

Highlights from the OECD Sovereign Borrowing Outlook N°4*

by

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Abstract

OECD governments are facing unprecedented challenges in the markets for government securities as a result of continued strong borrowing amid a highly uncertain environment with growing concerns about the pace of recovery, surging borrowing costs, sovereign risk and contagion pressures.

The fourth OECD Sovereign Borrowing Outlook provides estimates of sovereign borrowing needs for 2011 and projections for 2012. In comparison with pre-crisis levels, gross borrowing by OECD governments is expected to remain at the elevated level of USD 10.4 trillion in 2011. In 2012, the borrowing needs are projected to reach USD 10.5 trillion, with a strong increase in longer-term redemptions. Against this backdrop net borrowing is estimated to fall to USD 2.1 trillion in 2012, while government debt ratios are expected to remain at high levels.

Raising large volumes of funds at lowest cost, with acceptable roll-over risk, remains therefore a great challenge for a wide range of governments, with most OECD debt managers continuing to rebalance the profile of debt portfolios by issuing more long-term instruments and moderating bill issuance.

Additional challenges for government (and corporate) issuers are the complications generated by the pressures of a rapid increase in sovereign risk, whereby “the market” suddenly perceives the debt of some sovereigns as “risky”, as well as euro area-induced contagion effects. Growing concerns among investors have resulted in the offloading of significant holdings of European debt.

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* This overview is based on the (forthcoming) OECD Sovereign Borrowing Outlook 4.

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OECD's work on public debt management

The OECD provides authoritative information on policies, techniques and operations in the area of public debt management and government securities markets through its Working Party on Public Debt Management (WPDM). The WPDM is a very practical and hands-on policy forum for the most senior OECD debt managers.

Since its creation, the WPDM has given senior government debt managers the opportunity to exchange informally and frankly their views and experiences in the field of government debt management and government securities markets. To that end, the agenda of meetings of the WPDM tracks closely the rapid development in government debt policies and markets. Accordingly, the Working Party has focused in the recent past on a wide range of topics, including such pressing government debt policy issues as sovereign risk, ensuring uninterrupted access to markets and borrowing strategies, new selling techniques, links between public debt management and macroeconomic policies, the organisation of primary and secondary markets in government securities, advances in risk management, how to manage OTC derivatives, and the role of Debt Management Offices in assessing and managing contingent liabilities. Information on meetings (including Global Forums) organised under the aegis of the OECD Working Party on Public Debt Management, and other related activities can be found on www.oecd.org/daf/publicdebtmanagement

Each year, the OECD circulates a survey on borrowing needs of member countries. The resulting reports¹ provide regular updates of trends and developments associated with sovereign borrowing requirements and debt levels from the perspective of debt managers. Accordingly, OECD's sovereign borrowing outlook provides data and information on funding policies for the OECD area and country groupings, including

- Gross borrowing requirements
- Net borrowing requirements
- Central government marketable debt
- Funding strategies
- Distribution channels

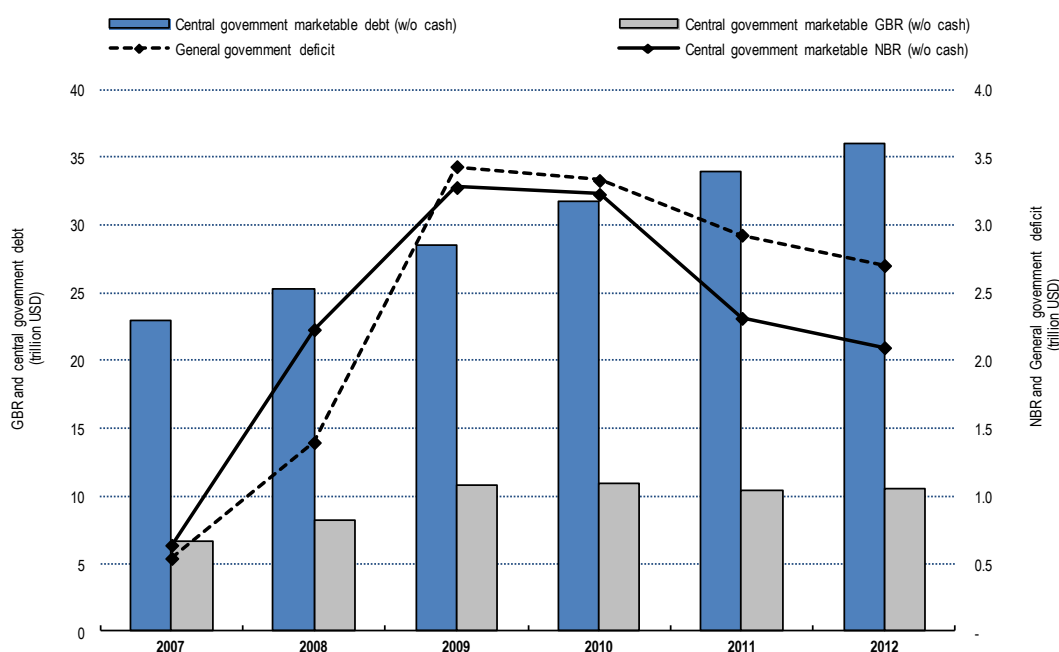
1. A highly uncertain issuance environment: concerns about the recovery and growing sovereign risk²

