to the event, which has brought the public debt managers and experts from the SAARC countries under one roof to exchange knowledge with one another, I am sure it will be a memorable one for all the delegates. Sri Lanka has the distinction of being the first SAARC nation to organise the SAARC Public Debt Manager's meeting in Colombo last year and this being the second meeting of the forum. This forum, as I recognise, brings together the senior debt managers from central banks and Ministries of Finance of all the SAARC countries to discuss and deliberate on latest policy challenges, compare notes on best or leading practices and, more generally, to share experiences among practitioners. Looking at the theme of this conference, *'Sovereign Debt Management in Emerging Markets'* and its detailed programme, I see that we intend to cover a wide range of topics/issues which, *inter alia,* include the challenges posed by global developments for public debt management and its linkages with macroeconomic stability and strategies thereof, lessons and outcomes of product innovations as also market infrastructure for government bonds. Given the span of issues intended to be covered during the conference, I would like to make a few general observations with focus on the challenges posed to policy making for Emerging Market and Developing Economies (EMDEs) in the area of debt management in the context of recent developments in the global economy as well as the way forward to manage the uncertainties which have become certainty in an interconnected world.

Recent Global Developments: Risk and Challenges for EMDEs

4. The current public debt management forum takes place against the backdrop of a still weak global economy, especially in Advanced Economies (AEs) where growth in some countries still remains weak. Indeed, the global financial crisis has dramatically changed the policy environment. Risks - old and new - continue to dominate the outlook and new policy challenges are arising not only in macroeconomic policy but also in debt management framework, both for EMDEs and also the AEs.

5. Going a little in the past, we know the world economy was ambushed with full blown financial crisis in 2008-09 and the growth in world economy had

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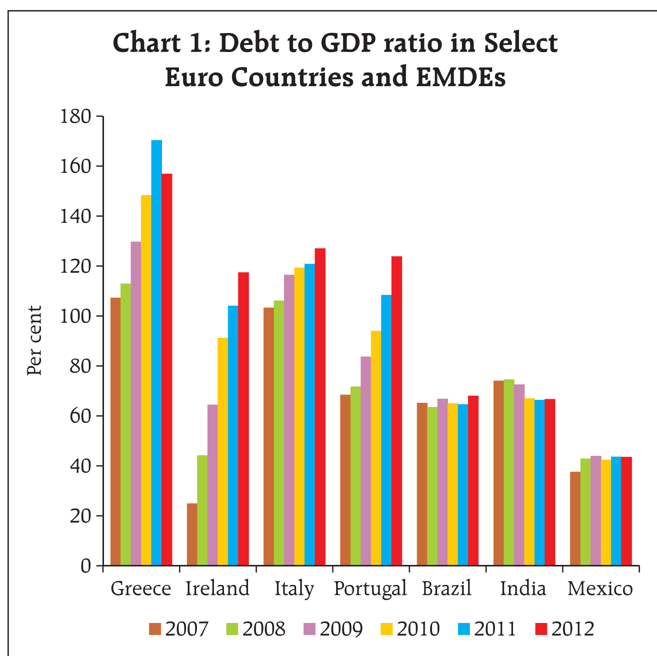
slowed down markedly from 5.4 per cent in 2007 to 2.8 per cent in 2008 and further to around half a per cent during 2009. The crisis which erupted in the US and other AEs with unravelling of sub-prime crisis soon traversed to the EMDEs, reflecting elevated inter-connectedness among countries in the backdrop of increasing external openness and cross-border financial flows. The growth in EMDEs also declined from 8.7 per cent in 2007 to 2.7 per cent during 2009. The governments across large number of countries had undertaken fiscal stimulus measures in order to contain the slowdown and revive growth, and this translated into steep increase in the government market borrowing. It was really challenging for debt managers, especially in EMDEs to complete the increased market borrowing in a non-disruptive manner. Subsequently, the European sovereign debt crisis unfolded in which the elevated debt levels coupled with sub-optimal debt structure in some of the European countries (*i.e.* high share of short-term debt and greater share of foreign investors' holding) triggered a major rollover risk for these countries (Chart 1).

6. The contagion emanating from the European sovereign debt crisis coupled with elevated market borrowing requirement amplified the challenges for debt managers in EMDEs, particularly for those who rely significantly on international capital markets for their government market borrowing. The challenge for debt managers in many EMDEs was on two counts: first, heightened volatility and uncertainty in the domestic financial markets due to capital flow reversals triggered by deleveraging of foreign investors; and second, increased exchange rate volatility mostly leading to sharp depreciation of the currency. The countries, which had scope to issue short-term debt due to elongated maturity structure and, at the same time, depended largely on domestic debt, could weather these challenges by issuing larger quantum of short-term debt domestically. On the other hand, the countries having short maturity debt structure were exposed to greater rollover risk. In the above backdrop, one could reasonably argue that optimal debt structure could help debt managers to meet challenges posed by the contagion from the global financial turmoil with less pain. Therefore, the debt managers need to pursue the optimal debt structure instead of a sub-optimal debt structure guided by the narrow and short-sighted objectives. I am sure that deliberations in the conference would focus in-depth on what should be the optimal debt structure compatible with local conditions.

