

OECD Sovereign Borrowing Outlook 2009

Hans J. Blommestein and Arzu Gok*

Many OECD governments are facing unprecedented challenges in the markets for bonds and bills, as a result of the explosive growth in their borrowing needs. Amidst an unusually uncertain economic outlook, the gross borrowing needs of OECD governments are expected to reach almost USD 12 trillion in 2009. The key policy issue is how to raise smoothly new funds at low cost, while also managing a rapidly growing debt stock.

For the time being, several factors are offsetting the trend towards higher yields. But the risk is that when the recovery gains traction and risk aversion falls, yields will start to rise. There are already signs that issuance conditions are becoming tougher with reports of weaker demand at some recent government bond auctions. Thus far, these less successful auctions can best be interpreted as “single market events” and not as unambiguous evidence of systemic market absorption problems. Also from this perspective lowering OECD sovereign ratings is not obvious.

The future could become more challenging, given that rising issuance is occurring in tandem with increasing overall debt levels. Also contingent debt is on the rise. In response, sovereign debt managers have begun to plan or implement credible medium-term exit strategies to avoid future “crowding out” and issuance problems.

Although fund raising strategies have become more flexible and somewhat more opportunistic, OECD debt managers remain committed to maintaining a transparent debt management framework so as to minimise medium-term borrowing costs. The other key challenge, roll-over risk as a result of the increasing use of short-term instruments, is being addressed by OECD debt managers by rebalancing the profile of their issuance programmes by incorporating more long-term instruments.

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Hans Blommestein is Head of the Bond Market and Public Debt Management Unit at the OECD. Arzu Gok is on secondment from the Turkish Treasury. This contribution is based on a revised version of Room Document 1 (2009 Funding Outlook in the OECD Area: Developments, Trends and Challenges for the Issuance Strategy) prepared as background for the second special session of the Working Party on Debt Management on “The Implications of the Credit Crisis for Debt Management Strategies and Operations”, held on 21 April 2009 at OECD Headquarters. The views expressed herein are those of the authors and do not necessarily reflect those of the OECD or its members.

I. OECD Working Party on Public Debt Management reports growing budget deficits and exploding borrowing needs

Gross borrowing by governments are expected to reach almost USD 12 trillion in 2009

Amidst a highly uncertain economic outlook, gross borrowing needs of OECD governments have increased explosively and are expected to reach almost USD 12 trillion in 2009. Borrowing needs have increased rapidly in response to soaring costs of financial support schemes and other crisis-related expenditures as well as recession-induced falls in tax income. Many OECD governments are facing this year a significant increase in expected budget deficits due to the fiscal fall-out of a recession that is worse than first anticipated and the financial consequences of resolving banking crises.

Consequences of increased borrowing need to be addressed

Delegates from the OECD Working Party on Public Debt Management (WPDM) confirmed that many DMOs¹ are confronted with dramatically increased borrowing needs². As a result, sovereign issuers need to address the consequences of increased competition in raising funds from markets, leading to higher expected borrowing costs. Issuance conditions have worsened with reports about sometimes weak demand at auctions, leading to postponed, failed or cancelled auctions. Thus far, these less successful auctions can best be interpreted as “single market events” and not as unambiguous evidence of systemic market absorption problems. Also from this perspective, changes in OECD sovereign ratings seem not warranted.

Less successful auctions are no evidence of systemic market absorption problems

Although fund raising strategies have become more flexible and somewhat more opportunistic, OECD debt managers remain committed to maintaining a transparent debt management framework so as to minimise medium-term borrowing costs.

But a timely and credible medium-term exit strategy is needed to avoid future “crowding out” and issuance problems

However, the future trend could be more challenging, given that rising issuance is occurring hand in hand with increasing overall debt levels. In response, several DMOs have adopted changes in issuance procedures³ and have begun to plan or implement sustainable and balanced medium-term issuance strategies that support a timely and *credible medium-term exit strategy*, thereby avoiding future “crowding out” and issuance problems.

