

High Level Workshop 2007

Developing Bond Markets in Emerging Market Economies:

Session V: Broadening the Database and Technical Assistance

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OPENING REMARKS

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I am very pleased to be here today to address this workshop. I appreciate the strong commitment of the G7 countries on these issues.

In my comments, referencing Ms. Pazarbasioglu's wide-ranging paper, I will address a) work of the Inter-American Development Bank to build a more robust database on our region's debt and implications we have drawn from this effort, and b) the need for technical assistance, and, in that regard, will cite a Latin American and Caribbean regional approach, the LAC Debt Group, that helps to generate more effective debt management skills, thereby enabling greater use of local currency.

An Improved Database and Its Implications

Ms. Pazarbasioglu has the unenviable task of trying to collect homogeneous debt data across all emerging markets of the world, and she has shown many of the disparate sources but perhaps, too kindly, not dwelt long enough on methodological concerns. Realizing these difficulties for our own region, and in completing the Bank's major report for 2007, Living With Debt: How to Limit the Risks of Sovereign Finance, our Research Department decided it was necessary to create a new database to measure more effectively the level and composition of the debt stock of our countries.

The usual sources are the IMF's International Financial Statistics and the World Bank's World Development Indicators and Global Development Finance. Data on a smaller set of countries comes from the UN Economic Commission for Latin America (ECLAC) and the OECD. However these sources present several drawbacks. First, most have incomplete coverage, even for some large

industrial countries, as well as comparability problems in how they report debt figures. Second, the items reported tend to differ across countries -- sometime good coverage of external debt but scant information on domestic debt, or only on long-term debt, and whether to include liabilities of the central bank or state-owned enterprises. Third, the country's liabilities depend on whether it has successfully privatized social security. Finally, information on characteristics of the public debt are often limited -- such as indexation mechanisms, external or domestic debt, bank or official debt, what share is short-term.

So, working with the countries, we compiled what we believe to be the first comprehensive database (through 2003) on sovereign debt to ensure comparability for all countries in the Americas, Internal and external debt together in a homogenous way over countries and over time.

Lessons Learned

Rather than go through decisions taken on methodological definitions to ensure comparability, and wear out my welcome here, let me jump ahead to what we learned from this information.

First, surprisingly, the average level of public debt in the region is similar to that prevailing in the early 1990s; however, the composition of debt has changed. External government debt has fallen, and internal debt has risen. While this change in composition may be positive for a variety of reasons, internal debt structures are still slanted towards short-term, currency-indexed, or floating rates in several countries.

A second striking finding is that recorded budget deficits play only a secondary role in explaining debt growth. Large changes in debt are the result of balance sheet effects due to exchange rate adjustments, the resolution of banking crises and other contingent liabilities, and extra-budgetary items. For example, in the Dominican Republic, the debt-to-GDP ratio rose from 25 percent of GDP in 2002 to 55 percent of GDP by the end of 2003, owing to a costly banking crisis. Debt-

to-GDP ratios in Argentina and Uruguay more than doubled in 2002 as a result of the exchange rate depreciations in those two countries. This underscores the conclusion that the structure of debt and contingent liabilities often involves more risks than the level of debt itself.

Third, in some countries, overall debt levels continue to raise issues regarding sustainability. The report considers new approaches to the analysis of debt sustainability that take into account many aspects of debt structure. Unfortunately, exchange rates, interest rates, and economic growth all tend to be volatile in emerging markets, and this volatility interacts with poor debt structures—tilted towards foreign currencies and currency-indexed or floating-rate debt—to create higher risks.

Fourth, along with prudent fiscal policies, improved debt management has an important role to play in limiting these risks. Experience has highlighted two key sources of vulnerability: currency denomination (or foreign-currency debt) and maturity (or short-term debt). Policies aimed at reducing these vulnerabilities are complicated as there may be a trade-off along these two dimensions. For example, shifting to domestic currency debt often requires employing short-maturity instruments. Inflation-indexed instruments provide an alternative that can help improve the terms of this trade-off, since it may be possible to issue long-term inflation-indexed instruments at moderate cost, because investors are protected from the risk of unexpected inflation. Past experiences—when financial indexation spearheaded the widespread indexation of wages, pensions, and the like, leading to stubborn inflation and inflexible relative prices—may make governments wary of such instruments. Still, some countries have productively used indexed financial instruments widely without perceptibly worsening inflation's persistence.

Fifth, lending from multilateral financial institutions and official bilateral sources continues to represent a significant share in international borrowing, both for low-income economies with no market access and for the emerging market economies in the region. The *Living with Debt* report finds evidence that

multilateral banks are countercyclical and have assisted countries when they lack access to private funds, but it also suggests a catalytic role for multilateral lending, because increases in multilateral flows tend to be followed by increases in private lending. Domestic debt markets, although still less developed than their international counterparts, are gaining importance and can play a key role in reducing vulnerabilities. While Latin America does not have comparatively large bond markets, the size of these markets is commensurate with that of overall financial markets in the region.

