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The Surge in Borrowing Needs of OECD Governments:

Revised Estimates for 2009 and 2010 Outlook

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OECD governments are facing ongoing, unprecedented challenges in raising smoothly large volumes of funds at lowest possible cost, while balancing refinancing-, repricing- and interest rate risks. Amidst continued uncertainty about the pace of recovery as well as the timing and sequencing of the steps of the exit strategy, gross borrowing needs of OECD governments are expected to reach almost USD 16 trillion in 2009, up from an earlier estimate of around USD 12 trillion. The tentative outlook for 2010 shows a stabilising borrowing picture at around the level of USD 16 trillion.

A looming additional challenge is the risk that when the recovery gains traction, yields will start to rise. Although there are signs that issuance conditions are becoming tougher, most OECD debt managers have been successful in financing the surge in funding needs. Less successful auctions can therefore best be interpreted as "single market events" and not as unambiguous evidence of systemic market absorption problems.

The future could become more challenging though, given that rising issuance is occurring in tandem with increasing overall debt levels and debt service costs. In response, sovereign debt managers, with the essential support of the fiscal authorities, need to implement a timely and credible medium-term exit strategy to avoid future "crowding out" and systemic issuance problems, while reducing government borrowing costs.

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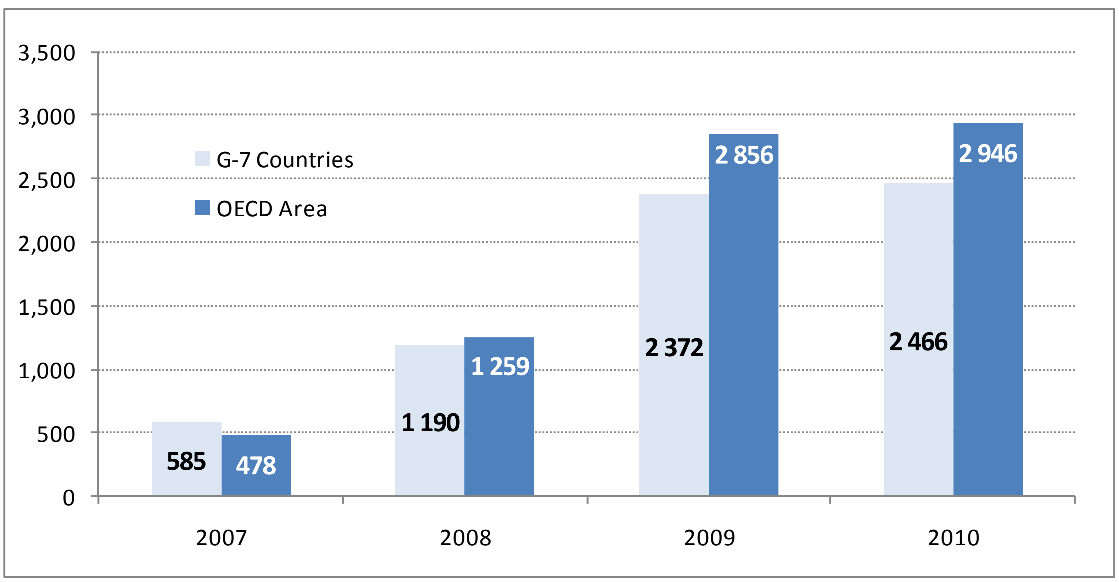
I. A Challenging Issuance Environment: A Surge in Budget Deficits, Borrowing Needs and Debt

Gross borrowing by governments is expected to reach almost USD 16 trillion in 2009

Amidst a still highly uncertain economic outlook with increasing budget deficits (Figure 1), gross borrowing needs of OECD governments have increased explosively and are expected to reach almost USD 16 trillion in 2009, up from an earlier estimate of around USD 12 trillion. The tentative outlook for 2010 shows a stabilising borrowing picture, but at the level of USD 16 trillion as well. In this note we are making a policy distinction between funding strategy and borrowing needs. Gross borrowing requirements are calculated on the basis of budget deficits and redemptions, while the funding strategy entails decisions how requirements are going to be financed using different instruments (*e.g.* long-term, short-term, nominal, indexed, etc.) and distribution channels[1]. Calculating short-term gross borrowing requirements is not without complications. Using a new uniform method for measuring short-term gross borrowing needs across different OECD jurisdictions shows a similar development for 2009-2010, though at lower levels.[2]

Figure 1. Fiscal deficits in G-7 countries and the OECD area

In USD billion



Source: OECD Economic Outlook 86 Database, November 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 a significant increase in expected deficits this year due to the fiscal fall-out of a recession that is worse than first anticipated and the financial consequences of resolving banking crises. In 2010, the OECD area-wide fiscal deficit is projected to peak at a post-war high of around 8.25% of GDP.[3]

For the time being, upward pressure on yields are tempered by several factors…

Delegates from the OECD Working Party on Public Debt Management (WPDM) confirmed that many DMOs[4] are confronted with dramatically increased borrowing needs[5]. As a result, sovereign issuers need to address the consequences of increased competition in raising funds from markets, leading to higher expected borrowing costs. A looming additional challenge is the risk that when the recovery gains traction and risk aversion falls further, yields will start to rise. For the time being, several factors are offsetting the trend towards higher yield, in particular high unemployment and weak output, low official interest rates and many investors continuing to seek safe, liquid instruments.

