Why are more sovereigns issuing in Euros?

CHOOSING BETWEEN USD AND EUR-DENOMINATED BONDS

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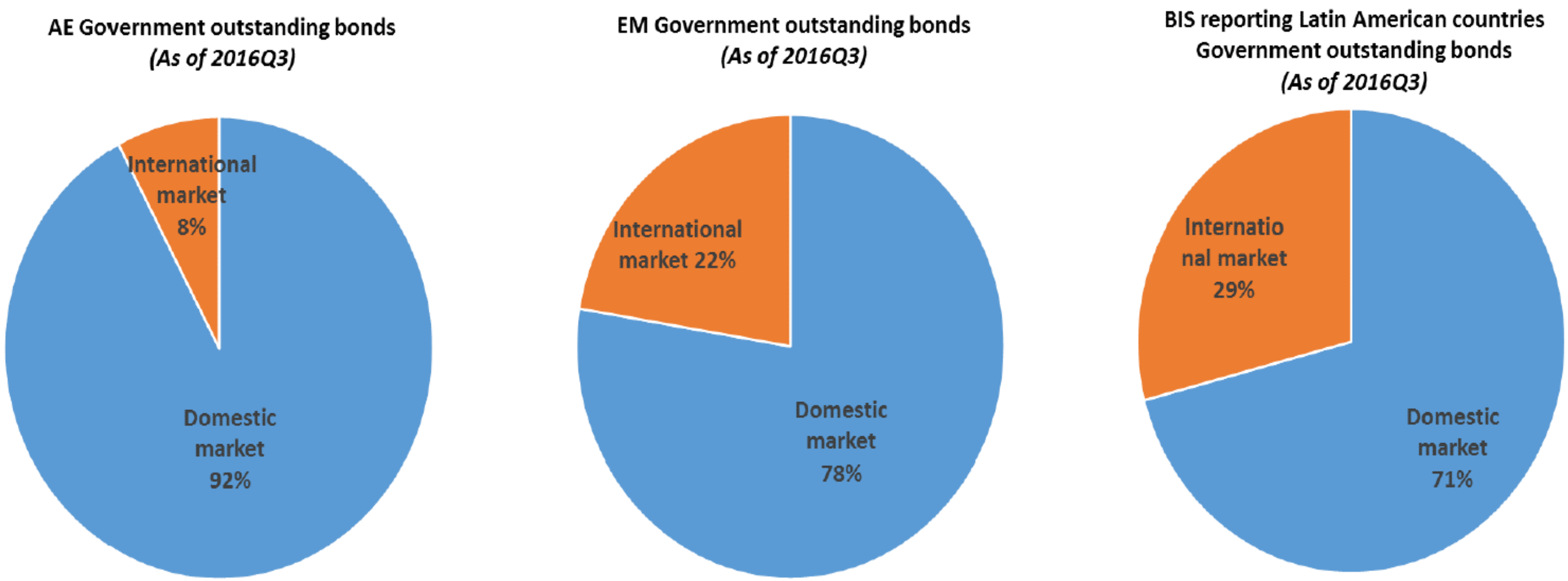
Agenda

- Foreign currency risk
- The currency choice: EUR vs USD
- Conclusion

Foreign Currency Risk

Emerging market economies have been trying to reduce FX exposure for years



Source. Bank for International Settlements.

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In practice debt FX risk is managed in two steps

- Countries first define the share of FX debt
  - Absorption capacity of the domestic debt market: use the monetary survey
- Then they decide on the composition of the FX debt
  - Finding a basket of currencies that has the least variance with local currency

For the composition of FX debt think at the variability of the budget

$$BBt = PBt - Ct \qquad (1)$$

$$var(BBt) = var(PBt) + var(Ct) - 2cov(PBt, Ct) \qquad (2)$$

BB_t : budget balance,

PB_t : primary balance

C_t : debt-service costs

- *Since the variance of PB_t is exogeneous, find the currency basket that minimizes the variance of Ct, and maximizes the positive covariance with the fiscal surplus PB*