Amid a still highly unsettled economic outlook, the fourth OECD Sovereign Borrowing Outlook expects the gross borrowing needs of OECD governments to remain at the elevated level of USD 10.4 trillion in 2011 (in comparison with pre-crisis levels). In 2012, the borrowing needs of OECD sovereigns are projected to reach around USD 10.5 trillion (Figure 1).

Against the backdrop of a general lack of confidence with mounting uncertainty about economic prospects³, high budget deficits and growing concerns about sovereign risk, OECD debt managers are facing unprecedented funding challenges in meeting higher than anticipated, strong borrowing needs, including a strong increase in longer-term redemptions in 2012. Some debt managers indicated that a few months ago they were planning to decrease offering amounts for bills and bonds in the near future, but that in view of growing uncertainty over the fiscal- and economic outlook a wait-and-see approach is more prudent.

Several OECD issuers (in particular within the euro area) had to pay (and are paying) significantly higher borrowing rates. In some extreme cases market access became a huge test for the issuer, a situation further aggravated by contagion pressures and periods of mood swings of markets that seem to be unrelated to changes in economic fundamentals (aka ‘animal spirits’). Financial stress has risen dramatically, in particular in the euro area, with adverse feedback loops between the financial sector and the real economy gaining strength, while most banks are having no access to the market for senior unsecured bank debt.

Figure 1. Fiscal and borrowing outlook in OECD countries for the period 2007-2012



Note: GBR=gross borrowing requirement, NBR=net borrowing requirement

Source: 2011 Survey on central government marketable debt and borrowing by OECD Working Party on Debt Management; OECD Economic Outlook 90 database; and OECD staff estimates.

Uncertainty increased due to the slowdown in the pace of recovery of the world economy, which is somewhat more pronounced than previously anticipated. Real GDP growth in the OECD area is estimated to be 1.9% in 2011 and 1.6% in 2012.⁴ Many issuers had to deal with complications generated by the pressures of a rapid increase in sovereign risk, whereby “the market” suddenly perceives the debt of some sovereigns as “risky”. Bond market pressures have the potential to generate self-fulfilling debt problems by triggering higher interest rates by way of demanding compensation for higher sovereign risk that, in turn, may affect the growth prospects of countries.

2. Evolution of budget deficits, sovereign borrowing and debt

The general government deficit for the OECD area as a whole is estimated to reach 6.6% of GDP in 2011 (the equivalent of approximately USD 2.9 trillion), with a projected decrease to nearly 5.9% of GDP in 2012 (the equivalent of around USD 2.7 trillion) – see Figure 1.

However, in spite of these (projected) improvements⁵, deficits are still standing at near historical record levels. In the wake of these developments, central government marketable net borrowing requirements are estimated to fall from nearly USD 2.3 trillion in 2011 to around USD 2.1 trillion in 2012 (Figure 1). This amounts to a decrease from around 5 % of GDP in 2011 to 4.4% in 2012.

