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GLOBAL ECONOMIC ENVIRONMENT AND BUSINESS STRATEGY: A MACROECONOMIC PERSPECTIVE

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Abstract
Economics serves as the language of business, providing a universal framework for understanding the complex dynamics of the global economic environment. This study, grounded in applied macroeconomics, aims to develop a comprehensive understanding of the external, economy-wide factors that influence the performance and strategic decision-making of firms in an increasingly interconnected world. It explores critical macroeconomic questions such as the determinants of economic growth disparities among nations, the causes and persistence of inflation and hyperinflation, the nature of global imbalances, and the factors influencing exchange rate movements. Furthermore, the study examines business cycle fluctuations and their implications for financial markets, along with the role of fiscal and monetary policies in stabilizing economies.

The paper develops a conceptual framework to analyze the interaction among key macroeconomic variables, including real output, economic growth, unemployment, inflation, interest rates, exchange rates, and the current account balance. By integrating theoretical insights with real-world examples and contemporary economic developments, the study enhances the ability to interpret economic trends and policy outcomes. Ultimately, it seeks to equip learners and researchers with the analytical tools necessary to understand and respond to the evolving global economic landscape.

Keywords: Global Economic Environment, Macroeconomics, Economic Growth, Inflation, Exchange Rates, Business Cycles, Fiscal Policy, Monetary Policy.

Introduction

World financial markets have been enjoying unprecedented breath and strength over the past decades. The total value of the world's financial assets, including bank deposits, public and private debt securities as well as equity securities, has been multiplied by 10 over the past quarter of century, jumping from $12 trillion in 1980 to $136 trillion by the end of 2004. During that period global financial depth has been steadily increasing, the value of global financial assets growing from an amount roughly equalling the global GDP to more than three times its size (McKinsey & Company, 2006). This boom has been accompanied by substantive structural changes in international finance. Global finance experienced a striking shift away from banks toward market institutions as the primary financial intermediaries. New actors emerged, the share of debt and equity securities exploded while the relative size of bank deposits in global financial stock shrunk from nearly 45 per cent in 1980 to 29 per cent today. The forces shaping the revolution in banking and capital markets have therefore radically changed the financial landscape.1 A remarkable feature of this changing new landscape has been the astonishing rate of internationalisation of the financial system in the last two decades, the multiplication of actors and the increasing use of complex products like derivative contracts, whose notional amount is rapidly approaching $300 trillion in 2006, according to the BIS.

Emerging markets have benefited from this financial globalisation process via enhanced cross-border trade in goods and services, increased foreign direct investment flows and the implementation of cross-

border portfolio investment strategies.2 An increasing number of takeovers of developed markets companies by leading multinationals from emerging economies took place in 2006, for an amount exceeding $55 billion out of a total $70 billion that involved emerging multinationals (on the emergence of these firms see van Agtmael, 2006; and on multilatinas Santiso, 2007).

These economies became particularly active in global financial markets. In 2005, emerging market equity funds absorbed more than $ 20 billion in net inflows, five times more than the previous year and beating the record of 2003, according to data from Emerging Portfolio Fund Research, a US company that tracks fund flows around the world. Emerging bond markets also soared, breaking the previous record of inflows of more than$10 billion in 2005 against a meagre $3 billion in 2004. Moreover, foreigners invested a net amount of $61.5 billion in emerging equities in 2005 (12.5 per cent of the private flows to developing countries, compared to 7.5 per cent of the total in 2000) and nearly $240 billion in direct investments. Total shares on exchanges in emerging markets were valued at $4.4 trillion at the end of 2005, more than a doubling since the beginning of the decade. The search for yield explains much of this story.

Historically low interest rates in OECD countries and soaring global liquidity, combined with structural macroeconomic improvements in the emerging markets asset class, prompted a widespread search for yield that benefited emerging markets (see Canela, Pedreira, and Santiso, 2006, for an analysis and discussion of these recent financial trends in emerging markets). Although financial policy makers from emerging markets have done much to raise their creditworthiness, they are still facing extra-ordinary challenges in developing efficient financial markets and maintaining financial stability (Blommestein, 2000). In particular, emerging markets (open to financial flows while closed to trade flows) remain highly vulnerable to crashes (Rey and Martin, 2005). Some suffered heavily from sudden stops (Calvo and Talvi, 2005; Calvo, 2005), a pattern that has great resonance to events in the first era of globalisation between 1880 and 1914, especially the events in the late 1880s and early 1890s (Bordo, 2006). More in general, the new financial system has the capability to rapidly transmit at a historically unprecedented speed the consequences of errors of judgement in private investments, unsound public policies and other shocks, around the globe (Santiso, 2003).