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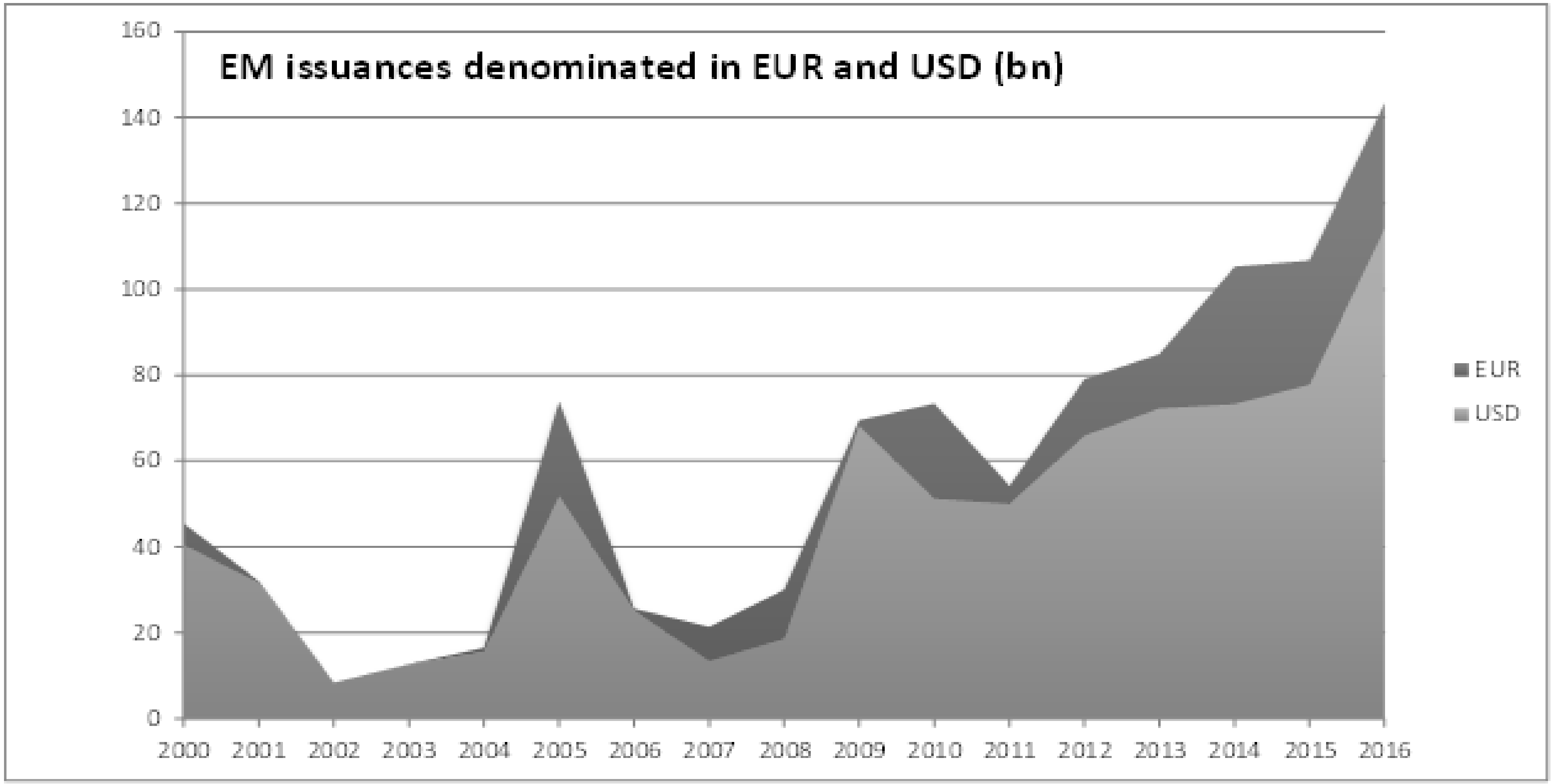
Pragmatic approaches

- ALM considering financial assets
- Matching the currency structure of export revenues or capital flows
- Favoring the currency or currency basket against which the local currency is managed

