Managing foreign debt and liquidity risks in emerging markets: selected issues from a South African perspective

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This note is intended to raise debate regarding a number of issues related to foreign debt and liquidity risk management, without pretending to have incontestable solutions or answers. South Africa has had more than its fair share of disruptions in foreign debt and foreign exchange markets; in the recent past it faced severe turmoil in the foreign currency market both in 1996 and in 1998. Extracting from that and earlier experiences, a handful of points will be covered in this short paper.

First, in analysing and managing liquidity risks, it seems advisable to guard against an excessive fixation on *quantities* rather than giving due attention to *pricing* and *underlying structure*. To illustrate: some countries with sound, well functioning financial markets and institutions and which are relatively open to international trade may have high short-term foreign debt, overwhelmingly related to trade finance – which should by its nature be short-term. It has been South Africa's experience that trade-related credit from abroad is quite robust, even during periods of extreme financial stress. This is, of course, related to exporters in all countries wishing to maintain and expand their profitable export business. Other countries, with underdeveloped financial markets, may find that their only avenue to foreign finance is through government or parastatal borrowing, which can be of a longer-term nature and the proceeds of which are then channelled by government or the parastatals to importers and other users of foreign currency. Perversely, the first group of countries may appear more vulnerable in terms of relative levels of short-term foreign debt. It is only when the underlying structure is understood that vulnerability can be properly assessed. Simple rules, while perhaps handy when attempting to sell policies, have strong limitations.

Pricing of foreign assets, liabilities and contingent items may be at least as important as quantities in assessing foreign debt and liquidity management policies. Artificial pricing, as is often encountered when for instance negative real interest rates are pursued or allowed by the authorities, should signal as strong a warning as weak liquidity ratios. The exchange rate regime also falls under the broad heading of pricing; it seems sensible that countries with fixed exchange rates would generally need more liquidity (or otherwise might be forced to become countries with floating exchange rates!).

Second, the combination of well developed, liquid money, capital and foreign exchange markets in any particular emerging market country can be a mixed blessing under conditions of general disillusionment with emerging market investments. There are indications that during the 1998 turmoil, when international investors decided to lighten their exposures to emerging markets, they liquidated their assets in countries such as South Africa where they could do so with great ease and on short notice, rather than in some of the other emerging markets with far less attractive fundamentals. However, this is of course not to say that poor-functioning, illiquid markets are to be preferred; the absence of well-developed financial markets would structurally sabotage growth and development. But great care must be taken in a liquid market environment to ensure robustness and ongoing liquidity, not least by reinforcing solid supervision and accepting price flexibility. In spite of all that, levels of reserves that inspire confidence should still be vigorously pursued. The appropriate level should most probably be based on more than the Guidotti rule alone. Judgment, formal models and scenario analysis should probably all play a part.

Third, when turmoil and liquidity outflows strike, it may be advisable to think very carefully about the often heard prescription of raising domestic interest rates promptly and strongly. About the direction and timing there should not be much of a dispute; there is probably no alternative. However, as far as the magnitude is concerned, great care should be exercised. Does a sudden, huge rise in interest rates not signal clearly to investors, "We're deep in trouble, we face volatile times, so if you are risk-averse or long-term oriented, rather stay out and allow those with a high-risk-high-return profile to play the market"? Quite perverse reactions may arise from this kind of policy response, with long-lasting adverse results. It would seem prudent in the setting of official interest rates to strive always for sustainability; if rates reflect a pattern of preferences between current and future consumption that

clearly cannot hold over anything but short periods, perverse reactions will probably dominate. While sustainability in policy is therefore the key, it might be devilishly hard to define the appropriate sustainable instrument settings in practice.