The main objective of this ‘OECD Sovereign Funding Outlook’ is to provide an overview of the trends and recent developments associated with the strong increase in sovereign borrowing requirements and increasing contingent debt levels from the perspective of DMOs. To that end, the OECD has circulated a Survey on the 2009 Funding Outlook among members of the WPDM. The responses (reported in aggregate form below) have been used to calculate (estimates of) *Total Gross and Net Funding (Borrowing) Requirements* of OECD governments, the share of short-term debt issuance in total gross issuance, and the size of outstanding contingent government debt.

II. Overview funding outlook in the OECD Area

Estimates of Total Gross Funding (Borrowing) Requirements refer in this paper to *Total Marketable Issuance* by the central government. These estimates will be presented in aggregate form for the following groupings of OECD

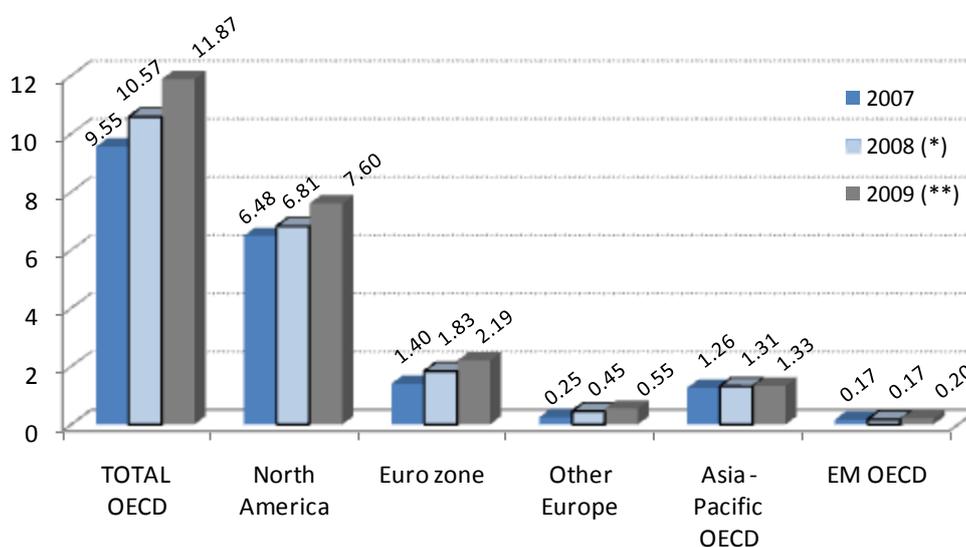
sovereign borrowers: (A) Euro zone; (B) Other Europe; (C) Asia-Pacific OECD; (D) North America; and (E) Emerging (EM) OECD.

The 2009 funding outlook is surrounded by high degree of uncertainty

Figure 1a shows that *gross funding needs* for the OECD area increased from more than USD 9 trillion in 2007 to around USD 10.5 trillion in 2008, while a further increase to almost USD 12 trillion is expected for this year. *Net funding requirements* is expected to increase from around USD 1.6 trillion in 2008 to more than USD 2.6 trillion in 2009 (Figure 1b). The 2009 funding outlook is, however, surrounded by an unusually high degree of uncertainty.