Recent crisis episodes3 that have emerged out of this new, complex financial structure appear different in important ways from those occurring during the earlier periods of high capital mobility.4 The form and structure of global finance - in particular the existence of complex, sometimes highly-leveraged positions on underlying market instruments, the widespread use of derivative technology and margin calls in response to rapid price movements in financial market instruments - had a major impact on the dynamics . impacts on more.

Review of Literature

Until the late 1990s, domestic fixed-income securities markets were relatively underdeveloped in many countries in Latin America, Asia, emerging Europe and Africa. In mid-1990s, total outstanding domestic debt securities in emerging markets were only 20 per cent. This situation had led to an excessive reliance on foreign financing14 (direct or intermediated via domestic banks), making the participation of these countries in the global financial system more vulnerable to shifts in expectations and perceptions. For example, the series of international financial crises in 1997-1998 brought sharply into focus the risks and costs associated with underdeveloped fixed-income securities markets, in particular, that underdeveloped domestic bond markets have encouraged excessive reliance on foreign

and domestic bank financing. The crisis of the 2000s also underlined the risks and costs associated with excessive reliance on bond markets and, in particular, on external debt denominated in foreign exchange or linked to foreign currency. As a consequence, a policy shift took place during the 2000s so as to avoid or reduce some of the previous vulnerabilities. First, all emerging countries tried to reduce both their global level of external indebtedness and their level of short term debt. Changes in debt composition, maturities and structure have been witnessed in all the asset class. The reduction of debt maturities has been particularly impressive in Russia, relative to the total of domestic debt, but this trend could also be observed in other emerging markets (Graph 8).

Exchange rateindexed debt also has been reduced, the most impressive case being Brazil where the share of such indexed debt in total public debt fell from 37 per cent in 2002, the year of the crisis, to 2.3 per cent at the start of 2006. However, the reallocation towards more local currency debt is also inducing a change in the risk profile of sovereign issuers. Foreign currency debt is decreasing, although this meant in some countries that debt maturity became shorter15 (even if things are changing quickly as some other emerging bond issuers are starting to be able to issue bonds in local currencies with maturities now over ten years as for example Mexico).

Research Methodology

Objectives of study

1. To analyze the key components and indicators of the global economic environment.
2. To examine the evolution and challenges of emerging markets in the global economy.

Data and Methods

In all crisis episodes, both the unsound structure of outstanding debt and the underdeveloped stage of bond markets played a significant role, sometimes, like in the Asian crisis, a decisive one. As in the period phase of financial globalisation, financial crisis, original sins or home bias, have been also common in the more recent one. The current phase is in many aspects quite comparable to the previous one. There has been however many developments that deserve attention and have been reshaping the way to deal with risk debt management in emerging countries as we want to stress in the following section. The key challenge for emerging market policy makers: underdeveloped bond markets and a vulnerable risk profile

Second, some improvements have been reached in emerging financial markets with the appearance of new instruments like international bond issuances with Collective Action Clauses (CACs). Both the numbers and volumes of bond issuances with CACs increased, without implying higher risk premiums for the sovereign bond issuers (all the bonds issued with CACs benefited from the lower spreads that characterized the recent risk aversion period) (Gugiatti and Richards, 2003; Drage and Hovaguimian, 2004). By the beginning of the 2000s, a meagre 30 per cent of emerging markets bonds was issued with such clauses.

By middecade nearly 97 per cent included such clauses (see Graph 11). More interesting: in early 2007, Belize successfully achieved the first debt restructuring based on CAC's. Largely unnoticed, the Central American nation has taken advantage of the once controversial mechanism – known as a collective action clause – to facilitate a quicker restructuring of about half of its $ 1.1 billion of debt, a process that started in August 2006 and ended in February 2007.

In doing so, it has become the first country in more than seventy years to use a collective action clause (CAC) to restructure a sovereign bond governed by New York law.

Global Economic Environment in India

The economy of India is a middle-income developing market economy. It is the world's fifth-largest economy by nominal GDP and the third-largest by purchasing power parity (PPP). According to the International Monetary Fund (IMF), on a per capita income basis, India ranked 142 and by GDP (nominal) and 128th by GDP (PPP). From independence in 1947 until 1991, successive governments promoted protectionist economic policies, with extensive state intervention and economic regulation. This is characterised as dirigisme, in the form of the License Raj. The end of the Cold War and an acute balance of payments crisis in 1991 led to the adoption of a broad economic liberalisation in India. Since the start of the 21st century, annual average GDP growth has been 6% to 7%, and from 2013 to 2018, India was the world's fastest growing major economy, surpassing China. Historically, India was the largest economy in the world for most of the two millennia from the 1st until the 19th century.

