

Second Sovereign Debt Management Forum

Issues in the Interface Between Debt Management Strategy and Macroeconomic Policy

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Macroeconomic policy and debt management: is there a connection?

- **For industrial countries no strong connection. Partial equilibrium risk-return calculations adequate.**
- **Developing countries might choose or be forced to default on their domestic and international debt.**
- **Renegotiation of contracts generates losses in output for some interval following default.**
- **These characteristics imply that governments of developing countries must do more than live within their permanent income.**

Macroeconomic policy and debt management: is there a connection?

- **Capital gains and losses on gross assets and liabilities have been important sources of crises. More important than flow deficits.**
- **The state contingent nature of these gains and losses mean that debt management policy in developing countries is much more important and difficult.**
- **The benefits associated with a government's financial intermediation must be balanced against costs of associated financial crises.**

Default and debt management

- **Default may be related to the composition as well as the level of net indebtedness.**
- **Multiple equilibrium arguments:**
Short term debt a potential problem if expectations are volatile
- **Asymmetric information arguments:**
The runs on countries might be similar to runs on banks.
- **Insurance crises:**
Net liquid assets, including lines of credit, are an invitation to insurance crisis.

Implementation of a debt management policy

- **Developing country governments have diverse and highly leveraged portfolios.**
- **Important examples of activities that generate assets and liabilities include:**
 - **foreign exchange market intervention,**
 - **deposit insurance,**
 - **lender of last resort commitments,**
 - **state owned enterprises,**
 - **membership in international organizations,**
 - **social insurance commitments.**

Implementation of a debt management policy

- **A good portfolio is one which balances the welfare gains from each activity with the costs generated by that activity's contribution to default risk.**
- **Debt management should consider both the contribution of a given debt structure to the probability that a default will occur and the costs of that default should it occur.**
- **A country with a very small chance of bad luck would choose a debt structure that generated costly renegotiation following a strategic default.**
- **The behavior of coalitions of creditors that emerge following a default may be difficult to predict.**

Implementation of a debt management policy

- Policy implication is that developing countries should be very conservative.
 - Strict limits of foreign currency debt
 - Domestic debt should be long term
 - Careful monitoring and control of implicit liabilities