Figure 1a. Gross marketable issuance in the OECD area

In trillion USD



(*) As of today, pending further revisions

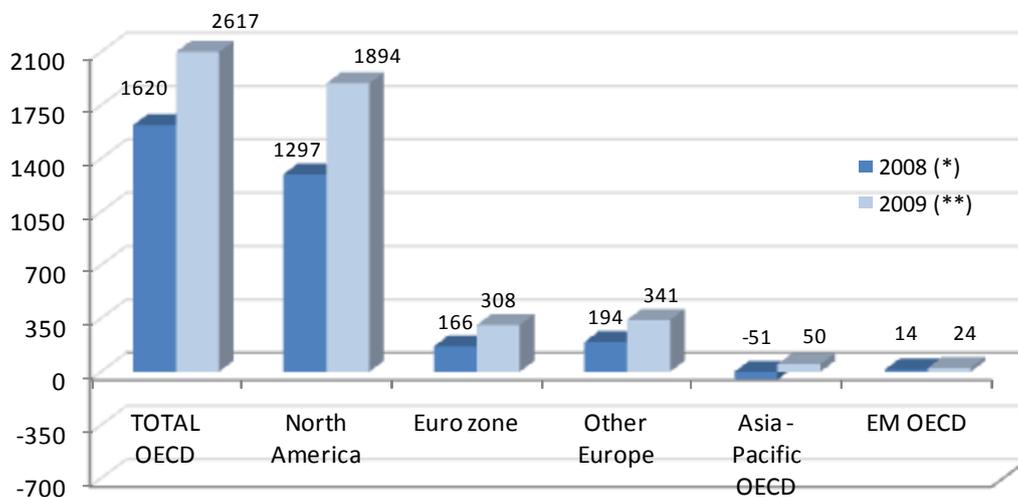
(**) Projection

Source: OECD Working Party on Debt Management.

The share of the *North American region* in total gross borrowing increased from nearly 61 % in 2007 to more than 65 % in 2008; and is expected to reduce slightly to 64 % this year. The share in total gross borrowing of *euro zone governments* is likely to increase by around 2%, from close to 17 % in 2008 to nearly 19 % in 2009. Interestingly, the share of *emerging OECD* and *Asia-Pacific governments* in total borrowing decreased slightly in the period 2007-2009 (Figures 2a and 2b).

Figure 1b. Net marketable issuance in the OECD area

In billion USD

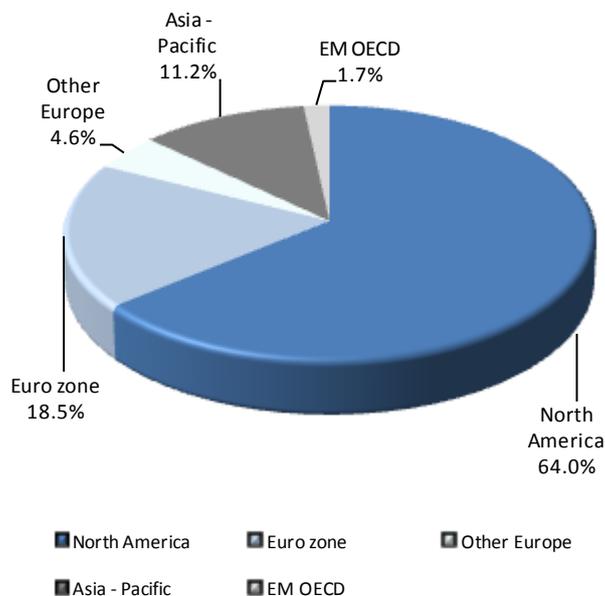


(*) As of today, pending further revisions
 (**) Projection

Source: OECD Working Party on Debt Management.

Figure 2a. Regional breakdown (2009)