During the 2008 global financial crisis the economy faced a mild slowdown. India undertook stimulus measures (both fiscal and monetary) to boost growth and generate demand. In subsequent years, economic growth revived. According to the World Bank, to achieve sustainable economic development, India must focus on public sector reform, infrastructure, agricultural and rural development, removal of land and labour regulations, financial inclusion, spur private investment and exports, education, and public health.

New Strategies for Emerging Domestic Sovereign Bond Markets in the Global Financial Landscape:

The forces shaping the revolution in banking and capital markets have radically changed the financial landscape during the past three decades. A remarkable feature of this changing new landscape has been the astonishing rate of internationalisation of the financial system in the last two decades, with emerging markets becoming increasingly important participants. At times this participation has led to excessive reliance on foreign financing, making the participation of these countries in the global financial system more vulnerable to shifts in expectations and perceptions. The sovereign debt management strategy suffered from many structural weaknesses, failing to take into account international best practices in financing budget deficits and developing ∗This article is based on OECD Development Centre Paper no. 260, New Strategies for Emerging Domestic Sovereign Bond Markets (DEV/DOC(2007)3).

It benefited from various presentations made by Hans Blommestein at Forums under the aegis of the OECD Working Party on Debt Management, and on the presentation by Javier Santiso, "The Way to Paradise? Emerging Bond Markets at the Beginning of the XXth Century," prepared for the Banque de France International Seminar, OECD Development Centre, 29 June 2006. It also benefited from the conference Living with Debt in Latin America, organised by the OECD Development Centre, in Paris, 10 November 2006. Hans Blommestein is Head of the OECD Programmes on Public Debt Management and Bond Markets & Javier Santiso the Chief Development Economist of the OECD, Deputy Director of the OECD Development Centre and Chair of the OECD Emerging Markets Network. He was previously the Chief Economist for Latin America and Emerging Markets at BBVA (Banco Bilbao Vizcaya Argentaria).

We would like to thank the organisers of the Banque de France International Seminar, Marc-Olivier Strauss-Kahn of the Banque de France and the IADB colleagues Ugo Panizza, Eduardo Borensztein, Eduardo Lora and Ricardo Santiago. We are indebted to Rolando Avendano for very helpful research assistance. For documents, data shared and ideas exchanged ˜ during the conferences and later we would like to thank Phillip Anderson, Zsolt Bango, Jose Mar ´ ´ıa Barrionuevo, Mike Buchanan, Jean-Dominique Butikofer, Beno ¨ ˆıt Coeure, Coskun Cang ´ oz, Maria ¨ Cannata, Daniel Cohen, Arnab Das, Udaibir Das, Ove Jensen, Par Nygren, Gerardo della Paolera ¨ Eduardo Pedreira, Arturo Porzecanski, Robert Stheeman, Ernesto Talvi and Antoine Van Agtmael. Finally, the authors are grateful to the referees, Nicolas Pinaud of the OECD Development Centre and Greg Horman of the OECD

A Historical Perspective on Financial Dynamics

To gain a better perspective on current constraints and complexities faced by emerging markets during the current globalisation period, we will analyse why the crises that have emerged out of the complex new financial landscape appear different in important ways in comparison to earlier periods. Before we need however to define what we understand by an emerging market.

Strictly speaking the concept as we understand it in the article is related to the countries included in JP Morgan's Emerging Markets Bond Index (EMBI), produced since the mid-1990s. However, if we take an historical point of view, some of the most well-known emerging markets of today were quite developed and sophisticated economies in early 1900s: Argentina for example ranked by that time as one of the most developed countries and the United States looked by the early years of the 20th Century as the pure prototype of an emerging economy. Even today some of the most established OECD countries are hard to classified:

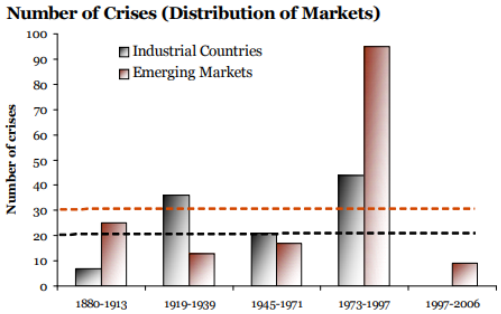
Turkey, South Korea and Mexico are all emerging economies and also OECD countries while some have been arguing that European or OECD countries like Greece could be classified as emerging economies (see for a discussion on Greece Angelopoulos, 2006). The asset class defined as emerging markets has been therefore a moving and evolving notion.

As already mentioned, a century ago, the US breakthrough as a global financial powerhouse was not obvious at all and the emergence of this economy came only after the chaotic years of the First World War. In 1914 the US economy was still a curious hybrid of developed and emerging market as stressed by William Silber in a recent book (Silber, 2006), prone to domestic financial crisis, with weak monetary institutions, vulnerable to sudden stops of capital flows from Europe. In 1914, when the crisis broke, the country did not even have a central bank.