Government liabilities were initially driven largely by the recessionary impact of the unprecedented 2007-2008 global liquidity and credit crisis, including government expenditures due to fiscal stimulus programmes and later by the influence of recession-induced negative growth dynamics. Because of this, and despite falling interest rates during 2008-2011, general and central government gross debt-to-GDP ratios are expected to continue to increase.

For the OECD area as a whole, the outstanding central government marketable debt is expected to increase from USD 34 trillion (72.8% of GDP) in 2011, to around USD 36 trillion at the end of 2012 in OECD countries (74.9% of GDP). General government debt-to-GDP is projected to reach 105.7% in 2012.

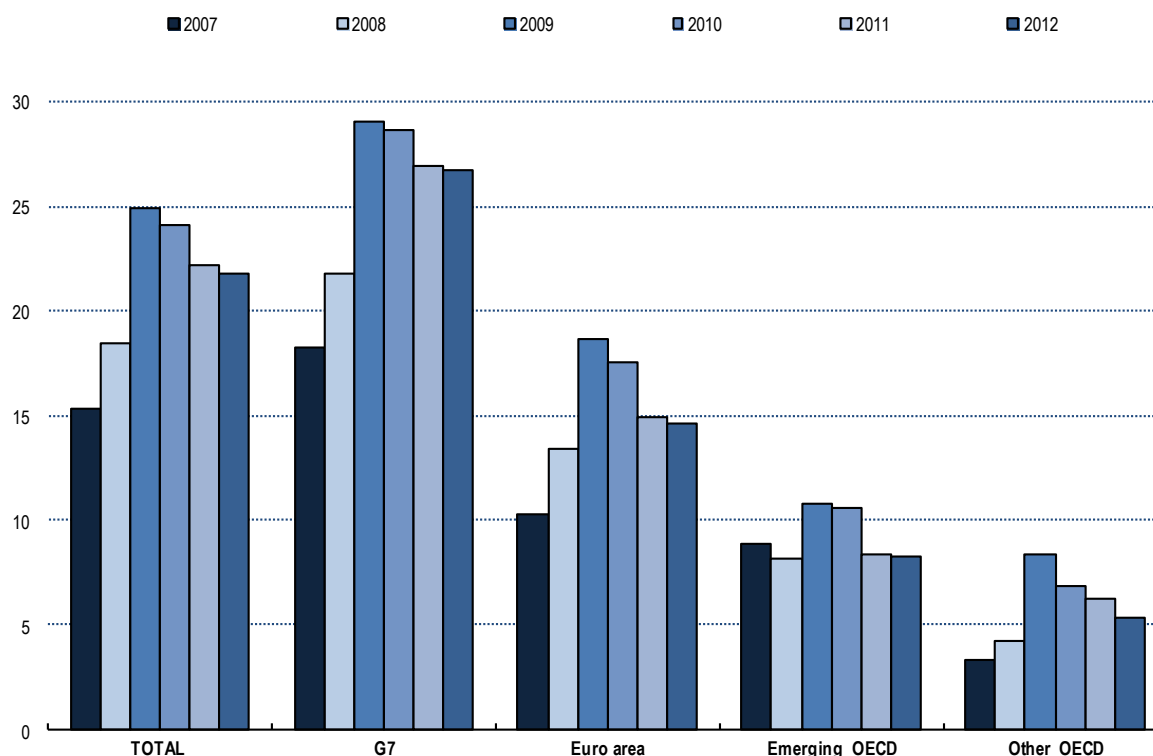
Of great importance for government funding operations and the projection of future borrowing needs, is the anticipated change in the direction of longer-term interest rates. After the peak of the financial crisis in 2008, long rates dropped. The OECD average long-term interest rate is expected to rise to around 4.7% in 2012, up from 3.7% in 2009. The projections assume that when government indebtedness passes a threshold of 75% of GDP, long-term interest rates increase by 10 basis points for every additional percentage point increase in the debt-to-GDP ratio⁶. Projections will therefore incorporate the recent impact on longer-term rates of the euro area crisis, in particular affecting the borrowing conditions of the so-called ‘peripheral’ economies, as to-day’s higher borrowing rates will be translated into higher debt-to-GDP ratios.

