Workshop on Debt, Finance and Emerging Issues in Financial Integration

Financing for Development Office (FFD), DESA
8 and 9 April 2008

Public Debt Management in Developing Countries: Key Policy, Institutional, and Operational issues

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Workshop on Debt Finance and Emerging Issues in Financial Integration

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February 2008

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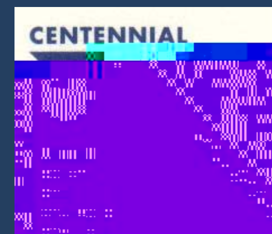

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Public Debt Management in Developing Countries:
Key Policy, Institutional, and Operational issues

Tomás J. Baliño and V. Sundararajan

1. Introduction

Over the past decade, a broad consensus has developed that good public debt management (PDM) can help countries reduce their borrowing cost, contain financial risk, and develop their domestic debt market. It can also facilitate maintaining financial stability and help develop their domestic financial system. While this holds for all countries, the needs and constraints of countries in designing good PDM systems vary depending, inter alia, on each country's degree of development. Thus, while the experience and

2. Public Debt Management Guidelines and other sound practice considerations; Objectives and components of Medium Term Debt Management Strategy.

The financial crises of the late 1990s encouraged the search for tools that would reduce the likelihood of future crises and reduce the impact of any that happened. International organizations got actively involved in that search. One product of these efforts was the *Guidelines for Public Debt Management* that the International Monetary Fund (IMF) and the

1. Increasing the vulnerability of the government's financial position by increasing risk, even though it may lead to lower costs and a lower deficit in the short run.

2. Debt management practices that distort private vs. government decisions, as well as understate the true interest cost.

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Coordination with Macroeconomic Policies

7. Coordination with Fiscal Policy
8. Coordination with Monetary Policy

Borrowing and Related Financing Activities

9. Domestic Borrowing
10. External Borrowing
11. Loan Guarantees, On-lending and Derivatives
12.

Cash Flow Forecasting and Cash Balance Management

13. Cash Flow Forecasting and Cash Balance Management
14.

Operational Risk Management

15. Debt Administration and Data Security
16. Segregation of Duties, Staff Capacity and Business Continuity

Debt Records and Reporting

17. Debt Records
18. Debt Recording

These indicators would be graded on a scale from A to C, using a companion "Guide to the Debt Management Performance Assessment". The World Bank wishes DeMPA to become another international standard.

A debt management strategy is a key element of sound practice. As Wheeler notes, that strategy "enables debt managers to make portfolio decisions within well-defined parameters for cost and risk".[5] Thus, it helps balancing the need for the debt manager to have operational freedom in implementing the government's debt objectives, but makes the manager accountable for attaining those objectives. The strategy should be explicit and made public, to inform the market and facilitate monitoring of the debt manager's performance. Moreover, the debt manager needs a planning horizon that goes beyond the immediate future. The desired debt composition may need time to be attained, and there are often constraints—such as underdevelopment of the domestic market—that require careful[m)88.6(13.24 03 TD.000 haifors and Datace. ra

developing countries done by the WB found that only half of the sample countries had such a strategy and that publication of the strategies was even rarer.[6]

3. Recent developments in debt structure and related institutional arrangements in developing countries.

A number of emerging market countries have carried out significant debt restructuring operations over the last few years, and several have also made progress in strengthening their debt management institutional practices.[7]

In an environment of high liquidity and low interest rates, it became easier for emerging market countries to restructure their debt, particularly their external liabilities. Debt buybacks allowed them to obtain financing

Table 1: Evolution of Foreign Currency and Short Term Debt in Selected Countries

	Foreign currency debt Total Marketable debt		Short term debt Total domestic mkt. debt	
	(in percent)			
	1996	2005	1996	2005
Brazil	48	14	57	22
Colombia	30	25	0	6
Czech Rep996	2005		1996	2005
Brazil	48	14	57	22