Less successful auctions are no evidence of systemic market absorption problems

Issuance conditions have worsened in some markets with reports about weaker 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.

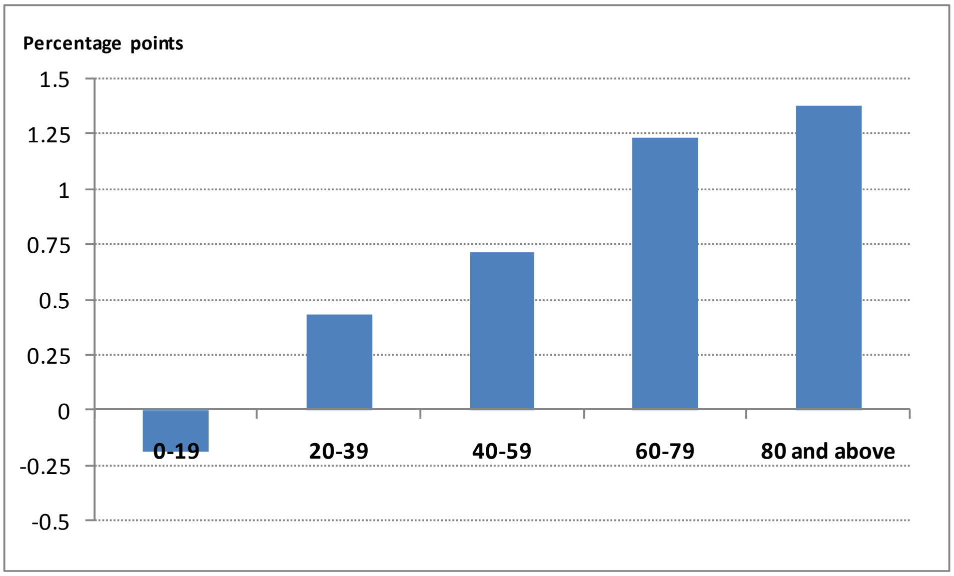
However, the future trend could be more challenging, given that rising issuance is occurring hand in hand with increasing overall debt levels. In response, several DMOs have adopted changes in issuance procedures and techniques[6]. Although fund raising strategies have become more flexible and somewhat more opportunistic, OECD debt managers remain committed to maintaining a transparent debt management framework so as to minimise medium-term borrowing costs.

A credible medium-term exit strategy is needed to avoid future "crowding out" and issuance problems

In addition, sovereign debt managers, with the essential support of fiscal consolidation policies, need to prepare and implement a timely and credible medium-term exit strategy to avoid future "crowding out" (Figure 2) and systemic issuance problems.

The main objective of this second 'OECD Sovereign Funding Outlook' is to provide an overview of the trends and recent developments associated with the strong increase in sovereign borrowing needs. To that end, the OECD has circulated a Survey among members of the WPDM. The responses (reported in aggregate form below) have been used to calculate (estimates of) Total Gross and Net Borrowing Requirements of OECD governments, and the share of short-term debt issuance in total gross issuance.

Figure 2. Spread between long-term and short-term interest rates versus gross government debt in % of GDP



Note: Bars represent average across all OECD countries for which data are available over the period 1994 to 2008. Short-term interest rates are typically rates on 3-month Treasury bills and long-term interest rates those on 10-year government bonds.

Source: OECD Economic Outlook 86 Database, November 2009.

II. Overview funding outlook in the OECD Area

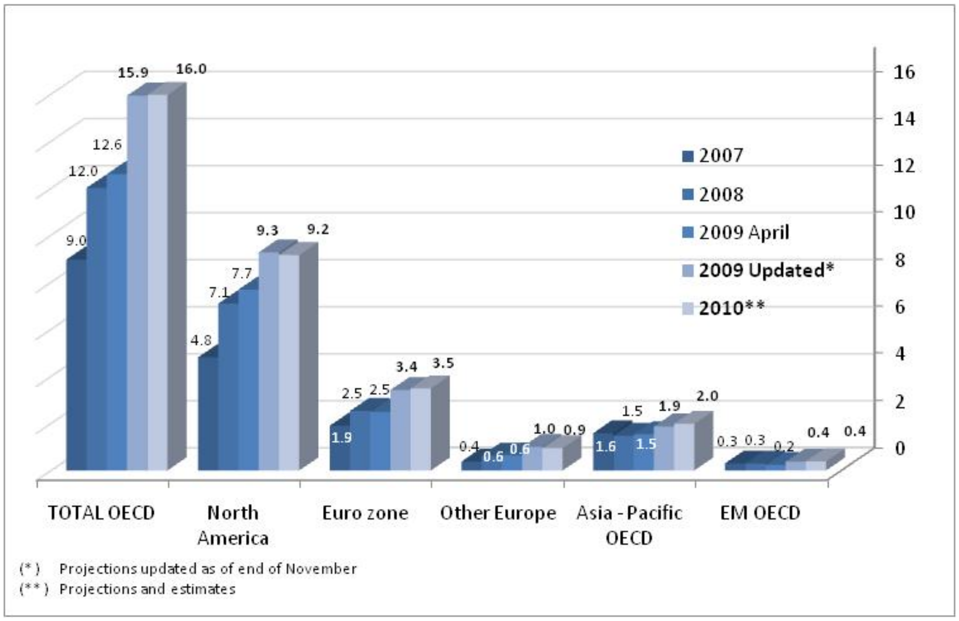
Estimates of Total Gross Funding (Borrowing) Requirements refer in this paper to Total Marketable Issuance by the central government. These estimates will be presented in aggregate form for the following groupings of OECD sovereign borrowers: (A) Euro zone; (B) Other Europe; (C) Asia-Pacific OECD; (D) North America; and (E) Emerging (EM) OECD.

