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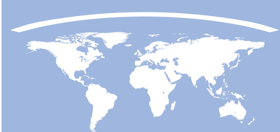

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Public Debt Management and Political Cycles: Challenges for Latin America

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(Based on the OECD *Latin American Economic Outlook 2009*)

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- Good public debt management in Latin America, now more than ever, is linked to the healthy development of the domestic bond markets in the region.
- Political cycles are felt in sovereign bond markets as investors worry about the effect of elections on debt management and future economic policy.

Over the last five years, most Latin American governments have made considerable strides in managing the composition of their public debt, while reducing their foreign-currency exposure. Issuing public debt in local currency is not new for Latin America; what is new, however, is the widespread issuing of local currency debt abroad. Indeed, while five years ago all Latin American sovereign external debt was denominated in foreign currency, today half the debt of countries like Brazil, Colombia, Peru and Uruguay is issued in local currencies.

The favourable economic climate of recent years has undoubtedly facilitated this trend, which is reflected in better ratings and lower spreads. However, as the OECD *Latin American Economic Outlook 2009* shows, challenges in public debt management remain, particularly with regard to developing domestic bond markets. For instance, while available maturities in domestic bond markets have increased over recent years, the overall maturity profile of the region's debt is short when compared to other emerging markets. Foreign currency exposure, the need to roll over short-term maturities and debt indexed to floating interest rates can all present risks in the absence of careful management. Dealing with these risks, in turn, is complicated by the complex trade-offs involved. Inflation and democracy, it turns out, create thorny problems for managing public debt in the region today.

An important element in the development of a sound domestic bond market is inflation-linked public debt, which protects investors against unexpected inflation and signals a government's commitment to price stability. This kind of bond represents a high percentage of the total sovereign domestic bond market in a number of Latin American countries. Of course, a sustainable inflation-indexed bond market requires transparent and credible official inflation statistics. Good inflation data are not always available: there is heated debate over the accuracy of the inflation data provided by the Argentine statistical bureau in recent years. Understating the extent of inflation can arguably be considered a quasi-default of the interest payments of debt. Setting and following proper rules regarding sovereign debt is thus crucial to the development of the domestic bond market.

Latin American sovereign-bond markets have been keenly sensitive to political events since the return of democratic regimes. In particular, investors and capital markets have reacted negatively to the uncertainty surrounding the outcome of elections.

First, investors worry that incumbent political parties will expand spending to encourage political support, with costs for post-election economic performance. This fear is well-grounded: during the period 1990-2006, the impact of general elections on fiscal expenditure in Latin America came close to 25 per cent of GDP growth, while

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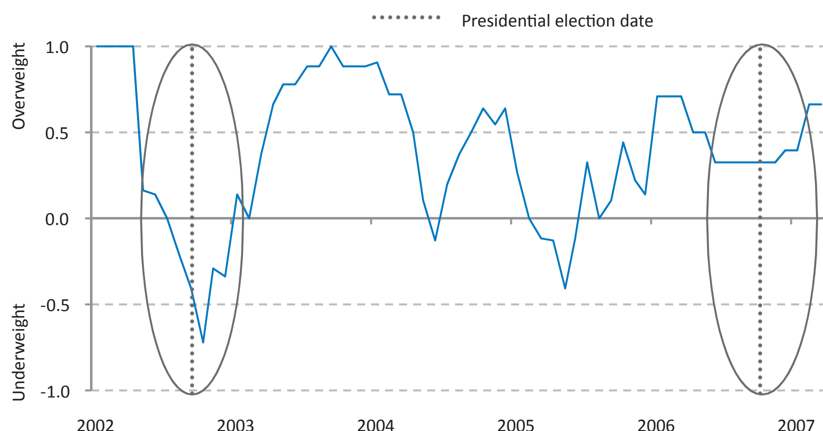
Figure 1. **Bank Recommendations and Elections in Brazil**



Note: Banks' recommendations can be classified into three groups: overweight (1), neutral (0) and underweight (-1).

Source: Latin American Economic Outlook 2009, OECD 2008. Also based on Nieto Parra and Santiso, "Wall Street and Elections in Latin American Emerging Democracies", *Working Paper* No. 272, October 2008, OECD Development Centre.

in OECD countries it was negligible. Even in the recent 2006 electoral cycle, the higher primary budget surplus achieved by countries in the region had more to do with high rates of GDP growth than with spending restraint around elections.

Second, capital markets are unsettled by uncertainty about the economic policies that will be pursued following elections. The different reactions of capital markets to the two elections won by Brazilian president Lula da Silva provide a clear example of the role political parties and candidates play in this regard. Perceived as the populist opposition to a fiscally conservative government in 2002, markets reacted with apprehension to Lula's candidacy as soon as his campaign began to gain momentum, and investment-bank recommendations moved sharply negative on Brazil until the new President reassured them. When Lula was re-elected in 2006, against an opponent who also espoused credible policies, the presidential elections caused hardly a ripple in the markets and spreads remained at historically low levels.

Unfortunately, Brazil's recent experience is not typical. In five of the eight elections that occurred in the same year as Lula's re-election, (Argentina, Ecuador, Mexico, Peru and Venezuela), at least one of the main candidates was perceived as a risk to the continuity of credible policies. Only the presidential elections in Brazil, Chile and Colombia escaped this perception.

Governments, political parties and candidates can all affect capital markets' perception of public debt. Governments can do so by providing sound public debt management but all political players have an influence through the perception of the economic policies they champion. Careful communication by governments and presidential candidates of their future policies can have a positive impact on sovereign bond markets. At the same time, better information flows from the rating agencies and the investment banks concerning sovereign bonds could be crucial to further decoupling fiscal policy from political cycles.

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