Title:

Challenges for debt management created by large capital flows

Sub-Title:

How large capital flows to and from emerging markets potentially create conflicts between achieving debt management and monetary policy objectives.

Description:

Many emerging market economies (EMEs) have performed remarkably well in recent years and macroeconomic conditions have improved substantially, leading to large capital inflows and upward pressure on exchange rates. This typically leads to increased liquidity in the financial system and challenges for central banks (CBs) in achieving monetary policy objectives such as exchange rate or price stability. Since the Federal Reserve has first signaled tapering in May 2013, however, capital flows have reversed in some countries. Outflows reduce liquidity in the financial system and create new challenges, such as an increase in funding costs and downward pressure on exchange rates.

In the case of capital inflows low funding costs incentivize debt managers to borrow in foreign currency. Some debt managers have thereby exacerbated the challenges for CBs to control the monetary base, increasing the costs of monetary policy implementation, and adding to the pressures of currency revaluation. Some CBs have responded by issuing short-term C-Bills (CB paper) to sterilize the effect of foreign exchange inflows, thereby weakening CB balance sheets. Moreover, from a consolidated public sector balance sheet point of view, the implication is that borrowing that looks very attractive may turn out not to be, if the cost of borrowing for monetary policy purposes is included. Additionally, the issuance of short-term C-Bills may fragment the public debt market, inhibiting the consolidation of a complete yield curve.

In the case of capital outflows reduced liquidity increases funding costs in local currency while debt servicing costs in foreign currency denominated debt also increase if the exchange rate depreciates.

To help resolve potential conflicts between monetary policy and debt management it is important for policy makers to coordinate policies to achieve their respective objectives; in particular, it is essential for debt managers to explicitly take into consideration the broader macroeconomic environment when formulating debt management strategies. An asset-liability management (ALM) framework can be a valuable tool to analyze the impact of capital inflows and outflows, and the respective responses of debt managers to these flows on the consolidated public sector balance sheet, to make interactions and
potential conflicts between the management of the two sides of a public sector balance sheet explicit, and to provide a framework to deal with these conflicts.