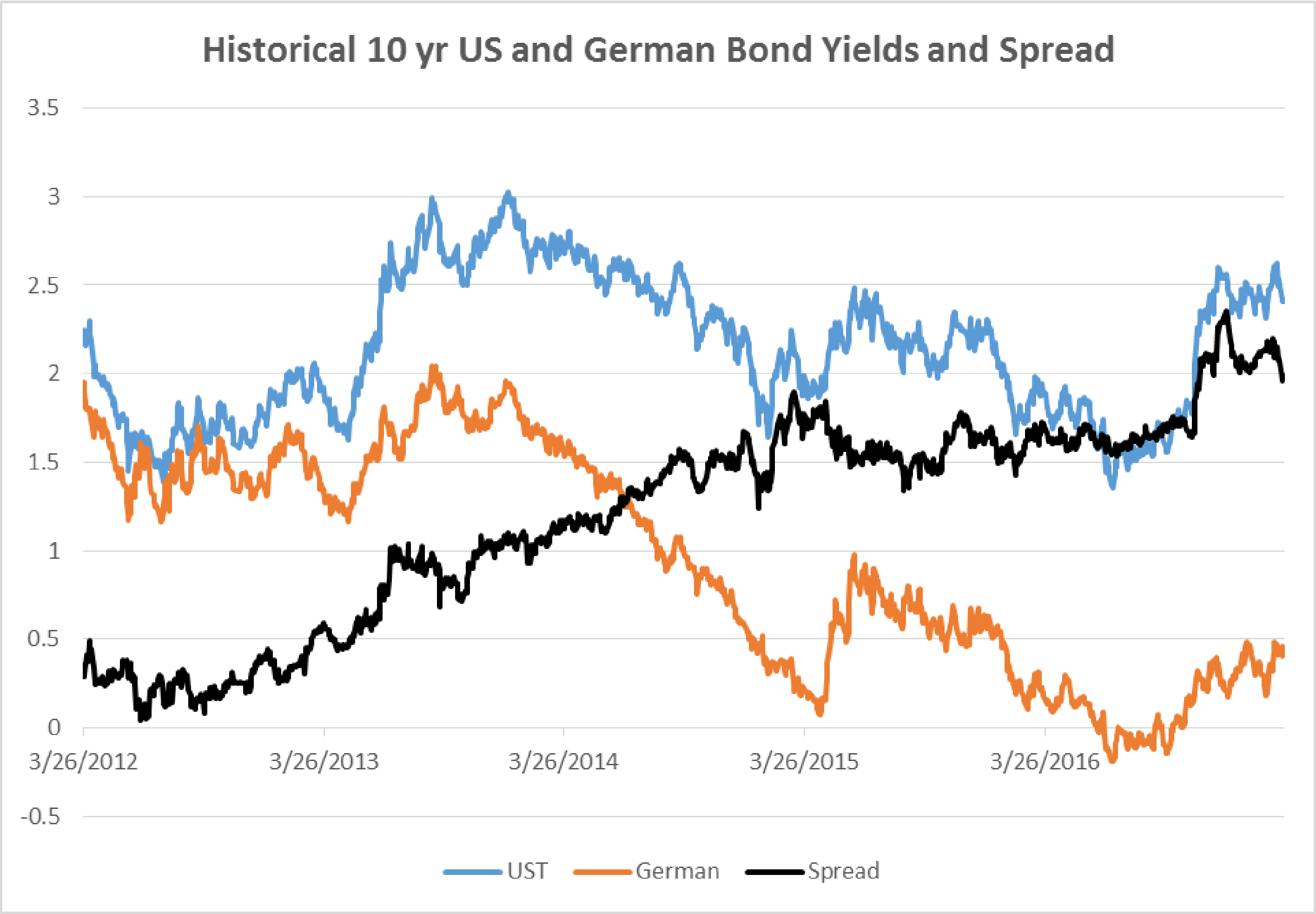
The currency choice: EUR vs USD

Strong growth of bond issues in EUR since 2011



Newcomers beyond Poland, Romania, Bulgaria, Tunisia, largely in Latin America. Also Indonesia (1bn July 2014, 1.25bn July 2015 and 3bn June 2016), small EUR issuance in 2014 from South Africa and Korea. These are all middle income, better rated issuers

Divergent monetary policies have triggered a widening in the spread of USD vs EUR interest rates