The Federal Reserve was still on the drawing board, just authorised by the Congress a year before, while the Bank of England existed since 1694. By that time, financiers like JP Morgan were the lender of last resorts, the only ones able to avoid cities like New York to default, as it happen to be the case in 1914 when the banker agreed to bail out the city of Wall Street, which came close to defaulting on a $82 million in foreign debt.

Graphical

GRAPH 1: SERIAL DEFAULTS AND CRISIS IN EMERGING MARKETS, 1500-2006

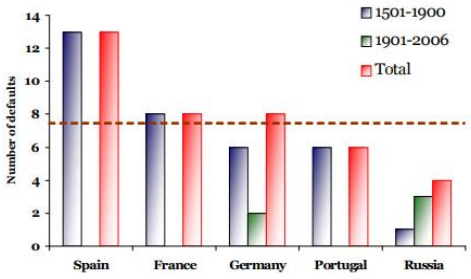


Source: OECD Development Centre, 2007; Own up-date based on M. Bordo and B. Eichengreen (2002); and N. Roubini and B. Setser (2004).

Note: Recent crisis episodes in the period 1997-2006 include Brazil (1998, 2002), Ecuador (1998), Pakistan (1998), Ukraine (1998), Turkey (2000), Argentina (2001) and Uruguay (2001).

Representation

GRAPH 2: SERIAL DEFAULTS IN DEVELOPED COUNTRIES, 1500-2006



ɹurce: OECD Development Centre, 2007; Own up-date based on Reinhart, C., Rogoff, K., and . Sevastano (2003).

But also the latest emerging markets boom needs to be put in a longer historical perspective. Although flows to emerging markets reached in 2006 record levels with emerging bond prices at all-time highs, this boom is not new. During the late nineteenth century, Latin American countries, for example, experienced during the first globalisation era massive foreign investment booms. A major part of the financial inflows took the form of sovereign debt, with bonds being traded in European financial centres. By that time, the market value of emerging market debt traded in London was impressive: at the turn of the 20th century, in 1905, its value was equivalent to 12 per cent of world GDP. Almost hundred years later, in 1999, during the current globalisation era, the total volume of emerging market debt traded was a meagre 2.7 per cent of world GDP. The recent attractiveness of emerging markets has seen the value of debt trading jump to $5500 billion in 2005 (roughly 12 per cent of world GDP), which is simply a return to a position already reached 100 years ago during the first globalisation era . Therefore, even if in nominal terms we are witnessing strong expansions.

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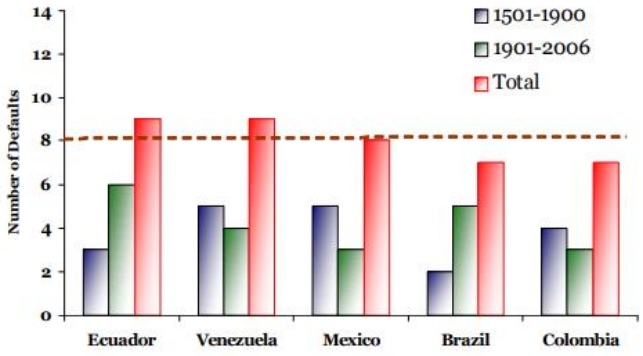
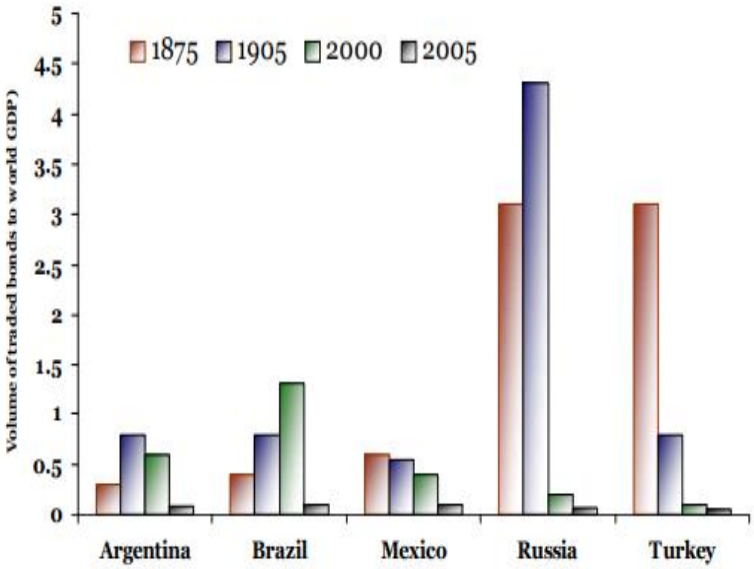
GRAPH 3: SERIAL DEFAULTS IN DEVELOPING ECONOMIES, 1500-2006



Source: OECD Development Centre, 2007; Own up-date based on Reinhart, C., Rogoff, K., and M. Sevastano (2003).