3. Summary overview of the borrowing outlook for OECD country groupings

The unprecedented global liquidity and credit crisis was at first associated with dysfunctional and collapsing financial institutions. This then set the stage for the second phase: the surge in government deficits and government (contingent) liabilities, driven largely by the strong recessionary impact of the global financial crisis. For the OECD as a whole (Figure 1), deficits peaked in 2009.

Gross marketable borrowing requirements remain elevated. The decrease in the estimated net marketable borrowing in 2011 and 2012 is striking (compared to 2009 and 2010), representing relatively high redemptions. Figure 2 presents estimates and projections of central government marketable gross borrowing requirements as a percentage of GDP for the various country groupings. For the G7 economies, gross borrowing requirements of the central government as a percentage of GDP are declining (by an estimated 2.7%), after having peaked in 2009, but remaining at elevated levels in comparison to pre-crisis levels (Figure 2). In contrast, borrowing needs are expected to return in 2011 to pre-crisis levels in “*Emerging OECD*”. Of particular interest is that the average gross borrowing ratio to GDP of the OECD countries in the *euro area*, after having peaked in 2009 (reaching 18.7 as a percentage of the GDP), strongly declined since then (by an estimated 4.1%) and is projected to fall below 15% in 2012.

Figure 2. Central government marketable gross borrowing as a percentage of GDP in OECD countries
Percentage of GDP



Source: 2011 Survey on central government marketable debt and borrowing by OECD Working Party on Debt Management; OECD Economic Outlook 90 database; and OECD staff estimates.

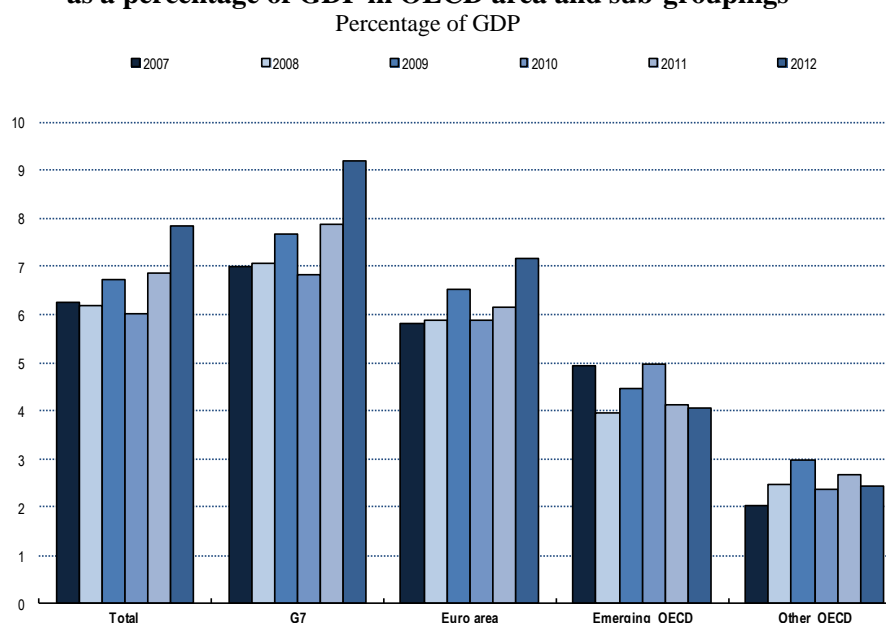
4. The challenge of raising large volumes of funds with acceptable roll-over risk during periods with changes in perceptions of sovereign risk

For countries facing historically high spreads, issuance conditions were quite challenging this year (in particular in the euro area). More generally, the backdrop of increasing debt levels and deficits added significantly to the difficulties faced by several countries in raising funds. As noted, these difficulties were sometimes compounded by very rapid (perceived) increases in sovereign risk without changes in fundamentals. Financial markets often react in a non-linear fashion to delayed or postponed fiscal adjustments as well as to sudden mood swings, thereby creating the risk of cliff effects where markets suddenly lose confidence in *yesterday's* safe sovereign asset. The mood swings of financial markets between periods of 'euphoria' and 'depression' are amplified at times by the actions of credit rating agencies (CRAs)⁷. Clearly, mood swings associated with changes in perceptions of sovereign risk are a major complicating factor for sovereign issuers as bond market pressures have the potential to trigger ultra-high funding costs by demanding compensation for (perceptions of) higher sovereign risks.