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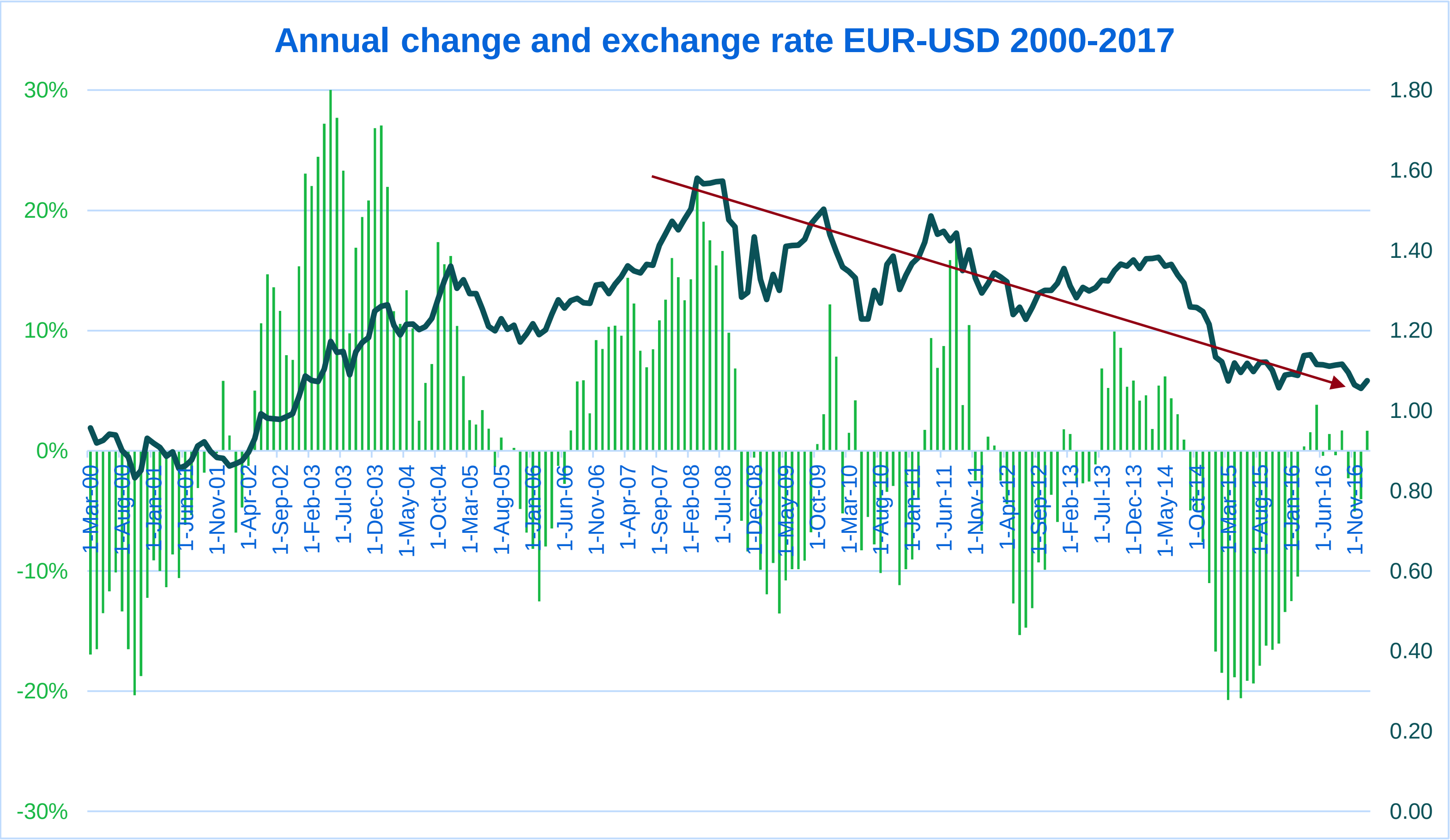
… and an adjustment in the exchange rate



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In most cases the combination of the macro and market environment was a strong influence

- Slowdown in China and the fall in commodity prices resulted in a sharp contraction of the current account surplus and in the government external revenues
- The increase in the funding needs coincided with devaluation and retraction in the demand for government securities in local currency
- Also some tightening in the USD market that makes book building more difficult
- While ECB keeps feeding liquidity to the market in EUR

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..that came together with the argument of diversification

- The investor base for EUR does not fully overlap with that in USD
- More real money investor in the EUR: German insurance companies and pension funds (9 to 30-year) and French investment funds (7 to 15-year)
  - Less sophisticated investors that wouldn't go for a USD security and do a swap
- Less relevant for small issuers

…and in some cases the externalities were also a consideration

- The private sector is also affected by the tightening conditions in the USD market and attracted by the liquidity and rates prevailing in the EUR market
- By issuing, the sovereign sets up a benchmark for the pricing of corporate issues
- For sovereigns building a link with international clearings, opening a market with new investors familiarizes them with the issuer and makes it easier to market local currency securities later on

What about the cost?

- The relative cost of funding cannot be made comparing the nominal interest rates but credit spreads over reference rates can. For most EMs the credit spreads in EUR tends to be larger than that in USD
- A fair cost comparison could be made using cross currency swaps:
  - Cost of issuing in EUR vs Cost of issuing in USD + swap to EUR.
  - The synthetic is cheaper: narrow credit spread in USD and distortion in swap market make forward EUR cheaper
- You still may want to issue in EUR for diversification but you need to accept the cost

What can be said about risk?

- Nothing can be said a priori and for all sovereigns about the relative risk of issuing in USD versus EUR since risk will depend on the country's desired composition of the FX debt (e.g. Mexico vs Turkey)
- Ideally debt managers should have a formal debt management strategy that includes clear guidance on the currency composition of the FX debt
- Selecting the FX currencies based on the debt manager's views of interest or exchange rates is tantamount to speculation
- The diversification is a recurring argument for issuing in EUR but given cost and benefits may not be a justification for everyone.

Conclusion

The currency choice should be anchored in a debt management strategy

- Use currency benchmarks to provide robust framework for the decision making on the currency choice. It will also facilitate measuring cost and risk

Disclaimers

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