

Domestic currency debt: Challenges to develop the market

Comments to Miguel Kiguel

Eduardo Fernández-Arias
Washington, October 2009

Interesting paper

- The pros and cons of various choices of denomination, maturity, duration, etc: watch out for all sorts of financial and inflation risks
- Empirical exercise simulating expected costs: inflation-indexed the most costly
- Megadepreciations are game changers: be careful with dollar (-linked) debt
- Final reflection: (LC) “*fixed interest rate is probably the best option*”

Comment 1: Conclusions require integrated portfolio/macro analysis

- Consider national balance sheet, not only public financial portfolio:
 - Financial externalities (shifting FD)
 - Real externalities (debt crisis)
- Simulations do not lead to a conclusion:
 - Interesting but unclear calibration; results vary widely by period and country
 - Abstracts from risks, which are *absolutely key*

Comment 2: Think twice before adopting some recommendations

- The case for ST debt:
 - Doubt that government has superior info
 - Global illiquidity may heighten roll-over risk
 - Preferability of nominal (LC) fixed-rate debt:
 - More predictable or safe (not in real terms)
 - Short-term due to inflation risk (roll-over risk)
 - Inflationary bias (Calvo)
- “Probably the best option” is unwarranted*

Major comment: inflation-indexed debt is not given a fair hearing of its advantages over other LC debt

- Predictable and safe (in real terms)
- Allows for long-term and long-duration debt even with inflation concerns
- No inflationary temptation
- Does not interfere with monetary policy
- All in all, the best substitute of FC debt
(Financial dedollarization, *Economia 200x*)

DEDOLLARIZATION

**Public Debt Management Specialists
Latin America and the Caribbean**

Eduardo Fernández-Arias
Inter-American Development Bank
Rio de Janeiro, March 2005

FINANCIAL DEDOLLARIZATION and Public Debt Management

- Minimizing Fiscal Risk
- Improving the National Balance Sheet
- How can Multilateral Development Banks help?

Minimizing Fiscal Risk

1. Dollar debt is a fiscal risk because it is a currency mismatch with public revenues (subject to real exchange rate shocks)

This is true in all countries because fiscal revenues are a fraction of GDP, so a real depreciation increases real debt burden

Minimizing Fiscal Risk

2. Dollar debt is a higher fiscal risk in LAC countries because:

- a) It is countercyclical, a negative real hedge (real depreciation in bad times)
- b) Real exchange rate is very volatile

The same with short-term real interest rates, plus roll-over risk so that short duration debt (short or floating) is also higher risk

Minimizing Fiscal Risk

3. Public debt management should be extremely risk averse (attach shadow risk prices) to offset mispricing of fiscal risk

Fiscal cost is not only volatile repayments but also high inefficiency of fiscal adjustment and systemic crisis, which accrues socially

Minimizing Fiscal Risk

4. Conventional naïve conclusion: Dedollarize in favor of long-term, fixed-rate, peso debt

Not a real solution. It does provide fiscal insurance but it is very expensive (or unavailable) due to fear of surprise inflation (the reason for domestic financial dollarization), possibly mispriced too because of inflation moral hazard.

Minimizing Fiscal Risk

5. Consistent conclusion: Dedollarize in favor of inflation-indexed, long-term, peso debt

This choice has all the right risk properties to match and hedge fiscal accounts and is an excellent substitute of dollars for domestic savers because it is not subject to currency, short-term interest rate or exchange rate risk.

Very worthwhile to invest in setting up the market

The national balance sheet

6. If overall domestic financial dollarization does not change, then dedollarizing public debt shifts the risk to private debts (or disintermediation due to offshoring or loss of access to foreign savings).

This risk shifting may or may not be welfare enhancing. Public debt management strategy needs to consider crowding out effects within a national balance sheet.

The national balance sheet

7. Conclusion: It is key that public debt dedollarization completes markets so that domestic financial dollarization and offshoring falls

Credible index and inflation-indexed debt is an excellent example of value added, present in all successful dedollarization experiences.

Multilateral Development Banks

8. MDBs can help complete markets by issuing AAA peso securities (without country risk) and onlending (staying currency matched).

The now unavailable risk-free peso securities may capture (dollarized) flight capital, which flew not to avoid currency risk but country risk.

Multilateral Development Banks

9. An ideal case would be MDBs issuing and onlending inflation-indexed securities, because it would combine many market completion features:
 - a) especially attractive as dollar substitute
 - b) delivers excellent risk profile to government
 - c) lends credibility to the index and new market

This ideal case may be attractive for example to domestic institutional investors such as pension funds or life insurance companies currently investing abroad.

Multilateral Development Banks

10. The big prize in terms of market completion would be for MDBs to attract foreigners to buy their peso issues (redress “original sin”), but it appears out of reach for the moment.

Due to home bias, domestic financial dollarization appears easier to crack and a prerequisite for foreigners to join new peso markets.