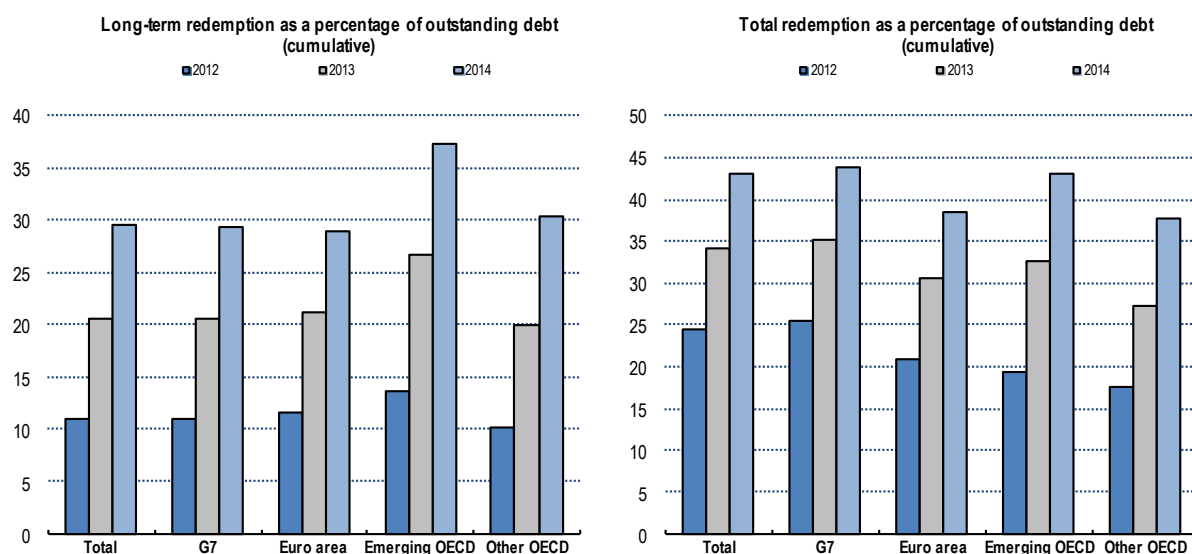
The redemption profile of medium- and long-term central government debt in the OECD area is fairly challenging with large projected payment flows for the G7 and Euro zone for 2012 (Figure 3).

Higher rollover risk is reflected in challenging redemption profiles for the coming years (Figure 4). The OECD area will need to refinance around 30% of its outstanding long term debt in the next 3 years. Of particular interest is that emerging OECD countries have the highest long term refinancing requirements in the next 3 years (Figure 4). Challenging redemption profiles combined with high deficits imply greater refinancing risk. Clearly, a spike in interest rates would then result in higher interest expenses which in turn would further increase borrowing needs.

Figure 3. Medium- and long term redemptions of central government debt as a percentage of GDP in OECD area and sub-groupings



Source: 2011 Survey on central government marketable debt and borrowing by OECD Working Party on Debt Management; OECD Economic Outlook 90 database; and OECD staff estimates.