Gross borrowing for 2009 and 2010 is estimated at around USD 16 trillion

Figure 3a shows that gross borrowing needs for the OECD area increased from USD 9 trillion in 2007 to around USD 12 trillion in 2008, while a further increase to almost USD 16 trillion is expected for this year. The tentative outlook for 2010 shows a stabilising borrowing picture at around the same level. Net borrowing requirements have increased sharply from around USD 500 billion in 2007, to almost 2 trillion in 2008. This trend is expected to continue in 2009, where net funding requirements are estimated to be more than USD 3.5 trillion. The outlook for 2010 shows a slight decline (Figure 3b).

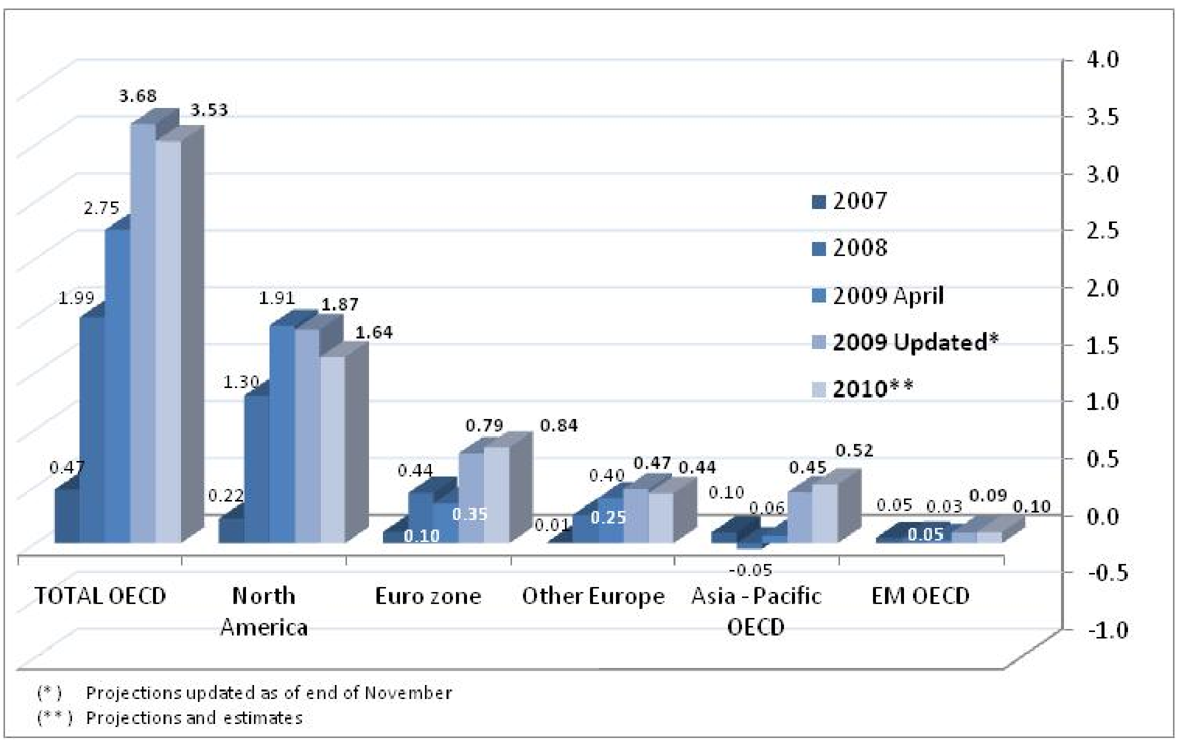
The 2009-2010 picture for the G-7 countries mirrors broadly the developments for the OECD area as a whole, with gross borrowing estimated for 2010 to remain at about the same level as in 2009 and net borrowing projected to decrease slightly in 2010 (Figure 3c). However, the 2010 funding outlook continues to be surrounded by a very high degree of uncertainty about the pace and strength of the recovery, the timing of the different exit measures and the ultimate budgetary costs of supporting the financial sector.