Sixth, although the international sovereign debt market is relatively liquid, emerging market premiums have been very volatile. More recently, global conditions have been very favorable to emerging market borrowers, and spreads have reached record low levels. There are reasons to be optimistic about these trends, but caution is still in order. Research suggests that current spread levels are not fully justified by improvements in fundamentals and that financial variables are required to fully explain spread compression. Although these financial variables may reflect high liquidity or reduced risk aversion, they may well reflect a wider diversification of risk through new instruments—including credit derivatives. This brings rewards through a lower cost of funds but also may carry risks. As many observers have said, these instruments are “untested” if market conditions do turn sour.

These findings are broadly compatible with my panel member’s conclusions.

On improving data, perhaps the regional collection of such information, led by the countries under the guidance of an IFI, working toward a universal standard, is the appropriate approach. Solutions in which countries have a vested interest will attract greater country cooperation. Work on sovereign debt could then open up the possibilities of a richer dataset on private sector debt. Certainly the IFIs should collaborate and not replicate each other’s work, and should decide on the comparative advantage of each, but they must be seen as solution providers or enablers and not imposers.

Technical Assistance and the LAC Debt Group

In terms of "What can be done?" and technical assistance, these must be matched with the goals of the country. Data collection is important, but data doesn't vote. Tangible assistance, both financial and experiential, focused on capital market development, and a higher standard of living, is likely to have greater impact. For example, a securitization market can make available, and lower the cost of, a home mortgage.

For proper domestic debt management, beyond the basic underpinnings of appropriate fiscal and monetary policy, sovereigns have a few critical needs: first, to build a domestic yield curve to be the basis of better pricing for itself and other local issuers, improving over time from inflation-adjusted, floating rates to fixed rate, at increasingly longer maturities, out to 30 years. Second, it needs to enable the diversification of risk, through the growth of swap and other derivative markets, securitizations, the ability to sell short, etc. Third, it needs to reduce the uncertainty, time delay and size of transaction costs, meaning an appropriate rule of law, tax regime, regulations, internationally-recognized custody, clearance and settlement, and the like. Fourth, in communicating and carrying out its own debt interventions, it needs to be transparent in increasingly standardized actions and as boring as possible, with an annual borrowing program, auction calendar, and an internet portal for information. Why these goals? To create market integrity for both public and private issuance. To facilitate intermediation of domestic savings for investments by pension funds, insurance companies, mutual funds and private banking, as well as international investors who are chasing yield with liquidity. To enable, as appropriate, de-dollarization of existing country debt and local issuance of new debt. These steps clearly have political consequences but they can also have dramatic political payoffs. Look what Mexico has done over the last ten years in developing a first-rate financial marketplace. Other countries can learn, follow and customize market examples to meet their own needs and circumstances.

In these important areas where progress needs to be made, technical assistance can truly help, especially for the less knowledgeable countries acquiring the

necessary skills and the more knowledgeable ones offering their assistance. That is why our Bank provides financial and manpower support for the work of the LAC Debt Group. Formally established in March 2005 at the request of several Latin American countries, the Group brings together debt management specialists from the LAC Treasuries and central banks for regional cooperation to create a more homogeneous framework for the debt and bond markets to: (i) contribute to the effectiveness of Debt Management Offices in the countries of the region; (ii) reduce the cost of debt; (iii) consolidate the harmonization of related norms and regulations; and (iv) promote financial and capital sector development. For example, Colombia agreed to provide support to Ecuador's debt management office, and Mexico, much further down the curve, can address issues such as REITs and repo markets. The Group also continues to be the sounding board for what the potential wider role might be for the IDB and the other IFIs. Participation at the Group's various functions is large and includes representatives from the region's national DMOs, the IDB, the World Bank, the IMF, UNCTAD, and the *Consejo Monetario Centroamericano*, as well as experts from the private sector and the financial community.

The Group holds annual meetings, videoconferences, and thematic seminars, develops the information system and database I mentioned, facilitates and coordinates interactions among countries, and publishes papers and annual meeting proceedings. Moreover, the Group has just agreed on a standardized set of templates for reporting data on each country's external and internal debt on its national debt website, preferably quarterly. In a breakthrough, this will apply not only to debt stocks, as above, but debt flows, as well as changes in value due, for example, to indexation and accrued but unpaid interest. Although voluntary, this comparable data should lead to increasing transparency in domestic markets and enhance governmental accountability.

The Group constitutes an essential part of the current drive to develop domestic currency markets. It has been funded by the IADB to-date, but there is a need for ongoing technical and financial support and coordination to support the large agenda ahead. The G7 could make a significant contribution.

To assist such LAC countries in developing their local currency markets, the IDB has taken a pro-active role in harnessing the growing appetite of international investors for securities denominated in our region's local currencies. In the last three years the Bank has raised nearly \$1.8 billion for development financing in 30 bond issues. Such offerings have helped to improve the domestic bond market infrastructure and the adoption of best practices, enabled asset diversification for domestic investors, supplied high quality assets to international demand for local currency, and strengthened the link between the domestic and international capital markets. Furthermore, the opportunities identified by our bond issues have opened up a new source of financing for Latin American corporates and governments, adding a fresh investor base and further liquidity for funding.

The Bank has also been converting existing Bank debt, at the request of the sovereign borrower, into local currency and expects shortly to borrow and on-lend in the same local currency. We believe such efforts will increase significantly in the future.

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