Figure 4. Percentage of debt maturing in next 12, 24 and 36 months

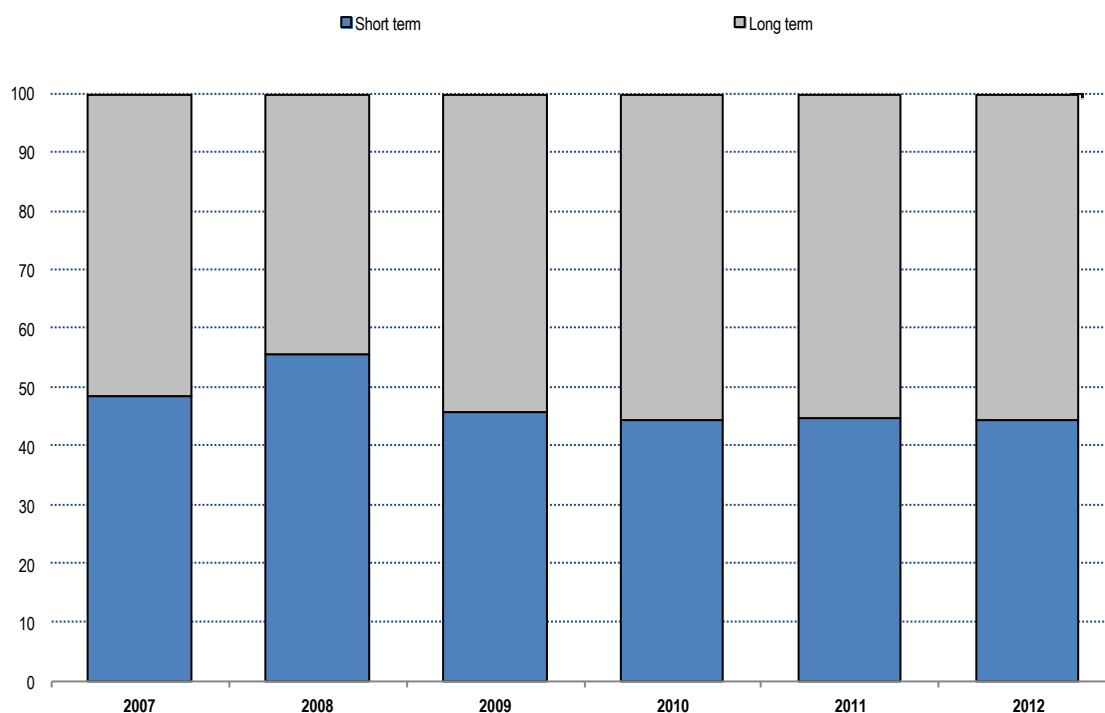
Source: 2011 Survey on central government marketable debt and borrowing by OECD Working Party on Debt Management; National authorities' data; and OECD staff estimates.

Average maturity is a common indicator to assess rollover risk. A country with a higher average maturity is expected to be affected less by a rise in interest rate movements.

Against this backdrop, many OECD debt managers continue to rebalance the profile of their debt portfolios by issuing more long-term instruments and moderating bill issuance. These debt management considerations are in many markets taken against the backdrop of elevated debt to GDP ratios and fiscal consolidation. Many governments aim to enhance *fiscal resilience* by seeking to mitigate refinancing and rollover risk (by spreading out the redemption profile along the maturity spectrum). On the other hand, some sovereigns with sounder fiscal and debt fundamentals may prefer to shorten their average maturity.

For the OECD area as whole, the share of short-term issuance to total gross issuance reached 55.8% during the height of the financial crisis in 2008 (Figure 5). The following two years, the share of short-term instruments dropped below the 2007 share, i.e. around 44%. The share of short-term issuance is estimated to continue to drop in 2011-12.

Figure 5. Maturity structure of gross-borrowing needs for OECD area
Percentage



Source: 2011 Survey on central government marketable debt and borrowing by OECD Working Party on Debt Management; and OECD staff estimates.

5. Funding strategy during periods of fiscal dominance and consolidation

The funding strategy entails decisions on how gross-borrowing needs are going to be financed using different instruments (e.g. long-term, short-term, nominal, indexed, etc.). Issuance of long-term instruments is dominated by fixed rate, local currency bonds. Of interest also is that, in 2009 (that is in the wake of the 2008 peak of the financial crisis) somewhat more foreign currency debt was issued, while the issuance of indexed-linked instruments declined. It is estimated that the issuance of long-term, fixed-rate instruments will slightly decrease in 2011-2012, while the use of indexed-linked may increase (projected to return to pre-crisis levels). Naturally, also the funding strategy is informed by cost versus risk considerations.

In addition, the government's preferences to enhance fiscal resilience reflect the situation of fiscal dominance in many OECD countries. The latter situation is shaped by conditions of serious fiscal vulnerabilities, perceptions of higher sovereign risk and considerable uncertainty about future interest rates⁸. Fiscal resilience encourages the maintenance of a diversity of nominal and price-indexed instruments along the maturity spectrum.