Figure 3a. Gross marketable issuance in the OECD area
In USD trillion



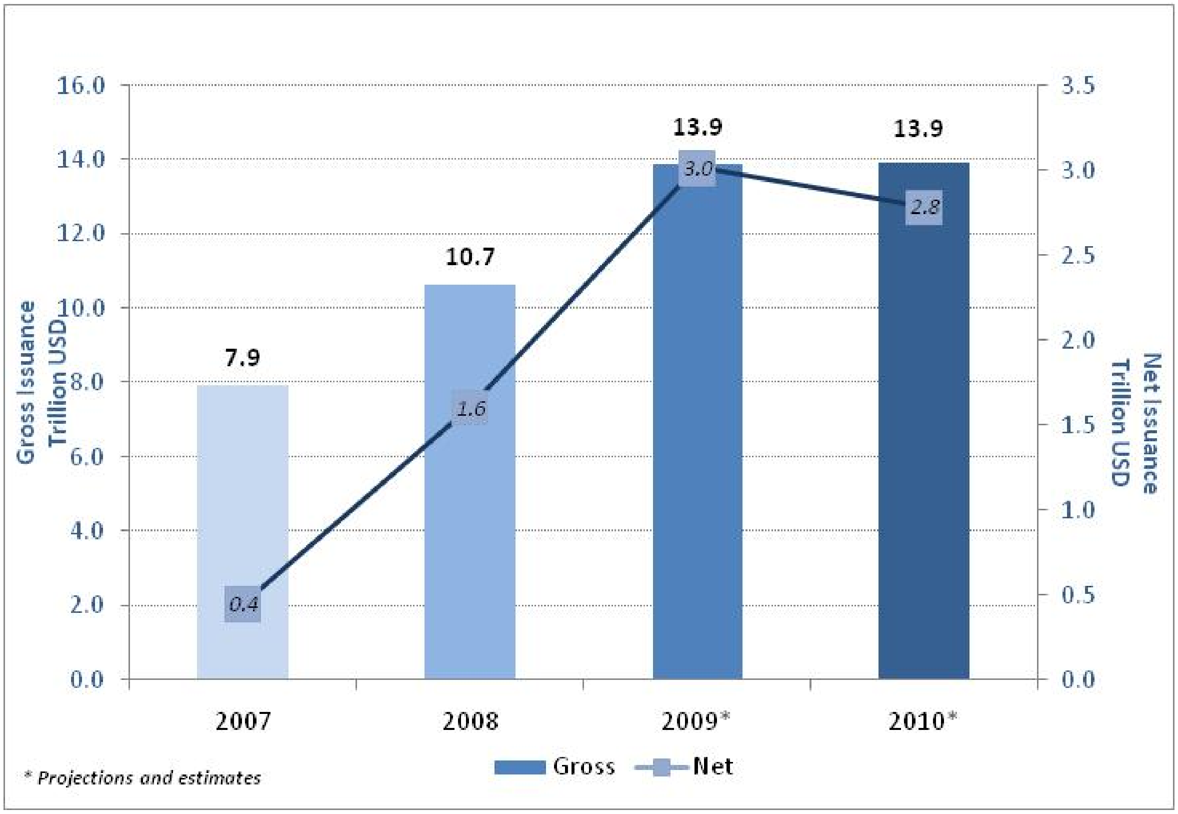
Source: Survey by the OECD Working Party on Debt Management; OECD staff estimates.

Figure 3b. Net marketable issuance in the OECD area
In USD trillion



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

Figure 3c. Gross and Net marketable issuance in G-7 countries
In USD trillion



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

The share of the North American region in total gross borrowing increased from nearly 54% in 2007 to 59% in 2008; and is expected to reduce slightly to around 58% this year and 57% in 2010. The share of euro zone governments in total gross borrowing has remained more or less at the same level throughout the period 2007-2009 and is expected to increase slightly to close to 22 % in 2010.

Like the North American region, the share of non-Euro zone European countries in total gross borrowing has increased from just over 4% in 2007 to 6.3% in 2009 and is expected to decrease to just below 6% in 2010. Interestingly, the share of Asia-Pacific governments has dropped from close to 18% in 2007 to nearly 12% in 2009. The share of Emerging OECD in total borrowing has decreased as well by 1% in the period of 2007-2009. For next year, the shares of both the Asia-Pacific and Emerging regions are expected to increase (Figures 4a and 4b).

Figure 4a. Regional breakdown (2007, 2008)

