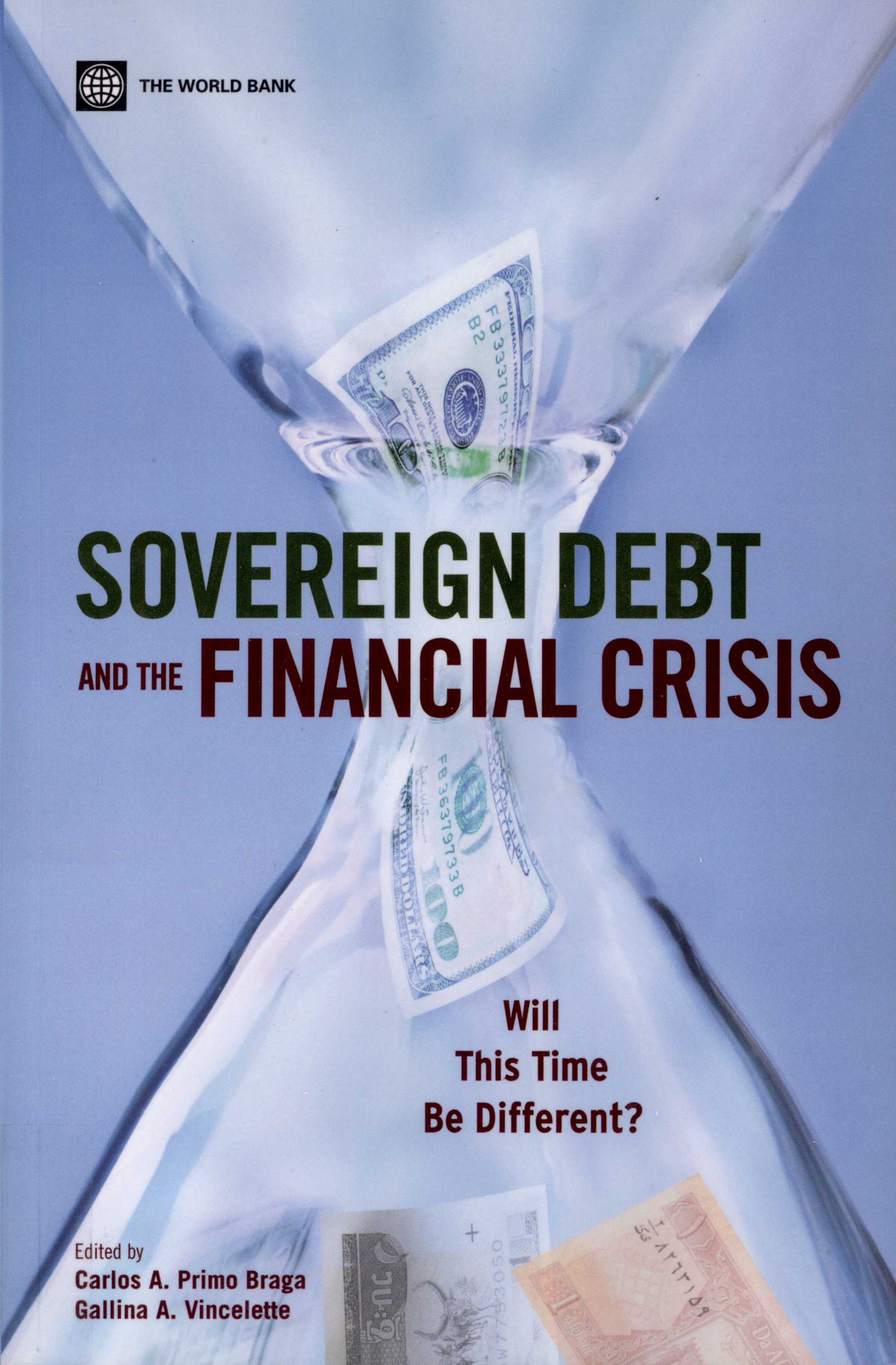

THE WORLD BANK

SOVEREIGN DEBT AND THE FINANCIAL CRISIS

Will This Time Be Different?

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Foreword

This volume on managing sovereign debt in the context of the financial crisis is extremely timely. Governments—especially governments in many affluent countries—will be heavily engaged over the next five years in reducing their fiscal deficits and managing large public debt portfolios.

Managers of sovereign debt shoulder enormous responsibilities in securing funding, structuring debt portfolios to best meet cost and risk objectives, and meeting other debt management goals, such as developing an efficient domestic market for government securities and managing the government's contingent liabilities. Government debt managers manage what is usually the largest debt portfolio in the country and the largest liability on the government's balance sheet. These portfolios can contain risky exposures, including significant proportions of foreign currency–linked and short-term debt. Because they represent the government in negotiating, structuring, and executing transactions, debt managers also carry important reputational responsibilities and risk for the government.