Trading Volumes Relative To World GDP



The next indicator we use to compare the two globalisation eras is based on a Financial Integration Index. This measure is calculated as the ratio between the share of international investments and the share of world GDP. This index is currently lower for emerging markets than at the end of the previous globalisation era (while the advanced market countries experienced a much stronger financial integration over the same period; Graph 5).

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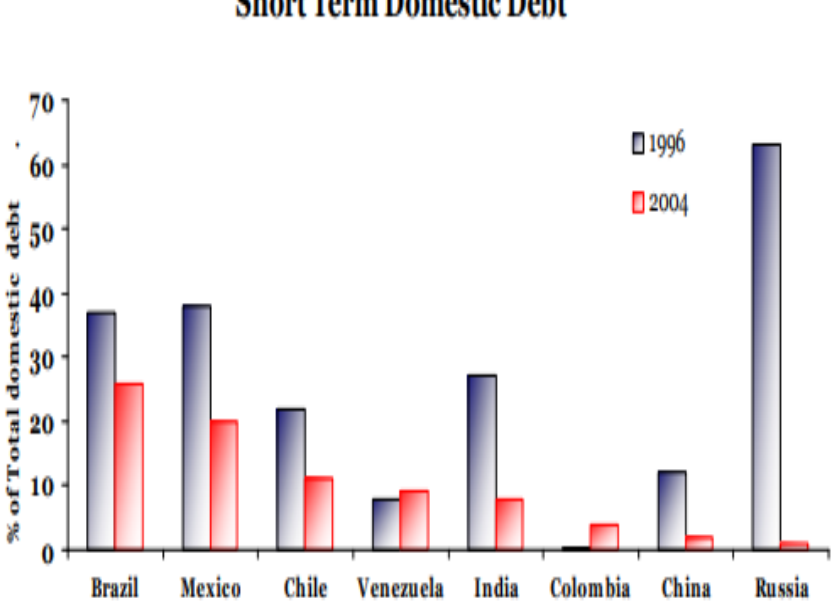
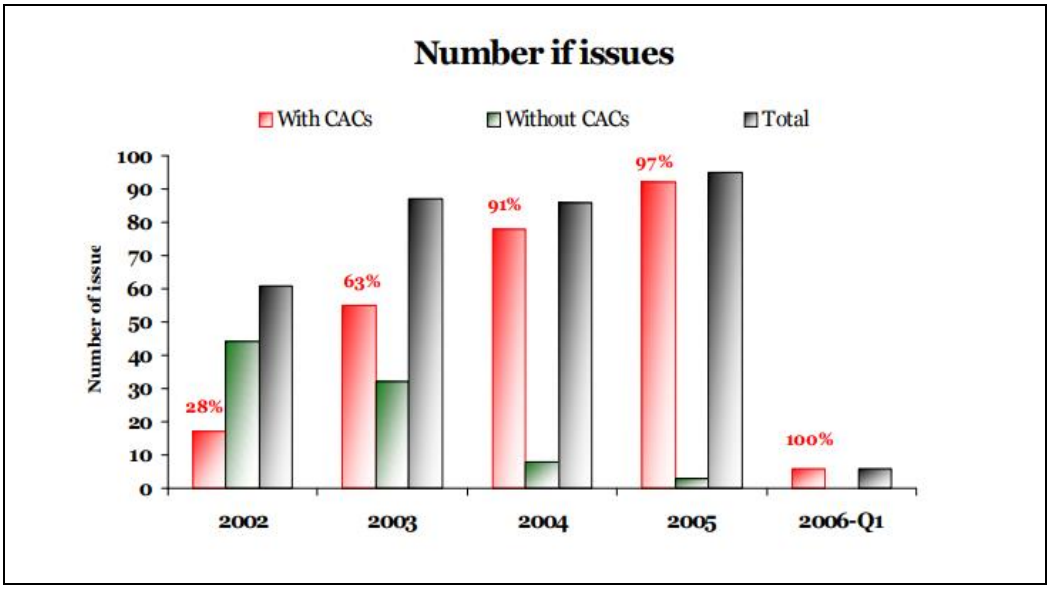
Short Term Domestic Debt in Emerging Markets