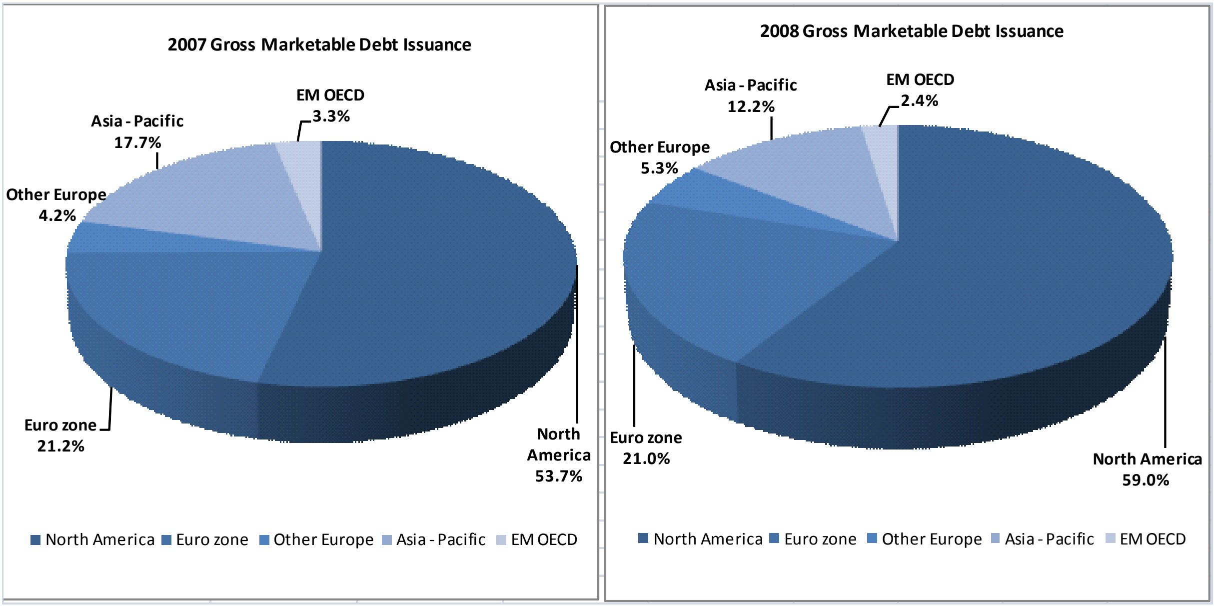
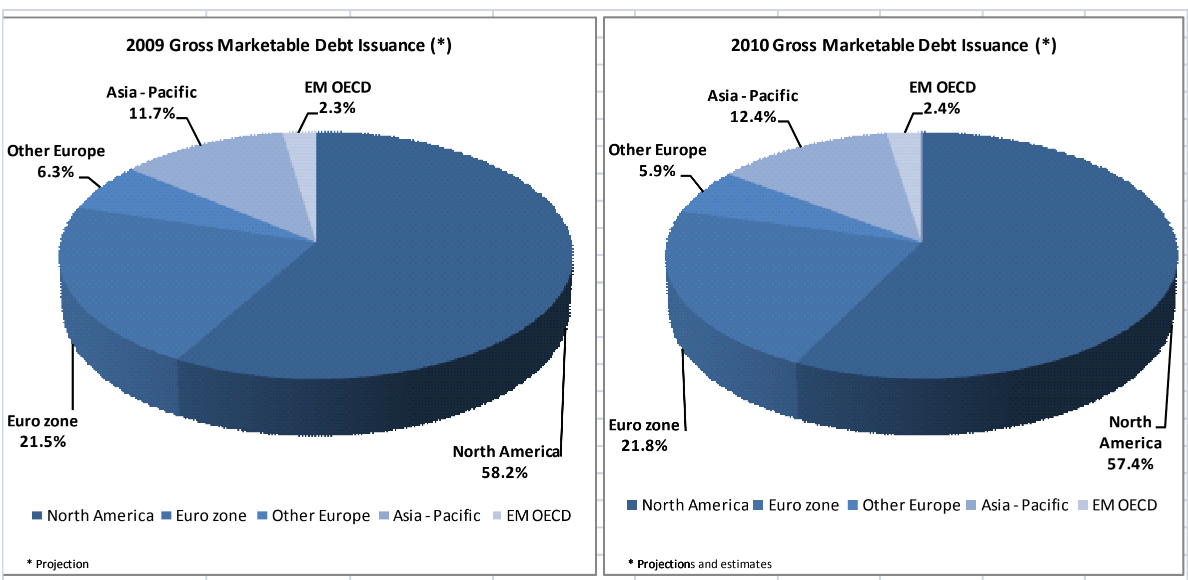


Figure 4b. Regional breakdown (2009, 2010)



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

III. Implications of record issuance

Since many OECD governments will also undertake this and next year (near-) record debt issuance, competition among sovereign issuers is set to remain strong. Borrowing needs have increased in all regions. For 2009-2010, this upward trend is expected to level off, but at a high level (Table 1a and 1b).

Table 1a. Percentage change in funding: Total issuance

	Change in Gross Borrowing			
	2007-2008	2008-2009	2009-2010	2007-2009
North America	47.5%	30.8%	-1.3%	92.9%
Euro zone	33.1%	35.4%	1.9%	80.2%
Other Europe	67.5%	58.0%	-5.1%	164.6%
Asia - Pacific OECD	-7.2%	27.1%	6.3%	18.0%
EM OECD	-0.7%	28.1%	4.4%	27.1%
TOTAL OECD	34.1%	32.7%	0.2%	77.8%

Table 1b. Percentage change in funding: Net issuance

	Change in Net Borrowing		
	2007-2008	2008-2009	2009-2010
North America	498.7%	44.7%	-12.7%
Euro zone	341.7%	78.7%	6.4%
Other Europe	1929.9%	91.1%	-7.6%
Asia - Pacific OECD	-152.2%	1000.6%	15.6%
EM OECD	3.4%	91.6%	4.3%
TOTAL OECD	321.4%	85.3%	-4.1%

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

Higher expected yields leading to higher debt-service costs…

Additional competition for funds has been coming from the issuance of government-guaranteed bank bonds. The rapid and massive increase in government issuance can be expected to push the prices of government debt down and yields up. Also higher debt levels can be expected to exert an upward pressure on rates (Figure 5a).