- *Public debt management consolidated in one unit (Colombia, Indonesia,* Uruguay)
  - Set up of semi-autonomous debt management offices (Hungary, Nigeria)
  - Creation of coordination committees (Nicaragua)
- ✓ **Improving transparency and communication with the market**
  - Both middle income and low income countries (Colombia, Indonesia, Jamaica, Lebanon, Sri Lanka, Tunisia, Turkey, Zambia)
- ✓ **Developing domestic public debt markets**
  - Publishing periodic debt auction schedules (Brazil, Turkey)
  - Introducing primary dealers (Colombia, Turkey)
  - Strengthening legislation and regulation (Kenya, Nicaragua)

Countries, however, faced problems in a number of areas:

- ✓ **Incomplete strategies**
  - Strategies do not include domestic debt (Tanzania, Papua New Guinea) or take into account contingent liabilities (few countries do)
- ✓ **Fragmented responsibilities**
  - Different agencies in charge of foreign and domestic debt or of fiscal and quasi-fiscal debt (Chile, Costa Rica, Guatemala, Nicaragua)
- ✓ **Lack of Medium Term Debt Strategy**
  - Many developing countries lack such a strategy
  - Publication of those strategies is rare
  - Insufficient linkage to debt sustainability

5. Key policy, institutional, and operational issues

The abundant market liquidity that prevailed in international markets until recently and initiatives like HIPIC (Highly Indebted Poor Countries and MDRI (Multilateral Debt Relief Initiative) have allowed developing countries to improve their debt profiles. The development of derivative instruments has provided further opportunities for debt managers to adjust their portfolios to match their risk/yield preference. To make these gains permanent, countries need to maintain sound macroeconomic policies and improve their debt management.

Debt management strategy and operational issues

A debt management strategy is a key piece of economic management. It provides a framework for the debt manager to meet the debt management objectives. The *Guidelines* define as the main objective of debt management as "ensuring that the government's financing needs and its payment obligations are met at the lowest possible cost over the medium to long term consistent with a prudent degree of risk….."

While some countries follow de facto strategies, a formal, publicly articulated strategy should be preferred. It makes explicit the objectives of the government debt policy, allowing for transparency and facilitating accountability. Moreover, it makes opportunistic debt issuance less likely, which makes the market less risky for investor. This can help lower the medium term cost

of government financing, and also contributes to developing the market. It can also minimize conflicts between debt management and monetary policy. Moreover, it avoids conflicts between strategies followed for different parts of the debt portfolio, allowing for a coherent borrowing strategy.

For those benefits to obtain, the debt strategy must be comprehensive, i.e., include all the debt under the control of the central government (however, it can leave out debt issued by state enterprises or subnational units—albeit it is still helpful for those issuers and the central government debt manager to exchange information). Achieving this comprehensiveness often poses difficulties: as noted earlier, for instance, sometimes central banks also issue debt to finance quasi-fiscal deficits. While not optimal, some countries (e.g. Costa Rica, Nicaragua) have addressed this problem by setting up coordination mechanisms between the central bank and the debt office.

Contingent liabilities that materialize have sometimes led to serious difficulties for governments and therefore need to be considered in the overall debt management strategy. However, identifying and valuing them pose difficult problems. Identification is easier for those that are explicit, like government-guaranteed loans or insurance schemes. However, some important contingent liabilities are implicit or materialize only in special circumstances but they can be sizeable and disruptive to public finances. Examples include bailouts of various entities: enterprises deemed to be of strategic value to a government, banks which collapse could cause a systemic crisis, or subnational governments unable to meet their obligations. The fact that they are contingent, rather than certain obligations like regular government debt, makes their valuation harder. Despite these difficulties, several OECD countries (like Canada, Denmark, New Zealand, and Sweden) have set up effective arrangements to manage this type of liabilities.
Doing so is probably even more strategy0sTc.1334(ilities0Cafus.)i8(portand for developinD counte strate49

bank with an instrument to execute monetary policy. But a sound domestic debt market requires certain elements: an efficient money market, active secondary markets, efficient custody and settlement arrangements, and laws and regulations that ensure the safe transfer of securities and the money counterpart. Experiences of 12 countries—covered by the IMF/World Bank pilot program mentioned earlier-- have been analyzed by World Bank (2007a 2007b). This analysis shows substantial progress in:

- making primary markets more efficient (e.g., by increasing transparency of issuance, improving auction mechanisms, or improving oversight of primary dealers)
- improving custody and settlement arrangements (e.g., by setting up electronic systems)
- debt market regulation (e.g., by addressing shortcomings in participation in money markets, access to primary auctions, appointment of primary dealers and trade transparency)

There are difficulties in broadening the investor base and in developing money and secondary markets. As regards the former, developing an institutional investor base (e.g., as part of the development of the pension system) and improving access to retail investors (e.g., by expanding electronic access) appear as possi

First,by providing technical assistance and training in carrying out the reforms. Technical

ANNEX

Table 1:Evolution of Selected External Debt Indicators for Developing Countries

INDICATOR (in percent)	COUNTRY GROUP	1996	2000	2005
Concessional debt/Total debt	Low income	49.95	49.49	56.67
Concessional debt/Total debt	Lower middle income	17.77	18.08	16.4
Concessional debt/Total debt	Upper Middle Income	4.3	2.87	1.81
Debt service /Exports of goods and services	Low income	18.54	12.83	10.56
Debt service /Exports of goods and services	Lower middle income	18.01	20.32	11.25
Debt service /Exports of goods and services	Upper Middle Income	18.75	21.65	17.84
Interest /Exports of goods and services	Low income	6.72	4.65	3.54
Interest /Exports of goods and services	Lower middle income	7.09	6.42	2.48
Interest /Exports of goods and services	Upper Middle Income	6.37	6.91	3.7
Interest /Gross National Income	Low income	1.32	1.07	1.06
Interest /Gross National Income	Lower middle income	1.63	1.91	0.97
Interest /Gross National Income	Upper Middle Income	2.09	2.65	1.58
Multilateral debt/Total debt	Low income	30.25	33.92	39.33
Multilateral debt/Total debt	Lower middle income	12.32	14.41	13.85
Multilateral debt/Total debt	Upper Middle Income	8.01	7.63	5.95
Reserves/Total debt	Low income	12.88	21.18	58.26
Reserves/Total debt	Lower middle income	34.02	35.91	104.61
Reserves/Total debt	Upper Middle Income	26.85	28.32	52.1
Short term debt/Total debt	Low income	11.81	7.46	8.52
Short term debt/Total debt	Lower middle income	20.81	13.17	25.95
Short term debt/Total debt	Upper Middle Income	18.15	16.76	17.76
Total debt /Exports of goods and services	Low income	259.42	184.16	92.79
Total debt /Exports of goods and services	Lower middle income	144.2	119.47	61.14
Total debt /Exports of goods and services	Upper Middle	116.43	111.68	83.48

Box 1 Costa Rica

Progress in Debt Management

The structure of Costa Rica's debt has changed over the years. Until it restructured its debt in 1990 with Brady bonds, foreign debt represented the bulk of public debt. Following the restructuring—and ensuing difficulties in obtaining foreign finance—domestic debt became the most important source of finance. Costa Rica regained access to international markets in the later 1990s. This allowed the country to diversify its sources of foreign finance, increasing the share of marketable debt relative to financing from multilateral institutions like the Inter-American Development Bank.

Costa Rica has made significant progress in debt management. The government and the central bank are the main issuers of debt, and sell it at a joint auction.[13] Their instruments are close (but not perfect) substitutes of each other. Both have reduced the range of instruments, improved standardization and lengthened the domestic currency yield curve. This has helped reduce refinancing risk for the government. Moreover, fixed-rate debt in domestic currency increased to about 1/3 of the total debt st

Box 2 Kenya

Institutional Reform after Setback[15]

Kenya improved its debt management arrangements between 1985-1994, setting up a debt management division in the Ministry of Finance, and training staff. This allowed the debt management function to have a well-trained staff and a committed senior management, enabling it to put together a debt management strategy and have good basic debt records. This progress benefited from international support from UNDP, World Bank, Commonwealth Secretariat, and SIDA. Unfortunately, the situation deteriorated in 1994-2003. The government gave lower priority to debt management, leading to the loss of senior management and qualified staff. Moreover, foreign technical support was no longer available. As a result, debt recording deteriorated.