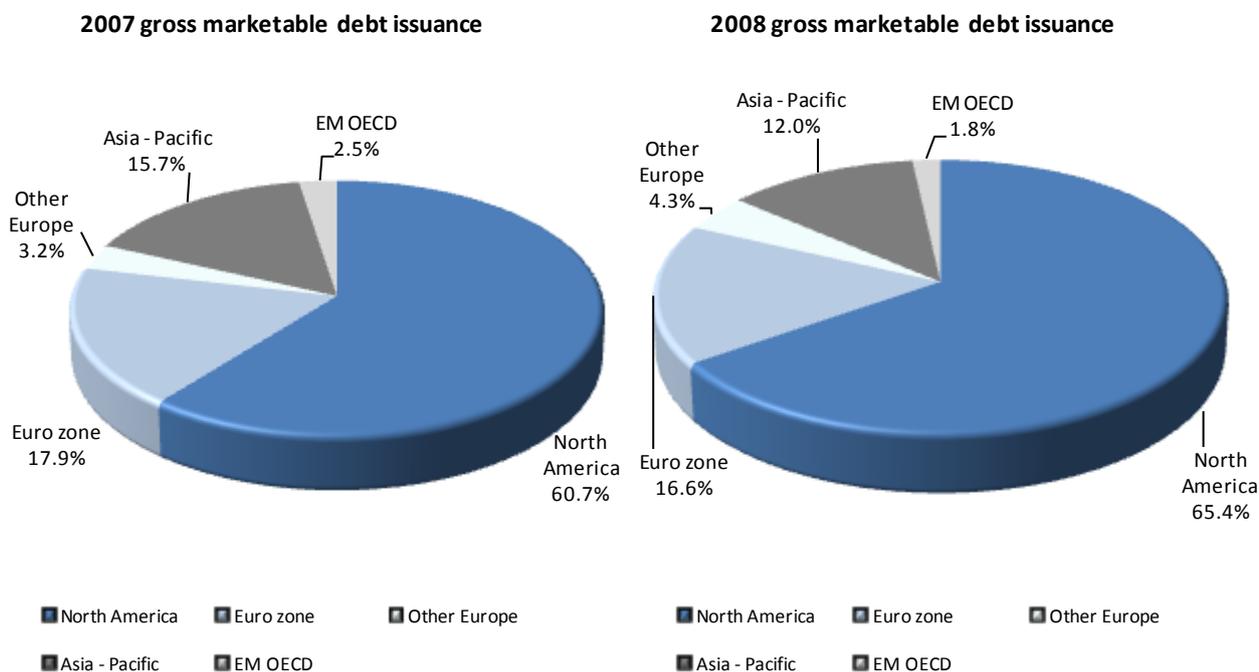
2009 gross marketable debt issuance*



* Projection

Source: Survey by the OECD Working Party on Debt Management.

Figure 2b. Regional breakdown (2007, 2008)



Source: Survey by the OECD Working Party on Debt Management.

III. Implications of record issuance

Since many OECD governments will also undertake this year (near-) record debt issuance, competition among sovereign issuers is set to remain strong. As noted, borrowing needs have increased in all regions (Table 1).

Table 1. Percentage change in funding

	Change in Gross Borrowing 2007-2008	Change in Gross Borrowing 2007-2009	Change in Gross Borrowing 2008-2009	Change in Net Borrowing 2008-2009
North America	47.6%	59.7%	8.2%	46.1%
Euro zone	26.8%	56.5%	23.4%	84.9%
Other Europe	83.6%	116.2%	17.8%	75.7%
Asia - Pacific OECD	5.1%	8.6%	3.3%	197.1%
EM OECD	-4.4%	3.8%	8.5%	71.2%
TOTAL OECD	37.1%	51.5%	10.5%	61.5%

Source: Survey by the OECD Working Party on Debt Management.

Impact on yields mitigated by fall in output, flight to safe assets, low official interest rates, quantitative easing and use of government paper as collateral

Additional competition for funds will come from the issuance of government-guaranteed bank bonds. This rapid and massive increase in government issuance can be expected to push prices of government debt down and yields up. However, the following financial crisis/recession-related factors are likely to mitigate or delay this supply impact on prices and yields: (a) the (projected) fall in output that is likely to keep expectations of future inflation in check; (b) high risk aversion that is encouraging a flight to safe and liquid assets; (c) low official interest rates; (d) the impact on (longer-dated) government debt of quantitative easing policies pursued by some OECD central banks; (e) the high demand for government paper for use as high-quality collateral.

But, clearly, when the recovery gains traction and risk aversion decreases, sovereign issuance will need to retrench in an orderly fashion to avoid crowding-out the private sector. To that end, a timely and credible exit strategy is needed.

IV. Structural changes in borrowing strategies?

Issuance challenges compounded by increasing debt

Tight liquidity conditions, the rapid increase in borrowing requirements, and highly risk-averse behaviour of market participants, have been forcing debt managers to change or modify their borrowing strategies in terms of maturity (shorter), currency (an increase in foreign liabilities⁴) and type of instruments (more bills and notes). The issuance challenges for many DMOs are compounded by increasing debt levels⁵ – a trend already visible prior to the crisis.