...but impact on rates mitigated thus far by high unemployment, demand for safe assets, low official interest rates, and non-standard monetary policy measures

Higher yields, in turn, will increase government debt payments (Figure 5b). [7] However, the following financial crisis/recession-related factors are mitigating or delaying this supply impact on prices and yields: (a) high unemployment that is keeping expectations of future inflation in check; (b) in spite of an increase in demand of some higher-yielding riskier assets, there is still a relatively high level of risk aversion that continues to encourage a strong demand by institutional investors for 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 by banks for use as high-quality collateral.

The importance of a credible exit strategy…

…supported by fiscal policy…

But, clearly, when the recovery gains traction, monetary exit measures are going to be implemented and risk aversion will decrease, while sovereign issuance will need to retrench in an orderly way to avoid market stress and crowding-out the private sector. To that end, a timely and credible exit strategy is needed, with the essential support of sound fiscal consolidation policies. It is also important to avoid or mitigate possible market stress related to the higher real-interest rates associated with the central bank's (CB's) exit strategy. To that end, it is important that the (future) shift to a tighter monetary policy is carefully implemented as regards the timing and sequencing of the different exit

…and information exchange between DMOs and central banks

measures to be taken by the monetary authorities. Since debt managers are financing historically high (and still increasing) budget deficits, it is important that DMOs and CBs keep each other informed about policy moves that can be expected to have significant market impacts.

Figure 5a. Long-term interest rates in selected OECD countries

In per cent per annum

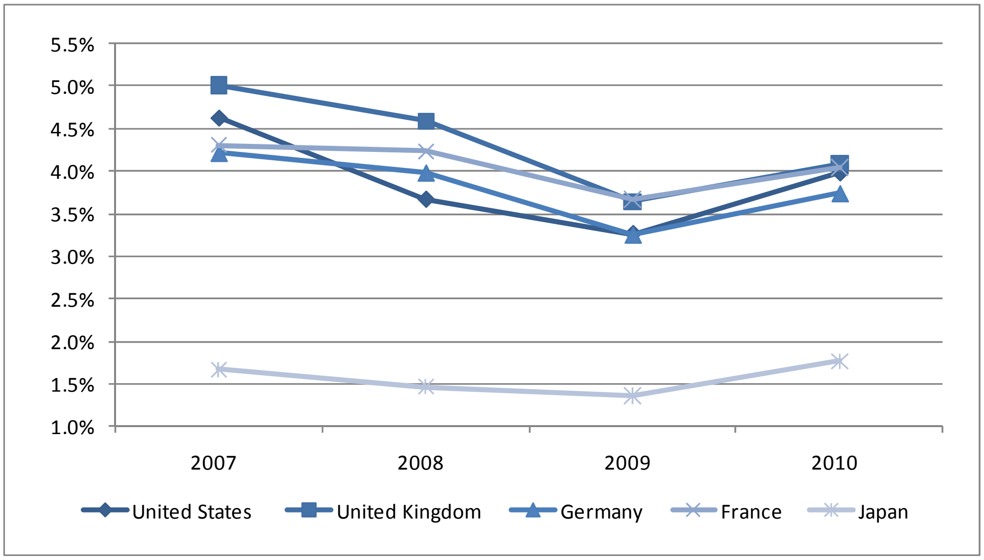
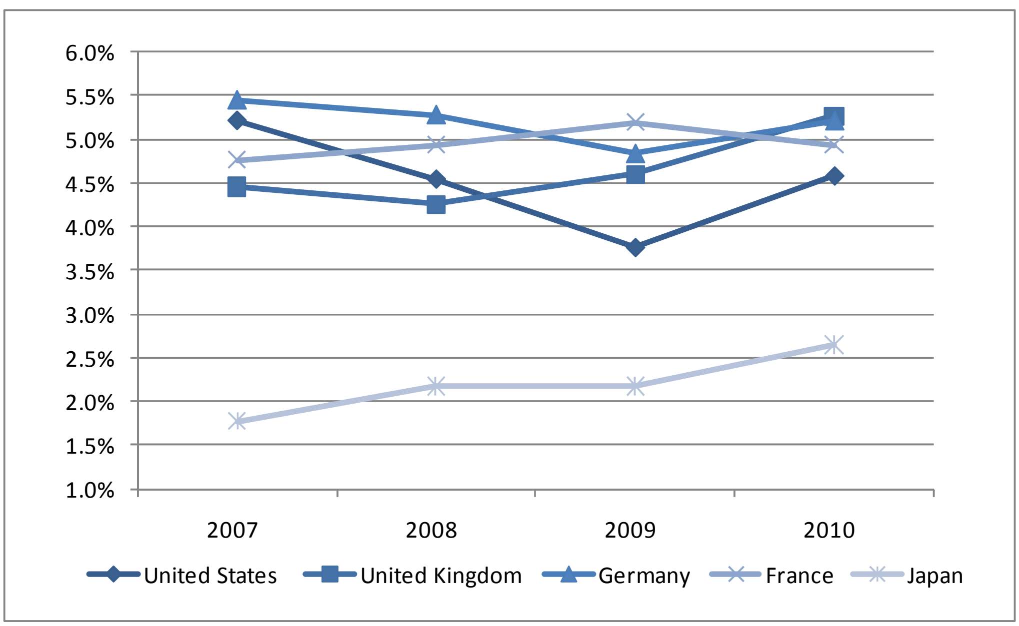


Figure 5b. General government net debt interest payments in selected OECD countries

In per cent of total outlays



Source: Calculations based on OECD Economic Outlook 86 Database, November 2009.