In the wake of a corruption scandal in 2004, the government took measures to improve governance arrangements. This gave a boost to the debt management function:

- ✓ The Debt Management Department (DMD) in the Ministry of Finance is being restructured into a Debt Management Office.
- ✓ DMD staff increased from five in 2003 to 24 in 2007
- ✓ DMD restructured into a front office, middle office and back-office functions
- ✓ Debt database updated and migrated to CS-DRMS 2000+[16]
- ✓ Debt data reconciled and validated

- ✓ Strengthened back office and internal procedures
- ✓ Publication of Annual Debt Management Report
- ✓ Set-up of debt management website

Kenya's experience clearly illustrates the fact that little can be done—and progress can be reversed—in the absence of full ownership and commitment of th

Box 3--- Islamic Bonds and Public Debt management

The growing demand for Islamic bonds, or Sukuks, and the growth in Islamic finance [1] generally poses challenges for public debt management and monetary operations. In countries with a significant presence of Islamic financial institutions (IFIs), the absence of, or inadequate availability of tradable and Shariah compatible instruments for conducting monetary operations with IFIs weakens the effectiveness of monetary policy. For this reason, and to meet the investment needs of IFIs, many governments started to issue sovereign Islamic securities that could be used for both monetary management and Government finance purposes. For example, governments of Bahrain, Malaysia, and Sudan, and the central banks of these countries have been issuing domestic currency Sukuks that have reached sizeable volumes. Other countries, such as Pakistan, and Bangladesh, and several Middle East countries also have issued Sukuks locally, and some are evaluating steps to bring about a regular issue program in Sukuks. More recently, with the growing appetite for Islamic securities, particularly in the oil rich countries in the Middle East, several governments have begun to issue Sukuks internationally.[2] However, the volumes issued, whether domestic or international, so far have remained inadequate relative to potential demand and issuance has been irregular in many cases. Moreover, the issues are typically held to maturity, and the liquidity of the instruments is consequently weak. These developments raise a host of legal and institutional issues on how to integrate sovereign issues of Islamic bonds into the overall public debt management framework, and create a liquid market for these instruments.

Islamic Bonds or Sukuks are “trust certificates” or “participation certificates” that grant an investor a share of an asset along with the cash flows and risks commensurate with such ownership. Sukuks represent “certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, and services, or (in the ownership of assets of particular projects or special investment activity….” Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Shariah Standard No. 17). Sukuks are classified according to the underlying Islamic contracts that underpin the securitization (IJara Sukuk, Musharakha Sukuk, etc…). Issuance of Sukuk involves creation of Special Purpose Vehicles (SPVs)) to own, service and operate specified assets, issue Sukuks, pass on the proceeds to the originator and enter into income generating contracts using the assets (e.g. leasing or trading, building and operating, etc…). Thus, ideally Sukuk issuance requires strong secured asset laws and trust laws to ensure true sale and bankruptcy remoteness of SPV in order to safeguard investor interests. In practice most Sukuks until recently have involved “purchase undertaking agreements “by the originator, so that the underlying risks are related to the credit rating of the originator, rather than the quality of the underlying assets and SPV governance. (Moody (2006)). In practice, the amount of Sukuk that can be issued is constrained by the availability of assets that the government can use or build for the purpose of Sukuk issuance. This limitation has led to irregular issuance of Sukuks by governments, or limited the volume of regular issuance. This has limited the liquidity of these instruments. Effective integration of Sukuk issuance into broader public debt and financing program requires that the following issues be addressed;

- Adaptations of public debt and other financial sector laws, notably laws relating to trusts, to facilitate the issuance of Sukuks; Shariah interpretations of the acceptable design features of Sukuks also need further development and harmonization.

- Bringing about a systematic linkage between spending decisions of the government with

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