Does debt management matter? Yes

A comprehensive debt management strategy can buffer developing countries from volatile international capital markets. Argentina's strategy provides a useful model.

East Asia's recent financial crisis was the largest and most widespread crisis of the 1990s. Rescue packages ranging from $10 billion to $50 billion were cobbled together in months or even weeks to help countries facing severe balance of payments problems. Devaluations in the region exposed important weaknesses in domestic financial sectors as banks and other borrowers scrambled to make payments.

One distinctive feature of East Asia's crisis is that most of the vulnerability emerged from large stocks of short-term debt rather than from more traditional shortcomings such as fiscal deficits. Short-term debt, private and public, proved much harder to service than had been anticipated. Rating agencies and other analysts were caught off guard because they put too much focus on indicators that signal fiscal and debt sustainability problems (such as the ratio of debt to exports) and too little on indicators that signal financial imbalance (such as the ratio of short-term debt to international reserves; see PREM note 16). In fact, most of the region's problems were triggered by sudden difficulties in rolling over short-term debt, in either domestic or foreign currency, and problems in the banking system.

How can governments stem large capital outflows that result from sudden changes in market sentiment? Efforts to reduce vulnerability to capital outflows must include a strategy to manage debt and to establish a solid banking system that is properly regulated and adequately supervised. Debt management can play a particularly important role in reducing financial vulnerability by limiting liquidity and rollover risks. Why is this important? Because if investors suddenly refuse to roll over debt, the government must pay higher interest rates to attract investment. And if the liquidity crunch lasts long enough, higher interest rates can damage fiscal accounts and threaten to become a solvency problem, increasing country risk—that is, the spread over the risk-free interest rate that the country pays for funds—and borrowing costs. The less solvent is the government, the higher are the costs of financing. This note describes what governments can do to manage debt and examines Argentina's strategy.

Argentina's debt management strategy

The ultimate goal of Argentina's debt management strategy is to improve the country's credit rating to investment grade. Argentina's debt is still considered speculative, and as a result it pays a higher premium for funds than do investment grade countries. To ease this burden, the debt management strategy tries to minimize long-term borrowing costs, ensure fluid access to domestic and international capital markets, and limit vulnerability to shocks in international markets.
The strategy has five main elements. The first seeks to develop a sound structure of amortization payments for long-term debt to avoid a concentration of principal repayments in a given year, thus limiting the refinancing risk. To achieve this goal, the government has issued most new debt at longer maturities (five years and more) to take advantage of periods when the amortization schedule is lighter. As a result, annual amortization payments of long-term debt are converging to $10 billion a year, equivalent to 10 percent of total long-term debt (figure 1).

The second element is a deliberate effort to limit short-term debt in an era of high volatility in international capital markets. As noted, in recent years there have been many episodes (including a few in Argentina in the late 1980s) where difficulties in refinancing short-term debt have destabilized domestic financial markets. This problem has been particularly acute for domestic currency debt, where interest rates are more volatile—especially if there is concern about a possible devaluation or a large increase in inflation that would erode the real value of domestic currency debt. Argentina issues all of its short-term debt in the domestic market in both pesos and dollars. Short-term debt accounts for just 3 percent of total debt, or less than 1 percent of GDP—a small burden, especially relative to other emerging markets.

The third element of the strategy secures a liquidity cushion at the treasury, equivalent to one-quarter of annual financial requirements, to provide flexibility in the timing of transactions and to avoid the need to issue debt at times of high volatility or interest rates. Other countries might not need such a mechanism if the central bank holds international reserves to provide this cushion. But in Argentina, which has a currency board, international reserves are used to back the monetary base, and the independent central bank is prohibited from financing the treasury. Thus the treasury needs its own reserves in addition to those of the central bank.

The fourth element diversifies sources of financing to increase the number of domestic and foreign investors that hold Argentine debt, thus improving the chances of tapping markets at all times. Even with global financial markets, access varies across currencies and across types of investors. Pension funds usually prefer long-duration instruments with the potential for capital gains, while money market funds lean toward debt instruments with low price volatility, preferably for the short term. In addition, experience shows that there is incomplete arbitrage between European currencies, the U.S. dollar, and the yen, perhaps as a result of transactions costs and credit restrictions. As a result there are often attractive opportunities for issuers who find it more cost-effective to issue in one currency than another.

Argentina has taken advantage of those opportunities and has diversified its issues across currencies (figure 2). The government has well-developed yield curves in U.S. dollars and European currencies, allowing a comparison of costs for different maturities and different currencies. These yield curves also allow the government to issue structured deals—that is, deals that use the yield curve for pricing but have some special features such as calls, puts, or adjusting spreads—for specific investors, thus broadening the investor base.

The final element of the debt management strategy seeks to develop a domestic treasury market, including T-bills (Letes) and T-bonds (Bontes) in pesos and dollars, respec-
experience shows that limiting the size of short-term debt and generating a sound profile of amortization payments for long-term debt greatly reduce rollover risk. These efforts have also helped Argentina access financial markets even at the worst times of the East Asian crisis. Indeed, because of this strategy, Argentina has had smaller overall (foreign plus domestic) refinancing needs than Brazil, Russia, or other emerging market countries.

One important lesson of the Asian crisis is that in today's globalized markets the risks of refinancing can be larger for domestic currency debt than for foreign currency debt. Since the onset of the crisis the cost of refinancing domestic currency debt has increased up to eight times, generating a domestic currency debt trap that threatened fiscal accounts.

With concerns about short-term debt on the rise, some economists have favored the imposition of capital controls. But Argentina’s experience suggests that volatile flows can be dealt with through prudential regulation in the banking sector and overall sound policies in capital markets. The Central Bank’s prudential regulation for banks is stricter than international standards and has ensured adequate liquidity for it to act as a lender of last resort to the banking system by negotiating a standby borrowing facility with international banks (box 1).

Avoiding the conversion of private debt into public debt also helped Argentina overcome the crisis. During the tequila crisis of 1994–95, despite continuous pressure from investors, the government stayed out of private contracts. Problems in servicing private, provincial, and municipal debts had to be solved by the parties involved without the participation of the federal government. This approach helped establish discipline and avoid losses because there was less moral hazard and hence more prudent behavior by private borrowers.

Looking forward, perhaps the biggest challenge is to develop new indicators of financial vulnerability. These new indicators

Lessons

Debt management matters and can help reduce country vulnerability. Argentina’s
Box 1 The Central Bank of Argentina’s repo facility

In 1996 the Central Bank of Argentina negotiated a contingent repo program with top-rated international banks. This line of credit was intended to increase systemic liquidity to the banking system while preserving the Central Bank’s capacity to act as a lender of last resort. The credit line originally represented about 10 percent of deposits, and it has been growing to reflect the increase in deposits in the banking system.

Under the program the Central Bank has the option of selling Argentine dollar-denominated bonds subject to a repurchase agreement. Depending on the bank, the program lasts from two to five years. Every three months the program is extended under the same terms and conditions to ensure access to the facility for a long enough period.

The repo has a 20–28 percent haircut, depending on the security. The margin is based on mark to market, and the Central Bank has to provide an additional margin (either in securities or in U.S. dollars). If the prices of the financial instruments fall by more than 5 percent, the Central Bank will provide sufficient margin to cover 125–140 percent of the amount of the transaction. The repo program costs $7.2 billion, with $6.7 billion coming from government bonds and $0.5 billion from mortgage-backed securities.

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