Thus far, many of the pressures to accommodate sharp increases in borrowing needs have been met by the issuance of short-term paper (*Short-Term Government Paper* – STGP). A recent OECD survey on ‘Changes in the Use of Short-Term Papers’ as well as discussions within the OECD WPDM and the Global OECD Forum on Public Debt Management⁶ covered two perspectives of the increased issuance of STGP, both prior and during the crisis: (a) debt manager’s point-of-view and (b) liquidity perspective.

The Survey focused on the changing role and use of short-term instruments issued by OECD DMOs in the period 1998-2007, while focusing on their strategic role in debt and/or liquidity management. The Survey shows that the use of STGP by emerging market economies had decreased significantly over the survey period. This is primarily the consequence of a structural trend whereby debt managers were able to lengthen the maturity of their portfolio, thereby decreasing the share of Treasury bills (T-Bills). T-Bills are the main instrument in the category of Short-Term Government Paper (STGP). Already before the crisis, countries with high borrowing requirements use more often T-Bills for funding purposes than the ones with low budget deficits or budget surpluses.

Crisis is having a major influence on issuance strategies and calendars

OECD debt managers underlined two important influences of the ongoing financial and economic crisis on borrowing strategies. *First*, the borrowing requirements in many OECD countries have increased significantly in response to financing bail-out operations and other-crisis-induced expenditures. *Second*, liquidity conditions tightened and market participants all over the world have become much more risk averse.

Almost 60 % of gross borrowing needs for 2009 covered by short-term debt

Debt managers confirmed that both factors are having a significant impact on their issuance strategies and calendars. Debt managers noted that in times of financial turmoil, STGP issuance is the major vehicle for governments to raise extra funds at short notice while providing liquid and secure instruments to the market. For the OECD area as a whole, it is estimated that almost 60 % of gross borrowing needs for 2009 will be covered by issuing short-term debt (Table 2). The share of short-term debt issuance in total gross issuance varies significantly across regions. For example, for 2009, this share drops to around 36 % when North America is excluded, approximately the same share as for *emerging OECD countries*, while the short-term issuance share is more than 50 % in the *euro zone area*.

Table 2. Overview of short-term issuance in 2009

	ST Issuance Projection 2009 (USD bn)	% of Short Term Issuance
North America	5350	70.4%
Euro zone	802	52.2%
Other Europe	156	28.5%
Asia - Pacific OECD	267	20.3%
EM OECD	73	35.9%
TOTAL OECD^a	6648	59.4%

^a Number of countries included: 26.

Source: Survey by the OECD Working Party on Debt Management.

Need to reduce roll-over risk

The sharp increase in short-term paper issuance has resulted in lower average maturities of debt portfolios with more challenging repayment schedules. Roll-over risk has therefore increased. In response, several borrowers indicated that they are aiming to reduce roll-over risk by incorporating more long-term instruments in issuance programmes.

V. Increase in contingent debt

DMOs need information on increase in contingent debt

Also contingent debt is on the rise. For 2009, for example, the issuance of government guarantees for financial institutions is estimated at over USD 3.4 trillion (Table 3). DMOs need to have reliable information about the outstanding amount of contingent liabilities. An increasing number of debt managers are involved in the management of guarantees.

Fiscal policy makers and debt managers need to contain the uncertainty associated with contingent liabilities. To that end, DMOs need not only to have a reliable picture of the total amount of contingent liabilities but also of the likelihood that these latent obligations become actual ones.

Table 3. Government guarantees to financial sector

	Outstanding Guarantee Amount (April 2009)	Projected Total Guarantee Amount for 2009
North America	349	1701
Euro zone	319	1073
Other Europe	170	540
Asia - Pacific OECD	139	177
EM OECD	0	0
TOTAL OECD	976	3490

Source: Survey by the OECD Working Party on Debt Management.