Chart 1: Debt to GDP ratio in Select Euro Countries and EMDEs



7. The world economy bounced back from a contraction of around half a per cent in 2009 to an expansion of 5.2 per cent in 2010. The global recovery was supported by fiscal stimulus measures along with accommodative monetary policy often backed by unconventional policy measures, pursued by various countries. As part of the unconventional measures, some of the countries, such as, the US, the UK and the European Union conducted large scale Assets Purchase Programme (APP) in order to bring normalcy in financial markets and improve the credit flow to the real sectors. These measures resulted in capital flows back to EMDEs, as net financial flows (private), which had declined from US$ 698 billion in 2007 to US$ 282 billion during 2009, increased to US$ 572 billion in 2010. Although, the US is still continuing

with accommodative monetary policy, the net financial flows to EMDEs declined substantially to US$ 237 billion in 2012. Some of the AEs are expected to withdraw the accommodative monetary policy and the prolonged period of strong capital flows may come to an end and EMDEs may face a transition to more volatile external conditions. An example of such volatile external conditions was experienced by EMDEs in the recent past following the announcement by the Chairman of the Federal Reserve in May 2013 about the expected tapering of APP by year-end and complete exit by mid-next year. The Federal Reserve, however, decided subsequently to continue with APP and pursue highly accommodative stance of monetary policy. But no country can be complacent, as APP by the Federal Reserve is not perennial and it has to come to an end sooner or later depending on economic activity and labour market conditions. In the meantime, debt managers in EMDEs should formulate strategy and develop buffers to deal with such an eventuality.

8. The strong, yet volatile capital flows present central banks and debt managers in EMDEs with unusual challenges and also raises the threat of a sudden drying-up of market liquidity in key segments. We are aware that large capital inflows engender benefits as well as costs. The good news is that strong fundamentals in many EMDEs have reduced their vulnerability along with much improved external positions and the buffers provided by accumulated forex reserves all played a part in this outcome unlike the past experience. Although the positive impact of capital flows and commodity prices are often quoted as catalyst for growth in EMDEs, it needs to be noted that there are many other drivers of long-term growth in EMDEs which are domestic in nature, *e.g.*, sound macroeconomic fundamentals, demographic advantage, high savings, *etc.* External factors could support growth only in the short-term. Thus, the recent global developments have brought into sharp focus the key interconnections between the financial, economic and macroeconomic policy constraints. Sound domestic macroeconomic fundamentals are essential and will become the differentiating criteria blurring the current distinction between the AEs and the EMDEs. In this context, the session on '*Public Debt Management and Macroeconomic Stability*' will throw light on the new and complex interactions between public debt management and macroeconomic policies. This kind of interaction provides an opportunity for mutual discussions in the interest of fostering further market development.

9. The resilience of EMDEs to date is a notable feature of the recent crisis unlike the past crises. This could be because the crisis did not emerge in EMDEs, and as also various initiatives in emerging economies have focused on the reform of debt management practices and the development of domestic debt markets supported by sustained improvements in macroeconomic and financial sectors over the past decade. Review of experiences with public debt management and how debt managers coped with the impact of this global shock in the form of various policy responses in primary and secondary markets would be informative. I think the session on *'Global Developments and its Impact on Public Debt Management of Small Emerging Market Economies'* would elaborate the impact on emerging economies more succinctly.

10. Another challenge faced by EMDEs during the recent global crisis and subsequent sovereign debt crisis was maintaining the fine balance between price stability, debt sustainability, and financial stability. This has also been phrased as "*New Trilemma*" by our former Governor Dr. D. Subbarao. Policies pursuing these three objectives are intertwined in several ways and impact other objectives often in unintended manner. It may be underlined that interaction and impact of these policies, however, may be different during crisis periods from normal periods. There could be two way impact of the policies pursuing these objectives, *e.g.*, policy aimed at price stability may adversely impact financial stability and debt sustainability and vice versa. To

elaborate further, increase in interest rates to bring down inflation and ensure price stability may impact debt sustainability/financial stability adversely. On the other hand, the policies pursued for debt sustainability, such as, monetisation by the central bank and write-offs, may be detrimental to price/financial stability. Such potential conflict does not imply that these objectives cannot be balanced simultaneously. To add another dimension, policies pursuing the above three objectives may also impact the growth objective and interplay these objectives could be called as "*New Quadrilemma*". For example, the debt consolidation pursued during slowdown phase may turn fiscal policy pro-cyclical impacting growth adversely. Hence, it is imperative that proper balance is struck among these objectives through optimal policy and institutional choices.