At the same time, during the 2000s, current account surpluses in most emerging markets enabled several countries to reduce their external debt.16 Foreign reserves have jumped to record levels in many countries, particularly in Asia and oil-exporting countries, acting as a mechanism of endogenous insurance (Graph 9). By the end of 2005 they reached nearly $2,500 billion dollars and crossed the level of $3,000 billions in 2006, helped in particular by China's impressive $1,000 billion. In some cases external debt levels have been reduced drawing on these foreign reserves. Russia, for example, cleared its debt to the IMF and repaid also the Paris Club in 2005. The same year Brazil also paid the IMF, the Paris Club creditor countries and in 2006 it paid off all its remaining Brady bonds ($6.6 billion), the securities that kick-started the emerging market bonds boom in the 1990s (albeit partly funded by new external debt), closing officially the debt restructuring process of the 1980s.17 Argentina followed also the Brazilian example, repaying its outstanding debt to the international financial institutions. In 2006, Nigeria became also the first African country to cancel its Paris Club debt (totalling $30 billion; one third being repaid and the remaining being forgiven). These mechanisms of self-insurance through increased levels of reserves continue to be pursued even after repayments as underlined by the Brazilian and Argentinean examples (see Graph 10). In parallel, emerging countries increased also their national saving rates, as counterpart of this external debt repayment strategy and current account surpluses. One notable example is Latin America, a region that saw its domestic saving rates increasing from levels around 17 per cent in the early 2000s to more than 22 per cent by the end of 2005.18

GRAPH 8: SHORT TERM DOMESTIC DEBT IN EMERGING MARKETS



3.2 Emerging Markets Bond Issuances With CACS:



Countries like Colombia, Mexico or Peru achieved to issue international bonds denominated in their currencies, reducing in an impressive way their original sin index (see Graph 12). At the end of 2003, for example, Uruguay started issuing a global bond denominated in real pesos (via indexing inflation). The following year, the country issued another bond, this time in nominal pesos. Colombia launched also nominal peso issues in 2004 and 2005, while Brazil started in 2005 to issue large bonds of USD 1,5 billion with long maturity and denominated in nominal reais (for a more detailed analysis see Borensztein, Eichengreen, and Panizza, 2006a; 2006b). Not only local investors have been active in these local markets but also foreign investors. In Mexico, for example, they bought 80 per cent of the domestic long-term bonds issued in 2004 by the Mexican government (Castellanos and Martínez, 2006). 19 In recent years, domestic bond markets became an increasingly source of financing in emerging markets.

Decrease in Original Sin in Latin American Emerging Markets

Also in Asia this trend can be observed. There governments amassed nearly $3 trillion dollars (2.7 billion by mid 2006) of foreign exchange reserves. With such of large pool of liquidity, they are now looking to diversify their portfolio investments beyond US Treasuries and other OECD securities. Consequently, important progress has been made in developing the once neglected domestic bond markets, in a region that has been traditionally relying on bank finance. While Asian local-currency bond markets are still tiny and unsophisticated,22 with a the total value of the outstanding bonds amounting for less than $2 trillion at the end of the 2000's, 23 the interest for these instruments is increasing. Expanding local bond markets is also perceived as an insurance against another financial crisis like the one experienced in 1997-98 when Thailand, South Korea and many other Asian countries were quite vulnerable due to an excessive reliance on short-term foreign currency borrowing and crossborder bank financing. International organisations such as the Asian Development Bank (ADB) and OECD24 are encouraging and supporting efforts and initiatives to develop local-currency fixed-income markets. The ADB has raised local- currency bonds in China, the Philippines, Thailand and Malaysia. More work is needed in view of the modest size of these markets, relatively low liquidity and in some cases also poor transparency. Reliable information is scarce with too few rating agencies covering local companies. However, Asian policymakers have indicated that they are determined to continue to develop deeper, more liquid and transparent local bond markets.

A Risk Management Perspective on Public Debt Management and Consequences for Developing Domestic Bond Markets

The effective management of the domestic and external debt of both the private and public sectors is of great importance for the successful participation of countries in the international financial system. Mismatches of maturity and/or currency have been identified as an important reason why countries experienced financial crises. Some countries in which the private sector or government issued large quantities of short-term maturity, foreign-currency denominated debt, became very vulnerable to sharp swings in the sentiment of foreign investors.31 The Asian crisis of the late 1990s prompted an important debate on the limitations of the role of macro-economic policies during financial crises.

The main lesson or conclusion from that crisis episode (and later from the crisis in Argentina) is that macro-economic policy makers need to take the structure of the domestic financial sector (such as bank fragility, size and composition of corporate and public debt, the degree of capital market development, etc) into account when setting and executing macro policies prior and during crisis episodes. Many analysts highlighted the role of the outstanding stock of debt of firms (assets for banks) in limiting the effectiveness of monetary policy.