Government debt managers have faced many challenges over the past 10 years. Around the middle of the decade, the global economy grew at its most rapid rate in 40 years. Fiscal positions steadily improved; in several advanced countries, government debt managers faced the prospect of managing a contracting stock of public debt and debated the merits of maintaining a sizable and liquid government bond market. Governments in many emerging market countries extended their yield curves, as foreign investors increased their currency and interest rate exposure and domestic institutions invested more in government securities following reforms to the pension and insurance sectors. These governments also increased the maturity of their debt portfolios and reduced the proportion of foreign currency–denominated debt.

The recent financial crisis originated in the advanced countries. It demonstrated how all of the elements that form the Basel II pillars, including market discipline, could fail in a G-7 economy, creating economic instability on a global scale. The crisis markedly increased the complexity of the challenges confronting government debt managers. Fiscal positions rapidly deteriorated, competition for funding dramatically increased, governments were forced into new roles, and well-established policy frameworks were soon tested by the markets.

Long-serving fiscal management frameworks that were based on medium-term policy settings and nominal anchors—such as golden rules, deficit- and debt-to-GDP targets, and fiscal responsibility legislation—were overwhelmed, as was the carefully designed signaling and transmission architecture that separated fiscal, monetary, financial, and debt management policies. Policy signals started to blur when governments became guarantors and investors of last resort and took on ownership interests outside their traditional risk habitat and risk tolerance. At a time when the funding needs of governments and corporations increased, many emerging market issuers found themselves locked out of the global capital market for extended periods or were able to access the market only for restricted amounts and for short maturities at much higher spreads than before the crisis.

Challenging times lie ahead for government debt managers. Funding costs are likely to increase as the competition for savings intensifies and governments strengthen their banking systems and continue their structural reforms. Many governments have taken over quasi-public and private sector debt obligations and provided a range of guarantees and other contingent undertakings that will need to be monitored and managed by budget teams and government debt managers.

Fortunately, nations are much better equipped to manage these responsibilities than they were 15 years ago. They have absorbed the lessons from the 1998/99 Asian crisis and subsequent contagion, and they have made impressive progress in strengthening governance arrangements and developing sound debt management strategies that reflect the government's cost and risk preferences. Governments have also improved their monitoring and assessment of risk and performance by investing heavily in the human capital and management information systems needed for sound government debt management. All of this experience will be needed in navigating the path ahead.

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former Treasurer and Vice President
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This book is dedicated to the memory of Dana Weist, a friend, mentor, and guide to many who contributed to this book and many more besides. We will remember her for her beauty, grace, wisdom, and energy.

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Abbreviations

$	All dollar amounts are U.S. dollars unless otherwise indicated.
BIS	Bank for International Settlements
BMA	Bayesian model averaging
BOT	Buoni Ordinari del Tesoro
CAC	collective action clause
CAIC	Comisión para la Auditoría Integral del Crédito Público
CARICOM	Caribbean Community
CPI	consumer price index
CPIA	Country Policy and Institutional Assessment
CRC	*chambres regionales des comptes* (regional chambers of accounts)
DeMPA	Debt Management Performance Assessment
DMF	Debt Management Facility
DMO	debt management office
DRF	Debt Reduction Facility
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
ECCU	Eastern Caribbean Currency Union
EMBI	Emerging Markets Bond Index
EMBIG	Emerging Markets Bond Index Global
EPFR	Emerging Portfolio Fund Research
EU	European Union
FCL	flexible credit line
FDI	foreign direct investment
GDF	Global Development Finance (database and publication)
GDP	gross domestic product
GNI	gross national income
HIPC	Heavily Indebted Poor Countries (Initiative)
ICSID	International Centre for Settlement of Investment Disputes
IDA	International Development Association
ILLR	international lender of last resort
IMF	International Monetary Fund

LCU	local currency unit
LLR	lender of last resort
M&A	merger and acquisitions
MDRI	Multilateral Debt Relief Initiative
MFC	most favored creditor
MTDS	Medium-Term Debt Management Strategy
OECD	Organisation for Economic Co-operation and Development
PIP	posterior inclusion probability
PMG	pooled mean group
PPG	public and publicly guaranteed
PRGF	Poverty Reduction and Growth Facility
QEDS	Quarterly External Debt Statistics
RIC	risk inflation criterion
SAR	Special Administrative Region (China)
S&P	Standard & Poor's
SDR	Special Drawing Rights
SDRM	Sovereign Debt Restructuring Mechanism
SDT	Sovereign Debt Tribunal
TARP	Troubled Asset Relief Program
TIA	Trust Indenture Act
VaR	value at risk
WEO	World Economic Outlook (database and publication)

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