The Indian Experience

11. Coming specifically to the Indian context, I would like to mention that the impact of the global financial crisis also traversed to India. Fiscal stimulus measures were undertaken to mitigate such impact and, accordingly, the Government market borrowing increased steeply (*i.e.* about 83 per cent higher market borrowings over the budget estimates of 2008-09 and about 65 per cent higher in 2009-10 over the previous year). At the same time, the financial markets became highly fragile and turbulent, reflecting an elevated interconnectedness and global integration. The liquidity in the system had dried up due to large capital flow reversals on account of deleveraging by foreign investors from EMDEs and an environment of uncertainty and general risk aversion in financial markets prevailed, posing a daunting challenge for the debt managers in the central bank to complete market borrowings in a non-disruptive manner. The elongated average maturity to life (AML) of the debt, however, provided a reprieve and the debt management strategy involved issuance of large short and medium-term debt keeping in view the market conditions. In fact, India had one of the highest AML of the Central Government securities and, thus, there was ample scope to manoeuver the maturity profile without compromising on the prudent degree of rollover risk (Table).

Table: Domestic Debt Securities – Average Maturity

(in years)

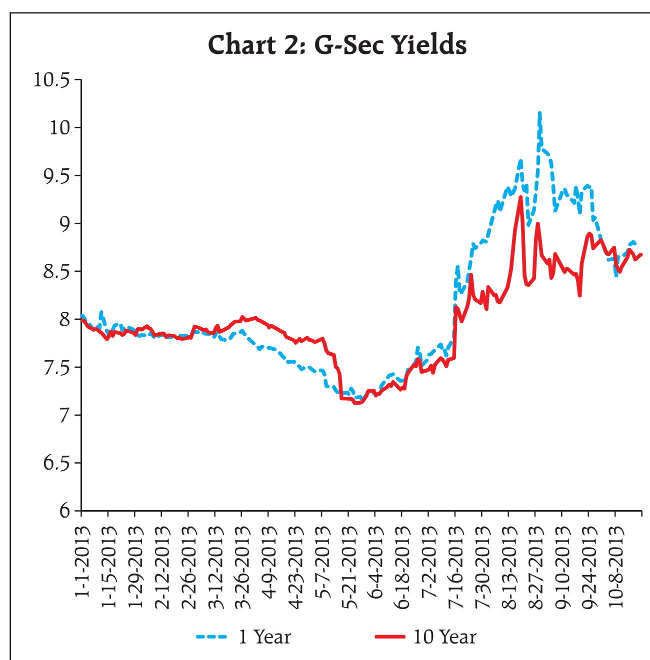
Country	2007	2008	2009	2010	2011	2012
Brazil	3.0	3.3	3.4	3.4	3.5	3.8
China	7.9	7.6	7.2	7.6	8.2	8.8
India	10.0	10.6	10.5	9.8	9.8	9.7
Indonesia	8.2	8.2	7.9	8.6	9.2	10.1
Malaysia	5.4	5.3	5.3	4.5	5.1	5.5
South Africa	8.5	10.0	10.6	10.6	11.6	12.3
United Kingdom	14.5	14.5	13.5	13.4	14.5	14.6
United States	4.6	4.2	4.6	4.9	5.2	5.4

12. A combination of other measures, involving monetary easing and the use of innovative debt management tools, such as, synchronising the Market Stabilisation Scheme (MSS) buyback auctions and open market purchases with the government's normal market borrowings and desequestering of MSS balances were also undertaken. By appropriately timing the release of liquidity to the financial system to coincide with the auctions of government securities, the Reserve Bank ensured a relatively normal liquidity conditions in the markets and in the process facilitated smooth conduct of the government's market borrowing programme. This, in fact, underlines the importance of high level of co-ordination between monetary policy and debt management policy for successful completion of market borrowings during volatile periods. During turbulent times, there remains a strong possibility of agencies pursuing their narrow objectives and in the process undermine coordination. In India, there is inherent seamless coordination on these policies by virtue of both policies being entrusted with the central bank. The Reserve Bank of India, in co-ordination with the fiscal policy makers in the Ministry of Finance could manage the huge borrowing programme without unduly impacting the financial markets. Such monetary and fiscal co-ordination was at display not only during the height of global crisis but throughout the recent period of market turbulence.