Fourth, there is a strong case to be made for utilising more policy instruments rather than fewer when dealing with sudden outflows of funds and volatile financial markets. Reliance on a single policy instrument or variable to rebalance matters may involve much more extreme settings of the instrument or variable than if several of them share the adjustment burden. In turn, this causes less fallout in the financial system and in the real economy. For instance, if the instability arises from a large current account deficit in combination with a sudden reversal of financial flows from inward to outward, the adjustment can be smoothed by adopting a combination of tighter interest rates, tighter fiscal policy, some foreign exchange participation by the central bank and exchange rate depreciation, instead of relying on the latter variable alone. The magnitude of overshooting and frictional costs to the economy are thereby contained. Of course, this brings us back to the matter of sustainability in policy which was raised under the third point above; a less dramatic change in each of several policy-related variables is more likely to be sustainable, and to be perceived as sustainable by all economic agents concerned.

Fifth, elaborating on the need for more policy instruments raised above: given the unique circumstances with which South Africa has had to deal, adjustment has on many occasions been smoothed through central bank involvement in the forward foreign exchange market. The South African Reserve Bank has for many years been involved in the dollar/rand forward foreign exchange market. The reasons for participation were primarily the need to acquire foreign exchange, particularly during the era of sanctions. The interaction between isolation from the rest of the world, international sanctions, low domestic savings, low foreign reserves and the existence of a dual currency "financial rand" system until March 1995 virtually ensured the continued participation of the Reserve Bank in the forward market.

In difficult times the existence of the forward book enabled South African institutions to borrow abroad. It also served as a means to protect the domestic economy from excessive volatility in international financial markets during the time of political transition and crises. It encouraged much needed capital inflows (in the form of short-term and long-term trade credit and project finance) to substitute for the normal portfolio inflows which were precluded by the financial rand mechanism.

Notwithstanding these advantages of using the forward book, there are various risks. Most importantly, the government incurs the foreign currency risk on the forward book. Moreover, the credibility of the monetary authorities has been called into question as the market focuses, from time to time, on the sustained ability of the Reserve Bank to run a large, uncovered forward book. The Reserve Bank, however, has not experienced any difficulty in rolling over maturing forward contracts, and earning the forward premium, should it not wish to deliver into the maturing contract.

Since late 1998 the strategy has been to work down gradually the forward book; considerable progress has already been made in this regard. In essence it can be reduced by either central bank buying of foreign exchange or by official borrowing of foreign exchange, in both cases delivering the foreign exchange against the forward book. If the Reserve Bank buys foreign exchange from the market, then it strives to purchase at times when flows judged to be of a more permanent nature augment the more fickle portfolio flows. More permanent sources of reserve flows, other than emanating from current account surpluses, tend to be long-term borrowing by the government, the offshore proceeds of privatisation and foreign direct investment including inflows emanating from offshore listings by South African companies. The risk associated with the purchase of foreign exchange from the market is that perceptions towards the rand may change, and an orderly decline in the nominal external value of the rand can turn into a sharp depreciation. The Reserve Bank may borrow reserves either itself or may purchase the foreign proceeds of government foreign currency denominated loans.

A sixth point, for the record: the latest World Bank *Global Development Finance* country tables show that South Africa has a ratio of foreign debt to annual exports of 68%, against 146% for all developing countries and 134% for middle-income countries. Similarly, they show South Africa's foreign debt to GNP ratio as 20%, compared with 37% for all developing countries and 36% for middle-income countries. Regarding the composition of South Africa's foreign currency

denominated debt, less than half constitutes debt of the public sector and less than one sixth is debt of the central government.

The South African government relies less on external debt in its overall funding mix than other emerging market countries, with foreign currency debt only around 5% of the government's total debt. This is easily manageable, leaving the government substantial scope in managing its future debt profile. Even after adding in the open position in foreign currency related to the South African Reserve Bank's forward market participation, the total exposure of government to exchange rate fluctuations as a percentage of total government debt would have only been around 25%. This compares favourably with the comparable average ratio of 40% for peer-group countries.

Lastly, sound policy requires reliable, timely information. The South African authorities are slowly phasing out the remaining exchange controls, but are making sure that sound monitoring systems are in place and will remain in place once the controls are fully phased out. Scrapping exchange controls and then discovering half a year later that key sets of balance of payments data can no longer be compiled is a trap that should be avoided. Nevertheless, some areas of information remain problematic, such as hedge fund activities, repurchase transactions and scrip lending; these require further brainstorming and hard work.