VI. Changing investor base

DMOs report greater urgency for organising road shows

Against the backdrop of concerns about market absorption problems, the crisis is also having an impact on the investor base of public debt markets with several DMOs reporting greater urgency for organising road shows for large (foreign) investors. It is important that the preferences of foreign and domestic investors are taken into account when making decisions about the modalities of supply/issuance programmes.

Pension funds and insurance firms important buyers of long paper

Debt managers expressed confidence that pension funds and insurance companies will continue to support demand at the long-end of the yield curve as important buyers of long paper.

Diminishing risk appetite foreign investors affecting emerging debt markets

The financial crisis has forced investors to reduce their exposure to riskier securities, thereby increasing the risk premium on emerging market instruments. DMOs from emerging debt markets expressed their concern that the *diminishing risk appetite of foreign investors* and associated out-flow of foreign capital are affecting especially the long end of the yield curve.⁷

VII. Policy conclusions

Since many OECD governments will also undertake this year *record debt issuance*, competition among sovereign issuers is set to remain strong. Additional competition for funds will come from the issuance of government-guaranteed bank bonds.

This OECD-area funding outlook is hampered by *unusual uncertainties* surrounding the general economic outlook. There is also uncertainty about the calibration of macro-economic stimulus plans and the risk that governments will reach funding constraints in keeping banks and other strategic companies afloat. In addition, contingent debt is increasing.

Issuance conditions have therefore worsened with reports about sometimes *weak demand* at auctions. In response, several DMOs have adopted changes in issuance procedures including the use of new sales channels and more flexibility

at auctions. But the risk is that when the recovery gains traction and risk aversion falls, yields will start to rise. There are already signs that issuance conditions are becoming more challenging with reports of weaker demand at some recent government bond auctions. Thus far, these less successful auctions can best be interpreted as “single market events” and *not as unambiguous evidence of systemic market absorption problems*. Also from this perspective lowering OECD sovereign ratings is not obvious.

Although fund raising strategies have become more flexible and somewhat more opportunistic, OECD debt managers remain committed to maintaining a transparent debt management framework so as to minimise medium-term borrowing costs.

However, the future trend could be more challenging, given that rising issuance is occurring hand in hand with increasing overall debt levels. Sovereign debt managers need therefore to continue with the implementation of a timely and *credible medium-term exit strategy*, supported by a sustainable and balanced medium-term issuance programme, to avoid future “crowding out” and issuance problems. For example, roll-over risk is being addressed by OECD debt managers by rebalancing the profile of their issuance programmes by incorporating more long-term instruments.

The crisis is having an impact on the investor base of public debt markets. DMOs have noted that a broad and diverse *foreign* investor base remains essential in maintaining a diversified and liquid domestic government bond market. Debt managers from emerging markets pointed to the *diminishing risk appetite of foreign investors* and associated out-flow of foreign capital that is affecting especially the long end of the yield curve. On the other hand, debt managers from all jurisdictions expressed confidence that pension funds and insurance companies will continue to support demand at the long end of the yield curve.

NOTES

¹ Debt Management Office (DMO).

² The policy information in this study is based on (1) the proceedings of meetings of the OECD Working Party on Public Debt Management (WPDM) held on 14-15 October 2008, 2 December 2008 and 21 April 2009; and (2) OECD surveys conducted among delegates of the WPDM.

³ See for details the article in this issue of *Financial Market Trends*: Hans J. Blommestein (2009), “New Challenges in the Use of Government Debt Issuance Procedures, Techniques and Policies in OECD Markets”, *OECD Journal: Financial Market Trends*, vol.2009/1.

⁴ Although many DMOs are using currency swaps to eliminate the resulting foreign currency exposure.

⁵ Clearly, OECD governments with low debt levels and modest borrowing requirements (some of them were until recently even running fiscal surpluses) are in a much more comfortable situation.

⁶ Annual Meeting of the Working Party on Government Debt Management held on 14-15 October 2008; and the 18th Global OECD Forum on Public Debt Management, held on 3 and 4 December 2008.

⁷ As noted above, many debt managers (also from mature markets) were forced to rely more heavily on the issuance of short-term and floating rate instruments.