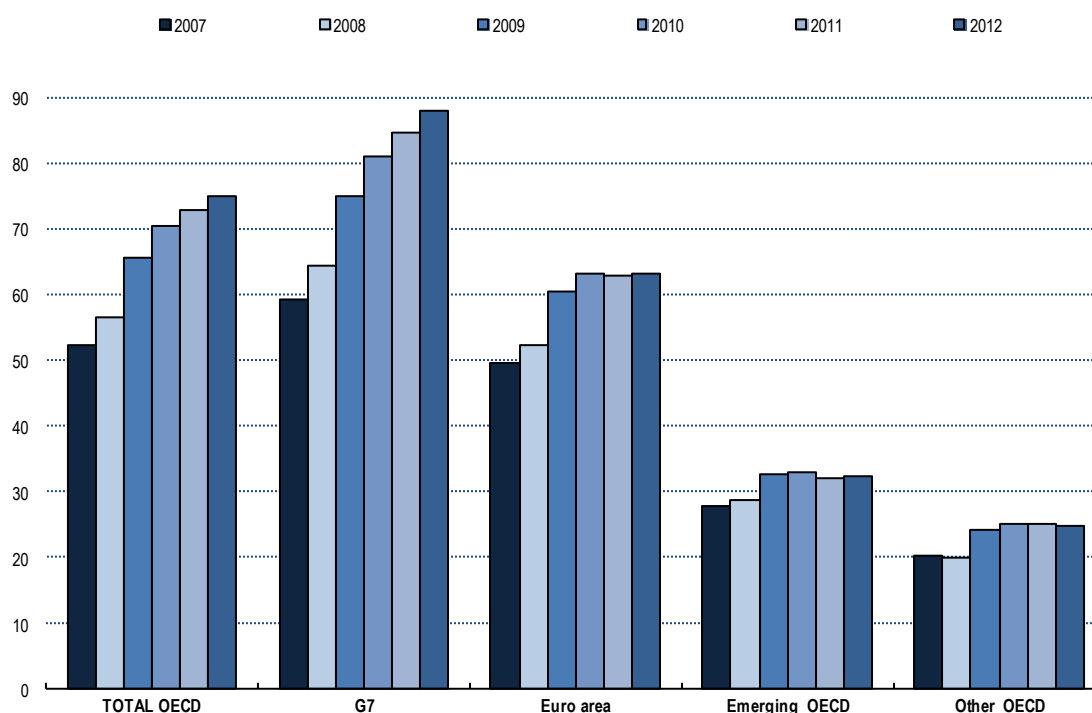
6. Central government debt at a glance

As noted, government debt is being driven largely by the recessionary impact of the global liquidity and credit crisis. Ratios of government debt-to-gross domestic product are expected to increase further in 2012. Figure 6 shows that the ratios of central government debt-to-gross domestic product of all country groupings considered here have increased since 2007.

The G7 central government marketable debt-to-GDP ratio is projected to reach nearly 87.9% in 2012. By comparison, the debt ratio of total OECD is expected to reach nearly 74.9 % in 2012. For euro area countries, this ratio is estimated to be slightly higher than 63%.

For *Other OECD* (includes a number of OECD countries⁹ with a fiscal surplus), this ratio is expected to be almost 25% in 2012, while for *Emerging OECD* this is expected to be around 32%. It is of interest to observe that *Emerging OECD* has far lower central government debt ratios than both the G7 and the OECD countries of the euro area.