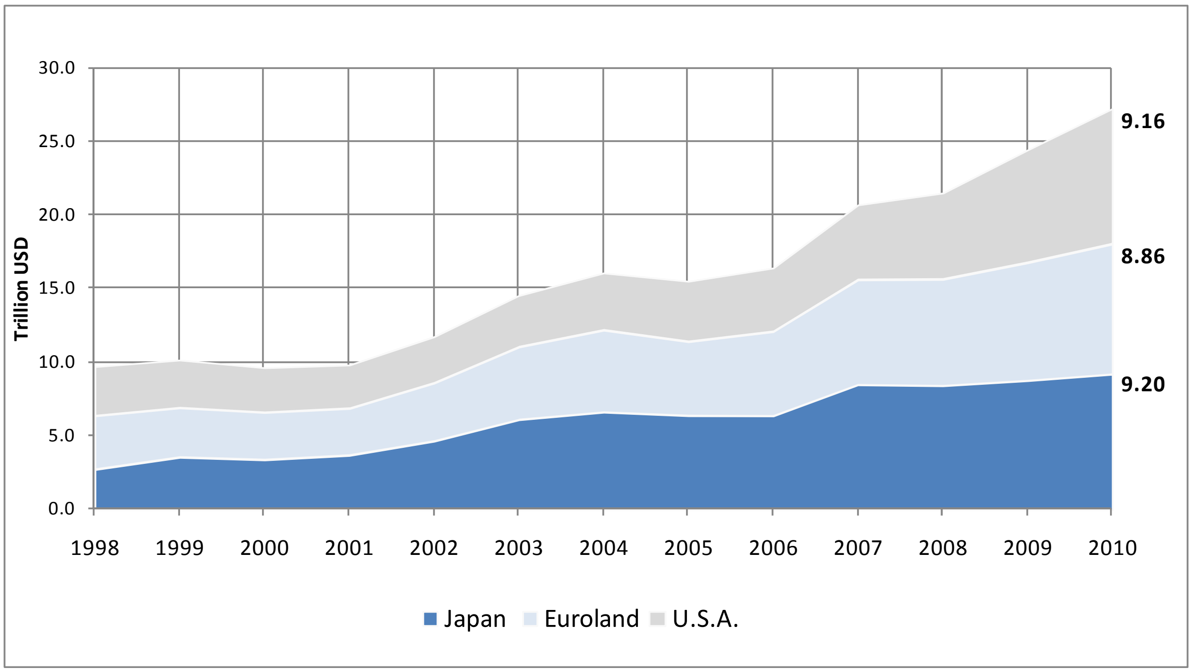
IV. Structural changes in borrowing strategies?

Issuance challenges compounded by increasing debt

Tight liquidity conditions, the rapid increase in borrowing requirements, the high demand for safe assets by many categories of investors, and the highly risk-averse behaviour of market participants, had been forcing debt managers to change or modify their borrowing strategies in terms of maturity (shorter), currency (an increase in foreign liabilities[8]) and type of instruments (more bills and notes). This response to crisis-related uncertainty has resulted in somewhat more opportunistic issuance programmes. The issuance challenges for many DMOs are compounded by increasing debt levels[9] – a trend already visible prior to the crisis (Figure 6).

Figure 6. Central government marketable debt in selected OECD countries

1998-2010



Source: 1998-2008: OECD Central Government Statistical Yearbook; 2009 and 2010: OECD WPDM, OECD Staff estimates.

Thus far, much 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); although more recently a shift to longer-term issuance can be detected (Table 2). 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 Management[10] covered two perspectives of the increased issuance of STGP, both prior and during the crisis: (a) the debt manager's point-of-view and (b) the liquidity perspective.

The Survey focused first on the changing role and use of short-term instruments issued by OECD DMOs in the period 1998-2007, while analysing 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 under favourable conditions, thereby decreasing the share of Treasury bills (T-Bills). T-Bills are the main instrument in the category of Short-Term Government Paper (STGP). Even before the crisis, countries with high borrowing requirements were using T-Bills for funding purposes more often than those with low budget deficits or budget surpluses.

Crisis (response) is having a major influence on issuance strategies and procedures

OECD debt managers underlined three 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 othercrisis-induced expenditures. Borrowing needs also increased via additional knock-on effects of the recession on expenditures and lower tax income. Second, liquidity conditions tightened initially and market participants all over the world became much more risk averse. Third, policy responses by central banks (both via conventional and non-conventional measures) and governments (with DMOs playing an important supporting role) improved liquidity conditions significantly.

Almost 70 % of gross borrowing needs for 2008 covered by short-term debt

Debt managers confirmed that these three factors had a significant impact on their issuance strategies and procedures.[11] Auctions are held more frequently than before, with an extra supply of short-term debt, notably bills. Debt managers noted that in times of extreme risk-aversion and high uncertainty, STGP issuance is the major vehicle for governments to raise extra funds at short notice while providing liquid and secure instruments to the market. The share of short-term debt in the total borrowing had jumped from 65 % in 2007 to nearly 70 % in 2008. For the OECD area as a whole, it is estimated that around 63 % of gross borrowing needs for 2009 and just over 62 % for 2010 will be covered by issuing short-term debt (Table 2). On the other hand, the share of short-term debt issuance in total gross issuance varies significantly across regions. For example, for 2009, this share drops to around 48 % for the whole OECD area when North America is excluded.