The 'traditional' view argues in favour of monetary tightening to limit currency depreciation and inflation. Higher interest rates will discourage capital outflows and thereby avoid a full-blown currency crisis. The 'revisionists' note that monetary tightening (higher interest rates) will have an adverse impact on the balance sheets of firms and banks (Radelet and Sachs, 1998; Furman and Stiglitz, 1998). The resulting wave of bankruptcies encourages additional capital outflows and depreciation of the exchange rate. The evidence supporting the traditional or revisionist view is mixed with ambiguous empirical results (Goderis, 2005).

However, when debt levels are taken into account, a clearer picture emerges. Eijffinger and Goderis (2005) show that the impact of monetary policy on the exchange rate is non-linear and non-monotonic. They find that for relatively low corporate debt levels (i.e., for short-term debt to assets ratios between 0 and 11.7) higher interest rates lead to an appreciation of the exchange rate.

Policy Implications For Latin-American And Other Emerging Markets

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In the wake of the crises of the 1990s, a consensus therefore emerged that both a sound banking system and a liquid domestic capital market are key elements of a robust financial infrastructure. This essential condition should be in place so as to allow emerging financial markets to participate in the international financial system without making them excessively vulnerable to large, unanticipated withdrawals and speculative attacks. Various studies have presented evidence that the degree of financial sector development is a key determinant of an economy's volatility and vulnerability to financial crises.

Financial Market Development and Volatility

On the basis of the assumptions of the simple period model described in (2) and (3) in the main text, the optimisation problem for the firm at **t=1** can be written in the following simple way:

$$\underset{W}{MAX!} \quad Y - RW$$
$$subject\ to.\ \ W \le \lambda K\theta \qquad \textbf{(A1)}$$

The gross market interest rate on borrowing and lending is **R**. The unconstrained optimum for the ratio of working capital to physical capital $(\omega = W/K)$ is then given by:

$$\omega^* = \left[(R/\beta)^{\alpha/1-\alpha} - \beta \right]^{-1/\alpha} \qquad \textbf{(A2)}$$

When the constraint is binding, ω is given by:

$$\hat{\omega} = MIN[\omega^*, \lambda\theta] \qquad \textbf{(A3)}$$

As noted in the main text, volatility can be expressed via the variability of cash flows, with θ_H the cash flow in good times (with probability **P**) and θ_L the cash flow in bad times (with probability **1-P**); with $\theta_H \succ \theta_L$. The parameter β can be interpreted as the liquidity needs of the firm.

Monetary Policy and Financial Crisies

The financial crises of the late 1990s and early 2000s put the spotlight on the effectiveness of macro-economic policies to contain these crises. A consensus emerged that macro-economic policy makers need to take the structure of the domestic financial sector into account when setting and executing macro policies prior and during crisis episodes. Especially the role of indebtedness in explaining the effectiveness of monetary policy during crisis episodes was highlighted in academic work. The 'traditional' view argues in favour of monetary tightening to limit currency depreciation and inflation. Higher interest rates will discourage capital outflows and thereby avoid a full-blown currency crisis. In contrast, the 'revisionist' view argues that monetary tightening (higher interest rates) will have an adverse impact on the balance sheets of firms and banks.56 The resulting wave of bankruptcies encourages additional capital outflows and depreciation of the exchange rate. Where α1 a monetary policy coefficient and α 3 a vector of coefficients associated with the different fundamentals. Eijffinger and Goderis (2005) focused on debt levels, whereby they have estimated the marginal impact of monetary policy for different levels of corporate debt. They concluded that the impact of monetary policy depends on the ratio short-term corporate debt to assets. For relatively low corporate debt levels (i.e., for short-term debt to assets ratios between 0 and 11.7) the results support the traditional view (higher interest rates lead to an appreciation of the exchange rate), while for higher debt levels (i.e., for short-term debt to assets ratios higher than 11.7) the results provide support to the revisionist

hypothesis that a tighter monetary policy results in a weakening of the exchange rate, thereby aggravating an ongoing financial crisis

The Risk Management Approach To Debt Sustainability

The optimal debt composition can be calculated by assessing the relative impact of the costs and risk of the different debt instruments on the debt ratio, B (debt-to GDP). This means that the choice of debt instruments trades off the risk and expected costs of debt service57. Reducing the variability in the primary surplus (or deficit) and the debt ratio (for any given expected cost of debt service) is desirable, because it reduces the probability of a fiscal crisis due to adverse shocks to the budget (that in turn might trigger a financial crisis). The link between public debt management and the overall macroeconomic framework can be made explicit as follows. Let's assume that the overall or wider debt management objective58 is to reduce the country's fiscal vulnerability by stabilising the debt ratio. We shall use the following debt management model59 to illustrate the trade-offs between expected cost of debt service and the risk in choosing different debt instruments. In order to stabilise at time t the debt ratio, B(t) , the fiscal authority decides to implement a fiscal reform programme, taking into account the realisation of debt returns, output, Y(t) , inflation, Π(t+1) , and the subject to (C-2), (C-3) and (C-4). Solving (C-5) with respect to 1 b , 2 b and b3 yields the optimal debt structure. These first-order conditions show also the trade-off between the risk and expected cost of debt service related to the choice of debt instruments63. As noted in section II, the optimal debt composition constitutes the basis for the specification of the strategic benchmark. The risk management approach to debt sustainability goes therefore beyond the traditional debt sustainability literature that focuses simply on determining the primary deficit (surplus) and/or growth rate of GDP that would keep the debt level at a certain level.