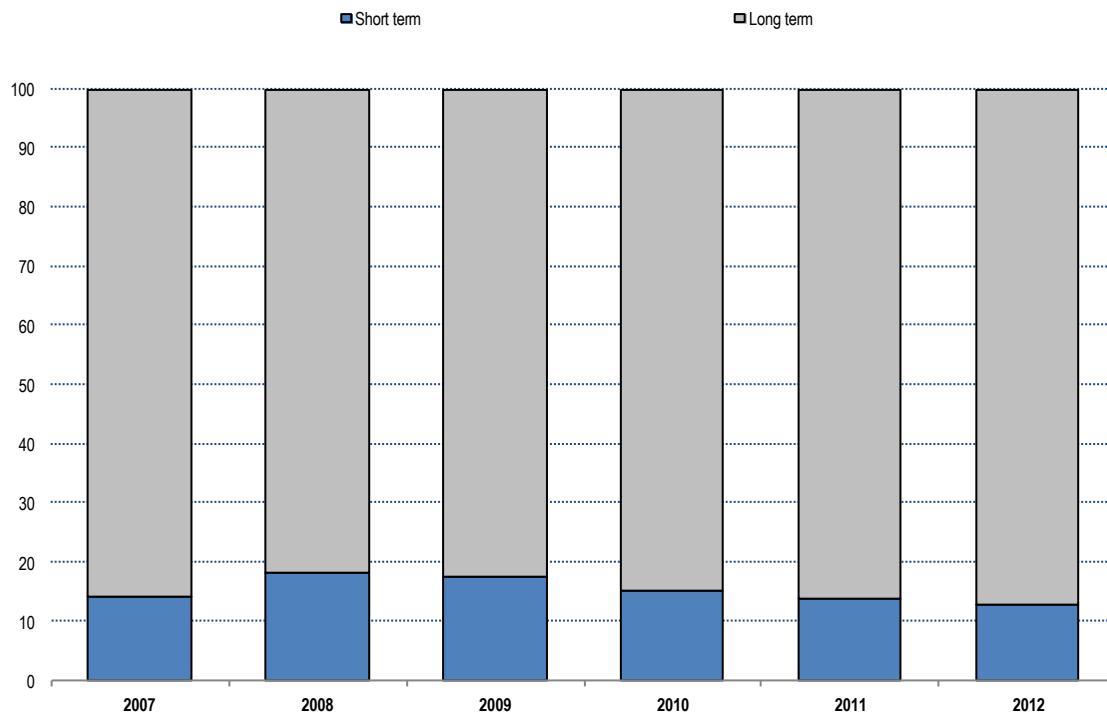
Figure 6. Central government marketable debt as percentage of GDP in OECD countries
Percentage of GDP



Source: 2011 Survey on central government marketable debt and borrowing by OECD Working Party on Debt Management; OECD Economic Outlook 90; and OECD staff estimates.

Figure 7 provides information about the maturity structure of the outstanding stock of central government marketable debt. At the height of the financial crisis in 2008, there was a sharp drop of almost 4% in the share of long-term liabilities in total marketable central government debt. The share of long-term debt is estimated to reach around 86% in 2011. For 2012, the long-term share is projected to reach approximately 87%.

Figure 7. Maturity structure of central government marketable debt for OECD area
Percentage



Source: 2011 Survey on central government marketable debt and borrowing by OECD Working Party on Debt Management; and OECD staff estimates.

Notes

- 1 The first OECD Sovereign Borrowing Outlook was published under the title “OECD Sovereign Borrowing Outlook 2009” in the OECD’s Financial Market Trends 2009/1, and the second OECD Sovereign Borrowing Outlook under the title “The Surge in Borrowing Needs of OECD Governments: Revised Estimates for 2009 and 2010 Outlook” in the OECD’s Financial Market Trends 2009/2. While the Third OECD Sovereign Borrowing Outlook was published in OECD’s Financial Market Trends 2010/2.
- 2 Figures are calculated using the exchange rates as of 1st December 2009. Additional information on methods and sources can be found in annex C of the (forthcoming) OECD Sovereign Borrowing Outlook.
- 3 OECD Economic Outlook 90, November 2011.
- 4 OECD Economic Outlook 90, November 2011.
- 5 OECD Economic Outlook 90, November 2011.
- 6 OECD Economic Outlook 88, 2010.
- 7 Many analysts argue that CRAs play a central role in the destabilising dynamics of financial markets.
- 8 Hans J. Blommestein and Philip Turner (2011), Interactions between sovereign debt management and monetary policy under fiscal dominance and financial instability. Paper presented at the ECB’s Public Finance Workshop on “*Challenges for Sovereign Debt Management in the EU*”, held on 7 October 2011 in Frankfurt, Germany. http://www.ecb.europa.eu/events/conferences/html/ws_pubfinance4.en.html
- 9 OECD Economic Outlook projections show a positive fiscal balance in 2011 for Chile, Estonia, Hungary, Korea, Norway, Sweden, and Switzerland. Moreover, Korea, Norway, Sweden, and Switzerland are expected to run a surplus in 2012.