Need to (further) 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, many sovereign issuers indicated that they are aiming to reduce (further) roll-over risk by incorporating more long-term instruments in issuance programmes. Several OECD countries have already made important progress in this direction.

Table 2. Revised overview of short-term issuance in 2009 and 2010

	ST Issuance Projection 2009 (Bn USD)	Total Issuance Projection 2009 (Bn USD)	% of Short Term Issuance	ST Issuance Projection 2010 (USD Bn)	Total Issuance Projection 2010 (USD Bn)	% of Short Term Issuance
North America	6923	9279	74.6%	6767	9161	73.9%
Euro zone	2061	3424	60.2%	2063	3489	59.1%
Other Europe	461	998	46.2%	446	947	47.1%
Asia - Pacific OECD	475	1869	25.4%	526	1986	26.5%
EM OECD	192	372	51.7%	193	388	49.8%
TOTAL OECD [1]	10113	15942	63.4%	9996	15971	62.6%

Source: Surveys by the OECD Working Party on Debt Management, OECD staff estimates.

V. Maintaining and expanding the investor base

Preferences of foreign and domestic investors…

Against the backdrop of concerns about (future) market absorption problems, it is crucial that DMOs maintain or even expand the investor base. In this context, it is essential that the preferences of foreign and domestic investors are taken into account when making decisions about the modalities of supply/issuance programmes, especially when broadening the investor base and when new (retail or wholesale) products are planned to be introduced. Since uncertainties related to the crisis can be expected to have an adverse impact on the investor base, several DMOs reported greater urgency for organising road shows for large (foreign) investors.

With greater urgency for road shows…

Although issuance programmes have become somewhat more opportunistic, transparent debt management remains at the core of good relationships with the market. To that end, during crisis periods, direct contact with investors (including via road shows) is more important than before, in particular to explain changes in the overall situation and policy framework. All forms of communication are of importance, including high-quality websites. In this context, primary dealers' principal job is to sell debt, while the principal task of DMOs is to explain how they (and the government moregenerally) operate.

…and importance of transparency and communication channels

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.[12]

VI. Policy conclusions

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

This second OECD-area funding outlook continues to be hampered by unusual uncertainties surrounding the general economic outlook, the calibration of macro-economic stimulus plans, increasing debt and debt-service levels, as well as the timing and sequencing of the steps of the exit strategy. In addition, contingent debt is fairly high.

Issuance conditions have therefore worsened with reports of 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 as indicated by reports of weaker demand at some recent government bond auctions.

Thus far, however, most OECD debt managers have been very successful in financing the surge in funding needs. Less successful auctions can therefore best be interpreted as “single market events” and not as unambiguous 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.

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 give high priority to the implementation of a timely and credible medium-term exit strategy. Addressing roll-over risk is a key element of rebalancing the profile of issuance programmes by incorporating more long-term instruments. A sound debt strategy needs to be supported by a credible medium-term fiscal strategy so as to avoid future “crowding out” as a result of higher interest rates and issuance problems. It is also important to avoid or mitigate possible market stress related to the higher real-interest rates associated with the central bank’s (CB’s) exit strategy. Since debt managers are financing historically high (and still increasing) budget deficits, it is important that DMOs and CBs keep each other informed about policy moves that can be expected to have significant market impacts.

The crisis is having an impact on the investor base of public debt markets. DMOs have noted that a broad and diverse investor base remains essential in maintaining a diversified and liquid domestic government bond market. Debt managers from emerging markets have pointed to the diminishing risk appetite of foreign investors and associated out-flow of foreign capital that is especially affecting the long end of the yield curve.

NOTES

[1] See, for example, Blommestein (2009a).

[2] See for details Olofsson *et al.* (2010).

[3] OECD Economic Outlook 86 (Preliminary Edition), November 2009.

[4] Debt Management Office (DMO).

[5] The most recent policy information in this study is based on OECD surveys conducted among delegates of the WPDM, public information from official sources, OECD Central Government Debt, Statistical Yearbook 1999-2008, and OECD Economic Outlook 86 database.

[6] See for details Blommestein (2009b).

[7] The data shown for Austria, Greece, Italy and Sweden are net of the impacts of swaps and forward rate transactions on interest payments, in accordance with national income accounts conventions. The data reported to Eurostat for the excessive deficit procedure includes such transactions and therefore may show lower interest payments in some years. For Belgium, the figures include interest payments on the debt of the railway company SNCB from 2005 onwards. For Germany, the figures include interest payments of the Inherited Debt Fund from 1995 onwards. In the case of Ireland and New Zealand, where net interest payments are not available, net property income is used as a proxy. For Japan, the figures include interest payments on the debt of the Japan Railway Settlement Corporation and the National Forest Special Account from 1998 onwards.

[8] Although many DMOs are using currency swaps to eliminate the resulting foreign currency exposure.

[9] 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.

[10] 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.

[11] See Blommestein (2009b).

[12] 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.

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