Conclusions

Emerging bond markets are changing at a very rapid pace. We may be witnessing the closing of an era as symbolised by the fast disappearance of the Brady bonds, the securities issued after the 1980s debt defaults and that kick-started the emerging market bonds boom in the 1990s. Following Brazil, also Argentina and Venezuela announced in 2006 plans to retire all their Brady bonds, closing an era that started more than two decades ago. Brady bonds were issued by governments, mostly Latin American ones, in order to facilitate a market-based exit from defaulted commercial bank loans, under an initiative named after the US Treasury secretary at that time, Nicholas Brady.50 This financial innovation enabled the transformation of huge amounts of illiquid bank claims into tradable bonds, opening the era of the emerging markets' boom of the 1990s. Once a dominant asset class, this instrument is now vanishing. It reached its peak in 1997, when the stock of dollar-denominated Brady bonds stood at a record high of $156 billion (in total $175 billion of Brady's were issued). During the 2000s, governments accelerated buy-back programs. Mexico, the first country that issued Brady bonds in the 1990s, started to retire them in the 2000s. By 2003, this country became also the first to exit the Brady bonds era. By early 2007, the outstanding amount of Brady's was just over US $10 billion. The improvement in the creditworthiness of many emerging economies combined with improvement in market infrastructure and the excess of liquidity around the world searching for yield, facilitated this exit. As a result, governments were able to repay debt at lower rates. Emerging markets have become more stable due to the implementation of long overdue structural changes. Ten years ago, emerging markets were registering current accounts deficits of 2 per cent on average, while they exhibited a 2 per cent surplus in 2005. Fiscal deficits that averaged more than 3 per cent of GDP ten years ago have been reduced to 1 per cent of GDP, even in countries with a history of considerable political cycles. The anchoring process of lower inflation has been even more impressive, averaging 15 per cent ten years

ago and now standing below 4 per cent. This reduction is particularly impressive for Latin American countries that had experienced hyperinflation. Moreover, public debt management has become more sophisticated by adopting the best practices from OECD countries, including a market-based issuance process, a risk management approach to public debt, the use of benchmarks, and emphasizing the importance of establishing liquid secondary government bond markets.51 Ten years ago, emerging markets were registering current accounts deficits of 2 per cent on average, against a 2 per cent surplus in 2005. They have been shedding their long-standing reputation as investment destinations of last resort. Symbol of the entrance into a new era, bankers are inventing new labels for these economies, believing that more differentiation is needed for this asset class by proposing new acronyms like the famous BRICs.52 The flood of global liquidity has encouraged yield-hungry buyers to cast the net wider in the search for higher income producing assets. However, of greater structural importance is that an increasing number of new investors have moved into the asset class, thereby diversifying the pool of portfolio investors far beyond the Indiana Jones investors of the 1990s looking for high risky exotic returns. In addition to dedicated "emerging market" funds, there is now a wider range of foreign investors such as investment banks, pension and mutual funds, private equity arms, insurance companies, hedge funds and even retail investors. In addition, pension managers from emerging countries and even central bankers are increasingly buying local securities as well as securities from other emerging markets. many reasons to remain cautious. Although a more diversified investor base and the spread of derivatives may enhance stability in emerging markets, the dynamics of the emerging market asset class has also changed rapidly due to structural changes in the global financial landscape (see section II). New structural developments will inevitably bring new risks that may trigger new financial crises. Moreover, the recent episode of ample liquidity and global shortage of creditworthy hard real assets mask to an important degree the real improvement in creditworthiness of emerging markets, while mispricing of the true risk cannot be ruled out. The 'real' test will come when risk premia will rise again. For these reasons, we advocate in this article the development of liquid local currency bond markets and the use of new risk-based debt management strategies in emerging markets. This approach requires both a macro-perspective and a need to pay attention to institutional micro-based strategies. Both perspectives require building proper databases, including complete databases of bond holders.55 unfortunately, many debt managers in emerging markets (but also some in more advanced markets) do not have reliable information on their investor base.

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