Policy Coordination: Experience of a (Small) DMO within the Euro Area

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*This presentation reflects my own views and not necessarily those of IGCP or the Portuguese Ministry of Finance.
The 4 main areas of macroeconomic policy

Monetary policy
- Money supply
- Interest rates
  - Target inflation / output gap / exchange rate

Macro-prudential policy
- Regulatory framework
- Supervision
  - Promote financial stability

Fiscal policy
- Tax rates
- Primary expenditure
  - Economic stability
  - LT debt sustainability

Public debt management
- Debt maturity / debt composition
  - Minimize inter-temporal costs
  - Guarantee low refinancing risks
We tended to believe policies could be set independently, especially in the euro area ...

Consolidated government budget constraint

\[ D_t = PD_{eff_t} + (1 + \dot{i}_t^{LT}) D_{t-1}^{LT} + (1 + \dot{i}_t^{ST}) D_{t-1}^{ST} - (M_t - M_{t-1}) \]

Policy interdependence

1) Monetary policy
   Macro-prudential policy

2) Fiscal policy

3) Public debt management

Source: adapted from Blommestein, H. and P. Turner (2012), “Interactions between sovereign debt management and monetary policy under fiscal dominance and financial instability”, BIS Papers, No. 65
Policy interdependence

... however, recent sovereign debt crisis showed us that this is not the case

Consolidated government budget constraint

\[ D_t = PD_{et} + (1 - i_t^{LT}) D_{t-1}^{LT} + (1 + i_t^{ST}) D_{t-1}^{ST} - (M_t - M_{t-1}) \]

Source: adapted from Blommestein, H. and P. Turner (2012), “Interactions between sovereign debt management and monetary policy under fiscal dominance and financial instability”, BIS Papers, No. 65
The 4 main areas of macroeconomic policy in the euro area

- Monetary policy
  - ECB

- Macroeconomic policy
  - ESRB
  - ECB
  - NCB 1
  - NCB 2
  - NCB 3
  - NCB 4
  - NCB 5
  - EBA

- Fiscal policy
  - MinFin 1
  - MinFin 2
  - MinFin 3
  - MinFin 4
  - MinFin 5

- Public debt management
  - DMO 1
  - DMO 2
  - DMO 3
  - DMO 4
  - DMO 5

Policy interdependence:
- SGP / European Semester
- EBA
- ESMA
- ESRB
- CRR/CRD IV
- SSM/SRM
- ECB
- NCB 1
- NCB 2
- NCB 3
- NCB 4
- NCB 5
Since 1990s Debt Management Offices gained more independence, being responsible for a specific set of policy variables

Public debt management tools and objectives

Tools:
- Debt maturity
- Debt denomination (inflation-linked, foreign-currency, floaters)
- Derivatives (to modify duration or hedge foreign-exchange risk)
- Cash reserves

Objectives:
- Finance government borrowing needs
- Minimize interest costs in medium- to long-term
- Guarantee low refinancing risks
Recent developments in all other 3 areas of macroeconomic policy had a tremendous impact on public debt management

Monetary policy:

- QE in US, Japan, and UK, with worldwide impact in fixed income markets
- Accommodative stance from the ECB, coupled with a series of new tools to promote market stability and improve transmission mechanism
  - SMP in 2010-12
  - 3y LTROs in 2011-12
  - OMT in 2012-
  - TLTR0s + ABSPP + CBPP3 in 2014-
  - PSPP in 2015-

Implications for public debt management:

- Lower interest rates and flatter yield curve
  - Extension of average debt maturity
- But more volatility (e.g. “tapering talk” in May-2013)
  - More flexible financing program
Recent developments in all other 3 areas of macroeconomic policy had a tremendous impact on public debt management

**Fiscal policy:**

- Large debt stocks
- Fiscal consolidation effort in recent years

**Implications for public debt management:**

- Uncertainty over ability to fulfill financing requirements without further official support
  - Reduce refinancing risk: buybacks; exchange offers; higher cash reserves
- Fiscal consolidation effort from 2011 onwards
  - Exit financial assistance program and return to regular market funding
  - Lengthen debt maturity
Recent developments in all other 3 areas of macroeconomic policy had a tremendous impact on public debt management

Macro-prudential policy:

- Implementation and/or discussion of a large number of regulatory changes
  - Capital requirements (Basel III + CRR / CRD IV)
  - MiFIR / MiFID II + EMIR
  - Banking union (SSM/SRM)
  - Capital markets union
  - FTT
  - ESRB report on the regulatory treatment of sovereign exposures

Implications for public debt management:

- Primary dealers with less capacity to warehouse sovereign bonds
  - Issue more through syndications / less through auctions
- More volatility (e.g. flash crash on Oct 15th, 2014)
  - More flexible financing program
Public debt management in Portugal

Portugal’s funding strategy to regain market access since end-2012

<table>
<thead>
<tr>
<th>Cash reserves</th>
<th>Liability management</th>
<th>PGB</th>
<th>MTN</th>
<th>Treasury bills</th>
<th>Retail funding</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Allow flexible timing to execute funding plan</td>
<td>• Explore opportunities to extend debt stock maturity through exchange offers and buybacks</td>
<td>• Improve liquidity</td>
<td>• Use superior flexibility to access enlarged investor base</td>
<td>• Increase international investors’ participation</td>
<td>• Regain loyalty of retail investors</td>
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<td></td>
<td></td>
<td>• Extend maturity redemption profile</td>
<td>• Access strategic investors</td>
<td></td>
<td>• Maintain stable domestic funding sources</td>
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<td></td>
<td>• Widening investor base</td>
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Reducing refinancing risk

Regular market access

Continuous communication

**FLEXIBILITY and PREDICTABILITY**
Public debt management in Portugal

Steep increase of public debt up to 2012, followed by strong fiscal consolidation effort

Public debt stood at around 130% of GDP in 2013-14

[\% GDP]

Structural primary balance adjustment of 9.6pp GDP

[\% GDP]

Source: Banco de Portugal and Ministry of Finance

Source: Statistics Portugal and Ministry of Finance
Public debt management in Portugal

Portuguese Government Bonds issuance is gradually becoming more regular

PGBs secondary market yields and market operations (syndications, auctions and exchange offers)

3.10.2012
Exchange PGB 2013 for PGB 2015
(EUR 3,8 Bil; YTM 5,12%)

7.05.2013
New PGB Feb 2024
(EUR 3 Bil; YTM 5,67%)

23.04.2014
Return to auctions
PGB Feb 2024
(€750 M; YTM 3,59%)

02.07.2014
MTN Oct 2024
($ 4,5 bn; YTM 5,23%)
(3,65% € equivalent)

13.01.2015
Dual Tranche Deal
PGB 2,875 October 2025
(€ 3,5 bn, YTM 2,92%)
and
PGB 4,1 February 2045
(€ 2 bn, YTM 4,13%)

23.01.2013
Tap PGB Oct 2017
(EUR 2,5 Bil; YTM 4,89%)

3.12.2013
Exchange PGBs 06/14, 10/14 and 10/15 for PGBs 10/17 and 06/18
(EUR 6,6 Bill)

03.09.2014
New 15y Benchmark
PGB 3,875 February 2030
(€ 3,5 bn; YTM 3,92%)

23.04.2015
Exchange PGBs 10/17 and 06/18 for PGBs 02/24 and 02/30
(€4 bn)

Source: Bloomberg
Public debt management in Portugal

Low implicit interest rate anchored by a relatively long maturity

Implicit interest rate on General Government debt

Average maturity increased to more than 8 years

[Interest cost / Previous year debt stock, %]

[Direct State debt after swaps]

Source: AMECO, Ministry of Finance

Source: IGCP
Several liability management operations have significantly reduced the refinancing needs in near future and smoothened the redemption profile.

Redemption profile of MLT debt (before extensions)  Redemption profile of MLT debt (after extensions)

[May-13; EUR billion]  [Apr-15 + rollover of EFSM loan; EUR billion]

(*) Exact final maturity date of each EFSM individual loan will be defined when the original loans are rolled over (IGCP simulation in orange), but it is not expected that Portugal will have to refinance any of its EFSM loans before 2026.
Greenwood et al. (2014) show that “the US Treasury’s decision to lengthen the average maturity of the debt has partially offset the Federal Reserve’s attempts to reduce the supply of long-term bonds held by private investors through its policy of quantitative easing”...
... they argue that this policy hampered the full impact of monetary policy and shows evidence of lack of coordination, suggesting the US Treasury should have actually reduced the debt maturity instead.

In euro area, longer average debt maturity may have favorable impact on risk premium that more than compensates portfolio-balance effect

Longer average maturity reduces refinancing risk and supports long-term debt sustainability, having a positive impact on monetary and fiscal policy

- This has **positive implications for monetary policy**, as it may help restore the transmission mechanism
- By reducing interest costs for a longer period, this also **allows more room for a less restrictive fiscal policy** (particularly for a small open economy within the euro area subject to very high uncertainty)
- This may also be favorable for fiscal policy and public debt management in other euro area countries, not least by reducing possible contagion effects
- Lower volatility **also favors financial stability**, given benchmark role of sovereign debt market for other fixed income markets