13. Post global crisis the debate has resurfaced about institutional location of the debt management functions; whether it should be with central bank or with a debt management office. In this regard, it may be pertinent to mention that one size does not fit all. In India, although process of separating debt management from the central bank is being discussed seriously, in the given circumstances of large size of market borrowings and the level of market development, it is felt that such separation at the current juncture could be sub-optimal. Post-crisis learning do suggest that to achieve public policy objective of ensuring growth, price stability and financial stability, co-ordination between monetary policy, fiscal policy and sovereign debt management is critical. There is inherent synergy of monetary policy and sovereign debt management strategy and if they operations remain with the central bank. There is, thus, a strong view that the present arrangements for debt management by the central bank in co-ordination with the Government need not be discontinued, especially when the fiscal deficit remains elevated warranting large market borrowings without disrupting financial market stability.

14. The May 22, 2013 talk of tapering by the Federal Reserve had led to turbulence in the external conditions and it spilled into the domestic debt market. The Reserve Bank of India had to increase the short-term rates in order to contain volatility in the foreign exchange market. The overnight call rate increased from 7.21 per cent on July 15, 2013 to 13.46 per cent on September 7, 2013. The hardening of the short-term interest rates got transmitted to medium and long-term yields eventually. The 10 year G-Sec yield, for instance, increased from 7.60 per cent as on July 15, 2013 to 9.27 per cent as on August 2013 (Chart 2).

15. Besides steep rise in yields that was largely attributed to liquidity tightening, the volatility in bond yield market heightened and this led to reduced demand for G-Sec. Thus, heightened volatility became a worrisome factor for debt managers who in such situations could be forced to issue debt which may not



be in alignment with the optimal debt structure and thus, the same may aggravate various risk parameters. In this context, it may be pertinent to underline that volatility in G-Sec market has subsided significantly after the Reserve Bank announced reversal of temporary policy measures starting September 20, 2013. Another positive development is that long term foreign investors' confidence in the Indian currency appears to be increasing lately and this is likely to translate into increased demand for G-Sec. I am certain that discussion in the session of 'Debt Management Strategy' would throw more options for the debt managers to deal with turbulent and fragile market conditions. Furthermore, the session on 'SAARC Country Experiences' would enable participants to know about each other's debt management practices and help in further improving their practices. Indian experience shows robust state of the art financial market infrastructure could be a source of resilience to the government bond market. It is in this context, the session on 'Market Infrastructure in G-Sec' which would closely look into the regulatory structure, developments in primary and secondary market infrastructure and would provide us useful lessons for building safe and efficient market infrastructure.

16. The debt management strategy in India has been continuously striving to expand the bouquet of instruments in order to broaden the investors' base for achieving the debt management objectives. Though the extant bouquet of instruments includes fixed rate nominal bonds, zero coupon bonds, floating rate bonds (FRBs), and the proposed inflation indexed bonds, the share of linkers in total issuances remained below five per cent. The debt management strategy has been exploring the idea of issuing sovereign bonds in international capital markets but as risks associated outweigh the benefits and thus, no such issuance has been contemplated. Some EMDEs which issued such bonds faced problems during the recent crisis period. The session on 'Product Innovations-Sovereign Foreign Currency bonds, IIBs Lessons and Outcomes' would be able to provide further insights on the benefits *vis-à-vis* risks associated with new products, especially with respect to EMDEs.

17. Some of the major take-away from the Indian experience with regard to debt management during the recent crisis period are:

a. Elongation of maturity during normal times provides enough headroom to the debt managers to deal with unprecedented volatile times like recent global crisis as debt managers can weather the turbulence by operating at the short to medium term on the maturity curve;

b. In an uncertain environment, the usage of combination of instruments, such as, fixed rate bonds, T-Bills, FRBs, *etc.* catering to the demand of divergent market participants plays a paramount role in debt management strategy;

c. Continuous dialogue/interactions with market participants to know the pulse of market are essential for formulating issuance strategy. In India, a bi-monthly meeting is convened with Primary Dealers (PDs) and other market participants to gauge their demand for various instruments and seek their feedback on policy choices;

d. Better communication of the debt management policy to market remains pivotal to avoid uncertainty in the minds of investors;

e. Institutional arrangement for debt management need not follow "one-size-fits-all" approach and, infact, in countries having huge government borrowing requirements the deeper involvement of the central bank is imperative for maintain balance between different policy choices for price stability, debt sustainability, financial stability and growth objective; and

f. Government bond markets should be developed domestically in terms of investor class, instruments, infrastructure, intermediaries and innovations and may be opened up to foreign investors in a calibrated manner to broaden the investors' base without unduly exposing them to the risks of sudden stops.

Conclusion

18. Going forward, the challenges faced by debt managers remain significant as greater integration of EMDEs in international capital markets would transmit the contagion to the domestic debt markets very fast. Further, strong capital inflows may expand the demand for Government debt but such flows also pose sudden stop risks. I am sure this conference would provide a hands-on policy inputs to the debt managers to help them minimise risks and design sound debt management strategies. I hope this one and half days conference will be eventful with many ideas and thoughts being deliberated with focus on practical suggestions for evolving sound public debt management policies & practices.